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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CV 2016-008390 01/30/2018

HONORABLE ROGER E. BRODMAN

CLERK OF THE COURT
M. Corriveau
Deputy

C P F VASEO ASSOCIATES L L C — TODD A BURGESS

v.

BRUCE W GRAY, et al. — JOHN NEIL STUART

WELLS FARGO BANK
LEVY PROCESSING MAC S3928-021
PO BOX 29779
PHOENIX AZ 85038
N S H E, C A BULLS L L C
5515 E DEER VALLEY RD
PHOENIX AZ 85054
GRAY SERVICES L L C
5515 E DEER VALLEY DR
PHOENIX AZ 85054
GRAY DEVELOPMENT L L C
5575 E DEER VALLEY DR
PHOENIX AZ 85054
GRAY ARCHITECTS P L L C
5515 E DEER VALLEY DR
PHOENIX AZ 85054
GRAY / WESTERN DEVELOPMENT COMPANY
5515 E DEER VALLEY DR
PHOENIX AZ 85054

RULING ON MOTION FOR SUMMARY JUDGMENT

The Court reviewed CPF Vaseo Associates, LLC's motion for summary judgment, the response and reply. The Court held oral argument on January 12, 2018.

I. BACKGROUND

As noted in the minute entry dated July 25, 2017, the parties are not strangers to the Court. The Court has held two evidentiary hearings and has entered provisional remedies rulings.

The essential facts are as follows. Plaintiff is the successor in interest on a $3.7 million loan made to East of Epicenter, LLC. This loan was secured by a deed of trust on certain property. Plaintiff is also the successor in interest on a $26.5 million loan made to Sonoran Desert Land Investors LLC and Gray Phoenix Desert Ridge II, LLC. This loan also was secured by other property. Mr. Gray personally guaranteed both loans. Ms. Gray personally guaranteed the larger loan. Both loans are unpaid, and the amount owed is greater than $34 million. East of Epicenter, Sonoran Desert Land Investors and Gray Phoenix Desert Ridge II are all controlled by the Grays and the Grays placed each into bankruptcy. CPF brings the instant action against the Grays based on their personal guaranties which are unsecured.

The loans originally carried an interest rate of 12%. Upon default, the interest rate increased to 18%. In addition, the loans have a "late fee" penalty of $1,500/day and $10,000/day, respectively. The loans allow the recovery of collection costs in the event of a default.

There is no triable issue of fact on whether the Grays entered into the guaranties, the amount of the loans or that the Grays failed to pay any money on the guaranties. Therefore, as a matter of undisputed fact the Grays are in material breach of the guaranties.

II. ANALYSIS

CPF moves for summary judgment, arguing that there is no genuine issue of material fact as to the existence, execution, and terms of the guaranties or the manner of calculating CPF's damages. CPF argues that defendants admit they have never paid a dime on any of the guaranties. CPF seeks summary judgment on its complaint as well as defendants' counterclaim.

Defendants argue that there are genuine issues of material fact relating to their defense that CPF has violated the covenant of good faith and fair dealing. In essence, the Grays contend that CPF has wrongfully interfered with the Grays' efforts to sell the properties in an attempt to pay off the loan. The Grays allege that CPF violated the covenant of good faith and fair dealing by impairing the value of the collateral.

1. <u>Breach of the Covenant of Good Faith and Fair Dealing</u>

The covenant of good faith and fair dealing is implied into every Arizona contract. "A party may breach the implied covenant even in the absence of a breach of express provision of the contract by denying the other party the reasonably expected benefits of the agreement." *Nolan v. Starlight Pines Homeowners Ass'n*, 216 Ariz. 482, 49, ¶ 27 (App. 2007). A party breaches the good faith covenant "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 Corp. v. Kramer*, 202 Ariz. 420, 424, ¶ 14 (App. 2002).

In the instant case, no evidence suggests that CPF had anything to do with the Grays' original default. Indeed, the loans were already in default by the time CPF purchased them. But the general rule is that even if a party has breached an agreement, that does not excuse the other party from acting in good faith in exercising its remedies. *Restatement (Second) of Contracts* § 205 cmt. e (1981) *cited in New York Community Bank v. Webber*, 2016 WL 512867 (Ariz.App. 2/9/2016). As a result, CPF could be liable if evidence demonstrated that it acted in bad faith in exercising its remedies and said actions caused the Grays' damages.

