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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CV 2009-036966 03/26/2010

HONORABLE J. KENNETH MANGUM

CLERK OF THE COURT
D. Glab
Deputy

BRIAN BARNETT GREGORY G MCGILL

v.

M & I MARSHALL & ILSLEY BANK JAMES E HOLLAND JR.

MINUTE ENTRY

This matter was tried to the Court as a hearing on a request for Preliminary Injunction on March 12, 2010. Having considered the pleadings on file, the testimony of the witnesses and the exhibits admitted into evidence, and the legal memoranda filed by plaintiff and defendant, the Court makes the following Findings of Fact and Conclusions of Law. If any Finding of Fact is more appropriately a Conclusion of Law or vice versa, it shall be so considered.

INTRODUCTION

The parties are sometimes described as plaintiff and defendant for convenience even though there is a counterclaim.

This hearing deals with the request by plaintiff to prevent the defendant from foreclosing on the house which was being constructed by plaintiff.

The testimony of the witnesses is summarized under their names and is given in the first person.

FINDINGS OF FACT

Brian Barnett

Brian Barnett is the plaintiff and homebuilder.

I stand by my 26.1 Disclosure Statement and my affidavit (exhibits 1 and 2).

I signed forms showing that my address is 6802 E. Beryl Avenue, Paradise Valley, Az. This was the address for the house I was constructing with the construction loan from defendant. I listed the address this way as it was my intent to occupy the property.

I didn't pay the May 2009, loan payment because the defendant wouldn't release funds to pay the contractors; in other words, the bank breached its contract with me. However, I had until the end of May to make the payment, though it was due on the 15th.

Trifecta Homes was not the general contractor, but was instead the construction manager. Nothing required me to have a general contractor. The bank never asked about the continuing participation of the general contractor.

Trifecta was to be the "contractor" as this was my first spec home and had no expertise in building. I wasn't licensed to build a home as a contractor. However, Trifecta wasn't doing the job they were supposed to so I fired them in August of 2008, and took over. I had people working for me who were on the job regularly when I wasn't. Maria Taylor at the bank knew that Trifecta wasn't there anymore. However, I continued to draw supervision fees for Trifecta and kept that money for the project.

I've never been sued before. I've never been foreclosed on before. I co-own a real estate company and have a real estate license. This was my first building project.

This home was to be my portfolio project and the launch of my custom home building business. I built this home as beautiful as possible. George, the bank's inspector, saw the house and told me I was doing a marvelous job.

I obtained a $1.5 million loan and I paid $150,000 as a down payment. I spent $65,000 of my own money (not including any funds from the bank) on this home.

The appraisal for the finished home was $2.2 million (or a minimum of $2.15 million). If I'd moved into it and sold it for that price, I would have made $700,000 in profit.

The house was 80% complete when the construction stopped. I'd only used 63% of the loan. In other words, $233,000 was left out of the $650,000 designated for the home.

I wasn't aware that the bank was not impounding money for property taxes. I didn't pay any taxes directly. I had to pay monthly payments on the loan from the bank.

Funds from the bank were wired to my account.

I was surprised that the bank told me that they couldn't adjust the line items for different contractors and materials, because this is done all the time. There were line items that I had not exhausted that could have been moved over to other items where I was over.

I "agreed" with the bank's statement that I needed to pay a net of $30,455.36 before the bank would continue to fund me, and to the remaining cost to finish of $264,117.21, because I meant I was agreeing to the *general* statements in exhibit 17. The bank calculated that I had finished 57% of the project rather than the 75% to 80% that I say. I later told the bank that I agreed with the bank's figures.

If my project fell out of balance, I was to submit revisions to the bank. I didn't understand that the bank had the contractual right to require me to make additional deposits.

I found out in early July per exhibit 18 that I was in default, but I was still negotiating with the bank.

By exhibit 23 Ms. Tobin for the bank was demanding $310,195.59 to finish the home. I asked her ten times to justify her figures but she never did.

On June 22, 2009, Ms. Tobin said they were still reviewing matters but I never heard back from them till the November foreclosure.

I understand that I obtained my loan based on my promises. I intended to move into the house upon completion, but then I expected that I would show it in those three months and get it sold at the end of the three months. I was going to decorate it appropriately and party in it until it sold.

