Snell & Wilmer

UNDER CONSTRUCTION

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The Weitz Company v. Summit at Copper Square LLC
Will this Case Clarify How the Doctrine of Equitable Subrogation Applies in Arizona?

by Josh Grabel

I. In Arizona, Parties Considering Investing in Real Estate Development Projects Have to Make Investments Without Full Knowledge about One of the Key Issues—Who Has a Priority Interest in the Property if the Project Fails.

Construction development projects generally involve multiple parties who "invest" some set of resources into the construction in an effort to obtain a return. Most projects include at least three types of "investors" who all invest differently in a particular project: (1) developers and their agents; (2) a commercial lender who invests capital to finance the purchase of the property and/or the construction; and (3) contractors and material suppliers who invest labor, machinery, fixtures, materials and tools for direct compensation. And, as with any investment, the more certainty those involved in a project can have of the potential risks and rewards at the outset of the project, the better decisions they will make going forward.

Before the 2008 economic downturn, many of these decisions were easy because the appraised equity in most real estate developments in Arizona exceeded the estimated costs for the project, so nearly everyone ended up getting paid for their investment. Obviously, that is no longer the case. As real estate values declined, multiple projects were substantially underfunded and

underwater, making it impossible to complete the project. Those left standing, whether a subsequent buyer of property, a lender who funded a purchase after construction, or a contractor who made improvements, were all left seeking to recover whatever they could. Since, in most cases, the "investors" had contractual relationships with the developer, who was often a single-purpose LLC or company with no assets other than the project in question, the only asset of any value was the property itself. Unfortunately, the property often did not have enough value to pay everyone back, so the question of who gets paid first often controls who gets paid for their "investment," period.

In Arizona, lenders and contractors often have separate property interests in these projects, through a deed of trust or a mechanics' lien, that allow the holder to foreclose on the property, extinguish all other claims on the property and take ownership. And, in a foreclosure context, one of the true keys is who has first priority as to the property, because the party with first priority will likely get control of the property because of current property values. Thus, being able to determine, before you invest, what your priority position will be if the project fails is a very important issue, as certainty makes for better risk assessment.

There is currently at least one area in Arizona law related to determining priority where making this determination is difficult, if not impossible, because of an apparent conflict in the law. That uncertainty relates to a doctrine known as "equitable subrogation," which allows for subsequent lenders to assume the interests of earlier lenders under certain circumstances. Unfortunately, what those circumstances are, and how they are applied, may differ based upon the particular facts involved on a project. This article outlines what that issue is, highlights a current case that is on appeal in Arizona in which the issue exists and notes the arguments likely to be made by both sides related to it. Regardless of which way the Court rules, it is important to have certainty in this area of the law.

II. **Arizona Law Related to Priority is Unclear**.

When it amended Arizona's mechanics' lien statutes in 2001, the Arizona legislature established what appeared to be a bright line rule for determining priority related to encumbrances on real property, at least related to such liens. A.R.S. § 33-992(A) states that mechanics' liens have priority over "all liens, mortgages or other encumbrances upon the property attaching subsequent to the time labor was commenced or the materials were commenced to be furnished except any mortgage or deed of trust that is given as security for a loan made by a construction lender … if the mortgage or deed of trust is recorded within 10 days." To determine priority under this

statute it would appear that all that needs to be done is: (1) determine when work started or materials were delivered to a project; (2) compare that to the date any other encumbrance on the property was recorded; and (3) account for the 10-day delay afforded a construction lender to record a deed of trust. Whoever is first in time would then have priority. The issue is not that simple.

In 2004, however, Division Two of the Arizona Court of Appeals issued an opinion holding that the doctrine of equitable subrogation still controlled priority determinations in Arizona, and that doctrine substantially changes this analysis. *See Lamb Excavation, Inc. v. Chase Manhattan Mortgage Corp.*, 208 Ariz. 478, 95 P.3d 542 (App. 2004). Under this doctrine, any lender who loaned money on a development project with "an express or implied agreement to subrogate, which is concordant with a party's having a reasonable expectation of receiving a security interest, and when an intervening lien claimant suffers no prejudice," has the same priority date as the first deed of trust up to the amount previously borrowed. The court further found that an ordinary mechanics' lien claimant suffers no prejudice to its lien rights if a construction loan is, after construction begins, replaced with permanent financing for a project. Thus, if Lender A lends money to a developer to purchase property and fund construction, construction commences creating potential mechanics' lien claimants, and then Lender B subsequently buys out Lender A's loan/interest with an intent that the new loan is replacing the initial loan, Lender B has first priority under the doctrine of equitable subrogation, according to *Lamb*.