Aggressive collection practices are not breaches of the covenant of good faith and fair dealing. In fact, the Court would expect aggressive collection practices directed towards an obligation of over $34 million, especially when the guarantor has placed the primary debtors into bankruptcy. In addition, without more, CPF's involvement in issues relating to properties held as security does not automatically suggest a breach of the covenant of good faith and fair dealing. CPF has a security interest in the properties, and would have foreclosed on the properties had Gray's entities not declared bankruptcy. Taking legitimate steps to protect one's business interest in secured property would not be a breach of the covenant of good faith and fair dealing. A personal guarantor on a loan could hardly claim that he did not reasonably expect a secured creditor to take aggressive collection actions to enforce a $30 million guaranty secured by property that the primary debtors (who are controlled by the guarantor) placed in bankruptcy.

In short, taking legitimate steps to protect an interest in secured property is not a breach of the covenant of good faith and fair dealing; improperly interfering with the Grays' efforts to sell the properties by impairing the value of the collateral could be. The issue, then, is whether admissible evidence supports the Grays' claim that CPF took wrongful actions to impair the Grays' ability to pay their debts.

2. Causation

Mr. Gray's affidavit establishes that he did not reasonably expect the lender to act to prevent, impair or obstruct the Primary Obligors' ability to repay the loan which would relieve the Grays of liability under the guaranties. DSOF ¶ 6. But establishing that CPF acted contrary to the Grays' reasonable expectations is not enough. In order to make a claim or defense based on the covenant of good faith and fair dealing, evidence must establish that CPF's conduct caused the Grays' damages. As noted in the Revised Arizona Jury Instructions, damages are intended to "reasonably and fairly compensate plaintiff for the damages proved by the evidence to have resulted naturally and directly from the breach of contract." *See* Contract 17, *RAJI (Civil), 5th* (2013).

A party moving for summary judgment must demonstrate both the absence of any factual conflict and his or her right to judgment. *United Bank of Ariz. v. Allyn*, 167 Ariz. 191, 195 (App. 1990). Because CPF does not bear the burden of proof at trial on the counterclaim, it could meet its burden of production on damages by "point[ing] out by specific reference to the relevant discovery that no evidence exist[s] to support an essential element of the [non-moving party's] claim or defense." *Nat'l Bank of Ariz. v. Thruston*, 218 Ariz. 112, 117, ¶ 22 (App. 2008).

Although unpublished, the Court finds *New York Community Bank v. Webber, supra,* to be instructive. In that case, Webber signed a promissory note secured by deeds of trust on properties owned by Webber. Webber alleged that the Bank violated the covenant of good faith and fair dealing by constantly postponing the trustee's sale while the fair market value of the properties substantially declined. Like defendants' allegations in this case, Webber argued that the Bank's conduct prevented him from selling the properties and paying down the indebtedness. The Bank countered by arguing that no evidence indicated that Webber had tried to market the properties.

The trial court granted summary judgment to the Bank, "concluding Webber had failed to show he has been damaged by Plaintiff's conduct in this case." *Id.* at ¶ 6.

The court of appeals reversed, finding that Webber's testimony and other appraisals in the record discharged Webber's burden of creating a triable issue of fact. The court of appeals found that evidence in the record supported the claim that the loan would have been satisfied if the Bank had conducted the trustee's sale when first scheduled. Perhaps more importantly, Webber, a former licensed mortgage banker, attributed the Properties' decline in value to the Bank's notice of the trustee's sales. The appellate court held that this testimony, which must be viewed in a light most favorable to Webber, provided a "link between the decline in the Properties' value and the trustee's sale notices, and creates a material issue concerning the fact of damages which a factfinder must resolve after an evidentiary hearing." *Id.* at ¶ 25.