I used $850,000 of the loan to buy the property from my parents. I then demolished the home and used the funds to construct the new home.

I ended up with three mechanics liens, though the Catalina lien wasn't accurate; the total of the liens is $97,000.

It could cost $400,000 to $450,000 to finish the home given the liens. However, all the liens arrived after we stopped construction in April.

In 2008 and 2009, the bank never said there was a tax lien.

I called Taylor and Bonnie Tobin hundreds of times and many times a day to solve the problems. Ms. Tobin never volunteered to look at the home.

Dale Grabois

Dale Grabois is a developer who testified on behalf of plaintiff.

I have been a developer since 1971 in Scottsdale and Fountain Hills.

I have known plaintiff for over a year. I want to know what's going on in the area and what people are doing, so I stopped by when I saw his project. This was in January 2009, plus three other times.

His home looked great. I'd say that the home was 80% complete by the time that the fence was placed around the home. However, I also saw that materials were being destroyed and being stolen.

In March 2009, he told me he was having problems with the bank so I told him to talk to Maria at the bank who had said that there was no need for line item changes. I had also spoken with Ms. Tobin who said that you can make line changes.

Bonnie Tobin

Bonnie Tobin is a manager for M&I Marshall & Ilsley Bank.

I've been the construction manager for three years.

If I'd known that plaintiff was an investor instead of an owner occupant, I would have halted construction and referred this out to the fraud department. Plaintiff was changing the terms of the contract without our approval.

There's a greater risk on a home built by a speculator so we require a higher down payment and higher interest rate. However, plaintiff was qualified as a person who could afford to live in this home without selling it for some 30 years. Regardless, we don't offer construction loans on investor properties.

We needed a general contractor for the project because plaintiff didn't have home building experience.

Each draw that plaintiff made affirmatively avowed that the contract hadn't been changed, but of course, plaintiff changed it without our knowledge.

This loan didn't escrow money for taxes. Plaintiff was required to pay property taxes directly. Plaintiff was paying the bank interest only on the loan amounts funded. When we funded, the 2007 taxes weren't yet delinquent, so they wouldn't have shown up on the search.

Exhibit 12 shows plaintiff's request for changing the cost items. I explained that when we earlier asked plaintiff to "separate" the line items, that was different than plaintiff's request to "rearrange" the cost breakdown. I wondered why we'd move supervisor fees because then he or it couldn't be paid (and we thought that there was a supervising contractor, or course). I thought that Franco, who actually worked for plaintiff, was a part of Trifecta. It wasn't until April 29th that I learned Franco worked directly for plaintiff.

Plaintiff never complained about me being non-responsive.

We needed to learn if our investment in the property was exceeded by the fair market value.

When plaintiff responded on exhibit 17 that "everything looks good," I assumed that he agreed with us that only 57% of the house was completed (and not the 75% or more that he now claims).

I agree that the cost breakdown changed, but that's because the bids changed from what plaintiff provided. We tried from April to June to get the right bids, and before June, plaintiff never said that we had the wrong ones.

CONCLUSIONS OF LAW

While this project apparently has nothing to do with the housing bust that has afflicted Arizona, the result seems to be the same: a house sits vacant and deteriorates as the legal issues are resolved.

The bank asserts that plaintiff has violated several different contractual provisions, some implicit and some explicit, including intending to sell the home immediately instead of being a long time occupant, payment of his monthly obligation on the construction loan, keeping the home free of liens, terminating the construction manager, and staying under budget.

The defendant points out that the right by the bank to declare a breach of the contract by plaintiff exists even if it only learned of a breach after it declared the breach.

> "[I]f a party has the power to avoid a contract by disaffirmance, that party's failure to perform is not a breach, even if the party is ignorant of his power of avoidance and believes that his refusal is a breach."
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> *O'Day v. Mcdonnell Douglas Helicopter Company*, 191 Ariz. 535, 959 P.2d 792 (Ariz. 1998). Indeed, to quote the additional language of *O'Day* but using the names of the instant parties, the rule can be further stated as follows:
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> "The after-acquired evidence of [Barnett]'s misconduct would, under this rule, constitute a 'first breach' of the . . . contract that would excuse [M&I Marshall & Ilsley Bank]'s later breach."