Although CPF presents evidence justifying its conduct, the Court finds that the Grays submitted some evidence by which a factfinder could conclude that CPF violated the covenant of good faith and fair dealing by attempting to impair the value of the collateral.

A much closer issue is presented by proximate cause. CPF argues that no evidence supports the claim that CPF's conduct proximately caused Mr. Gray's inability to sell the properties. The Grays admit they have no evidence of any specific sale that was affected by CPF's conduct. Nor do they present evidence from a potential purchaser that CPF's conduct prevented a potential buyer's interest. There is no evidence through appraisals that CPF's conduct devalued the properties. Testimony from Mr. Kulkarni thoroughly debunked the Grays' earlier claim that CPF's so called "lowball" appraisal in the bankruptcy court scotched the sale to Guefen.[1] Undisputed evidence shows that the City of Phoenix was frustrated with Mr. Gray well before CPF got involved.[2] Not a single broker, buyer or market participant testified that CPF did anything to interfere with a sale or potential sale. The Grays presented no evidence from Mr. Gray, the debtors' real estate broker CBRE or anyone else of any sale transaction that was pending and failed to close because of interference or attempted interference from CPF.

Mr. Gray offers testimony that, despite his team's "aggressive marketing efforts" in a moderate to good market, the Debtors have been unable to generate a sale. He states that: "this is the precise result a landowner would expect if its lender was acting to impair sales efforts." Gray Decl. at ¶ 10. He testified that the lender's "poison[ing] of the well" would dissuade potential purchasers, brokers or regulators from doing or facilitating business with the borrowers, especially if the property is in bankruptcy. *Id*. at ¶ 11. Here, Mr. Gray has substantial experience in the commercial real estate market and qualifies as an expert regarding sales of commercial property. But even if not qualified as an expert, a property owner can testify about the value of his property and the difficulties he encountered trying to sell it. *See Town of Paradise Valley v.*

1. Mr. Kulkarni, Guefen's representative, testified that the only reason Guefen failed to close had nothing to do with the so-called "lowball" appraisal and everything to do with Guefen's inability to finance the transaction. Mr. Kulkarni had not heard of CPF, was unaware of the CPF appraisal and testified that CPF didn't interfere with the sale.
2. The City viewed Mr. Gray as "an impediment to development" at Desert Ridge in March 2016 before CPF purchased the loans. DSOF ¶ 34. Ms. Mackay, the City's Director of Economic Development, testified that she is frustrated with Mr. Gray and the lack of development at Desert Ridge. PSOF at ¶ 35. Thus, the City was frustrated with Mr. Gray before CPF got involved and remained frustrated after CPF became involved. Having the properties in bankruptcy and having Mr. Gray viewed by the City as an "impediment to development" might seem a more significant drag on Mr. Gray's efforts to sell the properties than anything CPF did, but the Court won't resolve factual disputes on a summary judgment motion.

Laughlin, 174 Ariz. 44, 46 (App. 1992). The Court does not judge credibility in a summary judgment motion. If Mr. Gray's testimony is assumed to be true, it provides a link between CPF's conduct and the Grays' inability to sell the properties.

Whether the Grays' difficulty in selling the properties was a result of CPF's conduct, or whether the Grays' difficulties were caused by the Grays' own conduct or other causes unrelated to CPF, must await an evidentiary hearing. Although a close call, the Court finds that summary judgment is not appropriate on the Grays' claim that CPF breached the covenant of good faith and fair dealing.

3. <u>The Liquidated Damages Provision</u>

The original interest rate on the loans in question was 12%. Upon default, the interest rate increased to 18%. In addition, the smaller loan racks up a "late fee" penalty of $1,500/day. The larger loan's "late fee" is $10,000/day.

Judge Wanslee held that the late penalties in question violate Arizona law.

Putting aside the collateral estoppel issue, on this record the Court believes Judge Wanslee got it right. A recent Arizona Supreme Court decision controls the analysis of the enforceability of a liquidated damages provision. As noted in *Dobson Bay Club II DD, LLC v. La Sonrisa de Siena*, LLC, 242 Ariz. 108, ¶ 9 (2017), the parties to a contract can agree in advance to the amount of damages for any breach. But parties "do not have free reign in setting liquidated damages. Because the central objective behind the system of contract remedies is compensatory, not punitive, parties cannot provide a penalty for a breach. A contract term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty." (Internal quotations and citations omitted.) In *Dobson Bay*, the court adopted the Restatement's formulation and held that a stipulated damages provision is an unenforceable penalty unless "(1) the amount fixed is a reasonable forecast of just compensation for harm that is caused by the breach, and (2) the harm caused is incapable or very difficult of accurate estimation." *Id*. at ¶ 11.

In *Dobson Bay*, the issue was the enforceability of a $1.4 million (5%) late fee on an untimely payment. The supreme court held that a 5% late fee on a loan of $20 million was an unenforceable penalty because it did not reasonably forecast anticipated damages likely to result from an untimely balloon payment. In making this finding, the court emphasized that the 5% fee did not account for the length of time that the bank was deprived of the balloon payment and could not reasonably predict the bank's loss. In addition, the 5% late fee duplicated other fees triggered by the default and was grossly disproportionate to any remaining sums needed to compensate for the anticipated losses. The court ruled that the liquidated damages provision was unenforceable because “nothing indicates that either lender, separately or together, suffered an uncompensated loss that approached $1.4 million.” *Id*. at 32.

CPF asks this Court to enforce the “late fee” as a matter of law. The Court declines. Like the situation in *Dobson Bay*, there is no evidence that the late fee reasonably predicts the lender’s loss. There is already a 6% uptick in the interest rate for a loan in default and the creditor can recover its collection costs. Plaintiff presents no uncontroverted evidence suggesting that the *per diem* assessments are a reasonable forecast of anticipated damages or reasonably related to actual damages caused by the alleged breach.

Nor does uncontroverted evidence establish the second prong of the *Dobson Bay* analysis. Collection costs and attorneys’ fees are recoverable under the terms of the guaranties. Like the supreme court in *Dobson Bay*, this Court does not believe that plaintiff would have any difficulty proving losses in this case.

The procedural posture of this issue is unclear. The only motion pending for the Court is plaintiff’s motion to enforce the “late fees” because damages are undisputed. There was no corresponding motion to strike the late fees. As a result, the Court denies CPF’s motion to enforce the late fees.

III. CONCLUSION

IT IS ORDERED that CPF’s motion for summary judgment is granted in part to the extent that Mr. and Ms. Gray entered into personal guaranties on the $26.5 million note and that the Grays are in material breach because the guaranties were unpaid when performance was due.

IT IS ORDERED that CPF’s motion for summary judgment is granted in part to the extent that Mr. Gray entered into a personal guaranty on the $3.7 million note and that Mr. Gray is in material breach because the guaranty was unpaid when performance was due.

IT IS ORDERED that the motion for summary judgment is denied in all other respects.

IT IS ORDERED denying CPF’s motion for summary judgment on the counterclaim.

IT IS FURTHER ORDERED that no pleadings will be filed with this Court unless the parties use at least 13-point type size. *See* Rule 5.2(b)(1)(B). Failure to comply will result in sanctions.

IT IS FURTHER ORDERED setting a Telephonic Status/Trial Setting Conference on **April 6, 2018 at 9:00 a.m.**, (time allotted: 15 minutes) in this division, for the purpose of setting a firm trial date if the case has not settled, before:

The Honorable Roger E. Brodman
Maricopa County Superior Court
East Court Building, Fourth Floor
101 West Jefferson, Courtroom 413
Phoenix, AZ 85003
Phone: 602-372-2943

IT IS FURTHER ORDERED that counsel for the plaintiff is to initiate the telephonic conference by first arranging the presence of all other counsel or self-represented parties on the conference call and by calling this division **(602-372-2943)** promptly at the scheduled time. All parties appearing telephonically must be joined in a single conference call and be prepared to hold until called to testify.

The call should be placed from a telephone in an area with no background noise as this will prevent the parties from hearing the proceedings in the courtroom. The call may not be placed from a vehicle. Also, the use of cellular telephones to call into the hearing is strongly discouraged. Counsel shall have their trial calendars available.