O'Day, supra.

Some of the violations are more serious than others. For example, since plaintiff apparently had a steady job and/or the resources to pay the mortgage for 30 years without having to sell the house, his financial strength was greater than a spec home builder who might have to sell the home within a few months or go bankrupt. Thus, while there was a technical violation of the bank's policy to never lend to a spec builder, it is not clear how the bank was harmed (other than not charging a higher interest rate).

Regardless, while he had the appearance of truthfulness (in trying to avoid being a spec builder) by saying that he was going to occupy the home (while marketing it), the Uniform Residential Loan Application (exhibit 3), page 1, has the box marked that states that the

"Property will be Primary Residence." The alternative boxes are "Secondary Residence" and "Investment" and they are, of course, unmarked. Similarly, page 3 of the Application has the box marked that plaintiff intends "to occupy the property as your primary residence," but this box is subject to the fudging that it was going to be his primary residence but only for as long as it took to sell it.

Plaintiff certainly failed to make the May 2009, payment on his loan, but had his draw been allowed, he apparently would have been able to pay his May payment. This breach by plaintiff may be excused depending on how reasonable the bank was to not pay the draw.

The lien issue is also questionable. Plaintiff has allowed a tax lien and several mechanics and materialmen's liens to be recorded. However, the latter liens occurred after the May/June impasse with the bank. The tax lien may have also been inadvertent as it is not clear how well plaintiff knew taxes weren't being paid by the bank.

The termination of Trifecta, the construction manager, is also somewhat ambiguous. Plaintiff in his closing legal memorandum states that "A 'GC' was not required in the CLA," but there is certainly evidence to the contrary.

Exhibit 4 is the contract between Trifecta and plaintiff, and appears to be the Standard Architectural contract requiring a general contractor as the builder. In addition, the addendum to the Residential Construction Loan Agreement, exhibit 3, speaks of the "General Contractor" being allowed a maximum of 18 draw requests. Nevertheless, the court is unaware of a specific requirement that the General Contractor is a necessary part of the agreement by the bank to fund the project. Usage in the industry surely demands such, but it may or may not be spelled out directly. The bank was certainly *expecting* a General Contractor. (*See* exhibit 5 where "An Affidavit of Contractor, signed by your contractor" is required for each draw request.)

The issue of staying under budget depends on whom to believe. The bank states that the house was 57% complete and plaintiff says 75-80% with only 63% of the funds from the loan having been used. If plaintiff is correct, the bank should have continued to fund the property. If the house were only 57% complete, then plaintiff was in breach of the contract and had the obligation to bring the loan into balance to make the bank secure before it was required to issue more draws. This is simply a matter for the jury to resolve at trial.

All in all, it certainly appears that while there are breaches by plaintiff, some or all may not be *material* breaches.

As previously stated, this hearing involved plaintiff's request for a preliminary injunction to prevent foreclosure by the bank on plaintiff's significant investment. In requesting an injunction, plaintiff's burden is generally described as follows:

> "[Plaintiff] must show that:
>
> (1) there is a real threat of irreparable injury not remediable by damages;
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> (2) the threatened harm to the plaintiff weighs more heavily in the balance than the actual injury to the defendants;
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> (3) the plaintiff is likely to succeed in the trial on the merits and
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> (4) public policy favors the injunction.
>
> *See Brennan Petroleum Products Co., Inc. v. Pasco Petroleum Co.*, Inc., 373 F. Supp. 1312 (D.Ariz. 1974)."

Burton v. Celentano 134 Ariz. 594, 658 P.2d 247 (1982)

In using the four criteria above, the court is not convinced that there is irreparable injury that will be suffered by plaintiff that is not remediable by damages. Plaintiff argues that the blotch on his credit and the stain against his business reputation is what is unmeasurable. The court disagrees. Plaintiff will be able to explain to a jury his damages and be compensated therefor if the jury agrees with him.

Regarding the balance of the harm to the parties, the court finds that the bank is at greater risk than plaintiff if the injunction is issued. If the property stays uncompleted and continues to deteriorate, the bank might never recover it's investment. What seems clear is that if an injunction were to issue, plaintiff would stay in control of the property but he doesn't have the funds to finish the home. There was no testimony that he could sell the home in its present condition and pay off all the liens and loans on the house.

The Court cannot say that plaintiff is likely to succeed in the trial on the merits–plaintiff can make a strong argument for errors by the bank, but the bank can do the same in reverse. It appears that the final decision will depend on how complete the house was, something that is totally in the air at this point.

The public policy question is in part a summary of the prior three points. But if public policy does affect this case, it would be the benefit of having the bank take over the property and let the home be completed by a new buyer so that the house at the current stage is saved and the neighborhood is benefitted by an attractive, finished home. If the injunction were granted, plaintiff might ultimately prevail and keep the house, but he has no ability to finish the home before trial and a possible appeal, something that will easily take a year or two. In the meantime, the house may deteriorate badly--such loss in value does no one any good.

Thus, plaintiff's application for an injunction must fail because he has an adequate remedy at law for damages. Also, society will be benefitted by stopping the waste that will occur if the house is left to sit in an incomplete status and unoccupied by a family.

Plaintiff also fails in his application because of the doctrine of unclean hands. In other words, he must show sufficient innocence in the dispute that his actions shouldn't bar his claim to relief. *Phoenix Orthopaedic Surgeons, Ltd. v. Peairs,* 164 Ariz. 54, 790 P.2d 752 (Ariz. App. 1989). Plaintiff, although probably not as blamable as suggested by defendant, has failed to show that his hands are clean as required by the principles of equity. *American Credit Bureau, Inc. v. Carter* 11 Ariz. App. 145, 462 P.2d 838 (Ariz. App. 1969)

The parties briefed several additional issues. One is the implied covenant of good faith and fair dealing that applies in all contracts and ensures that each party fulfills "the justified expectations of the other party." *Wells Fargo Bank v. Ariz. Laborers,* 201 Ariz. 474, 492, 38 P.3d 12, 30 (Ariz. 2002). Moreover, "[E]xpress terms are presumed to be the best indicator of the parties' reasonable expectations." *Bike Fashion Corp. v. Kramer,* 202 Ariz. 420, 424, 46 P.3d 431, 435 (Ariz. App. 2002). Therefore, the bank argues that since plaintiff clearly breached at least one or a couple of the contractual provisions, the bank was clearly allowed to foreclose on the property.

The response to the bank's argument is stated by *Bike Fashion Corp, supra.* The court in *Bike Fashion* points out that the "law on the relationship between a contract's express terms and the implied covenant of good faith and fair dealing is turbid." (Emphasis added) The court then goes on to say:

"However, "[i]nstances inevitably arise where one party exercises discretion retained or unforeclosed under a contract in such a way as to deny the other a reasonably expected benefit of the bargain." *Wells Fargo Bank*, 201 Ariz. 474, 492 ¶ 66, 38 P.3d 12, 30 (quoting *Southwest Sav. & Loan v. SunAmp Sys*., 172 Ariz. 553, 558, 838 P.2d 1314, 1319 (App. 1992)). Thus, Arizona law recognizes that a party can breach the implied covenant of good faith and fair dealing both by exercising express discretion in a way inconsistent with a party's reasonable expectations and

by acting in ways not expressly excluded by the contract's terms but which nevertheless bear adversely on the party's reasonably expected benefits of the bargain."

Bike Fashion thus stands for the proposition that even though one party complies with the contract's explicit provisions, it may do so in a "way inconsistent with [Barnett's] reasonable expectations. . . ."

The bank may or may not have violated its obligation to act reasonably in all aspects of enforcing its contract. That is something the jury will have to decide. Regardless, for the reasons stated above, plaintiff has not shown that damages aren't an appropriate remedy and that is sufficient to deny him a preliminary injunction.

The bank is correct that plaintiff's claim that the bank's refusal to fund the balance of the loan is an argument involving mitigation of damages and is not a basis to grant an injunction. "[T]he doctrine of avoidable consequences affects the measure of damages, not the right to recover." *Universal Invest. Co. v. Sahara Motor Inn, Inc.*, 127 Ariz. 213, 215, 619 P.2d 485, 487 (Ariz. App. 1989).

For the reasons stated above,

IT IS ORDERED denying plaintiff's request for a Preliminary Injunction.