The question that the *Lamb* court did not answer was whether equitable subrogation applies when a subsequent lender provides a loan to pay a portion of an existing loan, particularly when that portion is paid specifically to pay off a construction loan on a part of the subject property. The answer to that question may, however, be coming soon.

III. **The *Summit at Copper Square* Litigation**.

On May 9, 2008, The Weitz Company, Inc. (Weitz) was the general contractor on a condominium project near Chase Field in downtown Phoenix known as the Summit at Copper Square (the Condos). The owner/developer of the project was Summit at Copper Square LLC (Summit), a sole-asset LLC. Summit obtained financing to purchase the property and build the Condos before any work began, meaning that the initial financing had first priority. After construction started, Summit sold various units to individual purchasers, who would buy their condo units with some sort of conventional financing (all of whom obtained some type of title insurance). Summit then used a portion of the sales proceeds to pay off part of the initial financing.

As construction came to a close, Summit began having problems with the project and failed to pay Weitz more than $2 million. Weitz recorded a mechanics' and materialmen's lien (the Lien); and then Weitz timely filed a lawsuit (the Lawsuit) seeking to foreclose out any and all security and/or ownership interests in the Condos (the Lawsuit). Weitz named all of the subsequent purchasers of the condos, along with the companies that lent them the purchase money for their residences (the Defendants), and Weitz claimed its Lien rights had priority over all the Defendants' interests. *See The Weitz Co. v. Summit at Copper Square, LLC et al.* Maricopa Cty. Sup. Ct. No. CV2008-028378. The Defendants (particularly the lenders) disputed Weitz's claims and alleged their interests were equitably subrogated to the initial loan and, that as a result, they have first priority.

It is undisputed Weitz's lien rights attached ***before*** all the interests of the Defendants were recorded. It is also undisputed that if equitable subrogation applies, the Defendants would have priority, as the original loan pre-dates any work Weitz performed. Thus, the parties filed cross-motions for summary judgment on the priority issue. The trial court found equitable estoppel did ***NOT*** apply, expressly distinguishing *Lamb* by noting that none of the loans at issue bought out the initial loan completely. The parties then entered into a stipulated judgment regarding the validity of the lien and the amount due, pending an appeal of the underlying finding related to equitable subrogation.

On November 2, 2011, the Defendants filed a Notice of Appeal seeking review of the Court's decision on this issue.[1] Briefing is currently in process.

IV. Hopefully *Summit at Copper Square* Will Clarify the Interplay Between Equitable Subrogation and the Lien Statutes as it Applies to Certain Types of Loans.

This case has substantial import to the litigants, but the reason we are discussing it is that it highlights this priority issue that is important to a number of members of the development community. Moreover, this case appears to be well suited for determination by an appellate court, as the legal issue is very relevant to Arizona construction and development, and is well positioned for determination.

Weitz likely will argue it has first priority for three reasons. First, it will agree with the trial court and likely argue that the subsequent lenders were lending money to individual condo buyers based on those buyers' financial status, not the developer and, thus, there was no intent to subrogate the loan interests. Second, Weitz will likely argue it would be prejudiced if equitable subrogation applies, as its lien rights would now be subject to the viability of possibly hundreds of condo owners making payments on their individual loans—a

liability different than the potential liability it had with one lender and one owner when it originally agreed to do the work. Third, Weitz may seek to overturn *Lamb*, contending that the doctrine of equitable estoppel should not apply to mechanics' liens in Arizona because of the public policy adopted by the Legislature when it amended A.R.S. § 33-992. Weitz will likely argue the legal maxim that "equity follows the law," and that the statute trumps any equitable doctrines. As a result, Weitz will argue it has first priority.

The Defendants likely will respond by arguing that equitable estoppel should apply for all of the same reasons it applied in *Lamb*. Specifically, they likely will argue the new lenders assumed that a portion of their loans were going to pay off the original loan and that there was at least an implied intent to subrogate. They likely will also argue that, just as in *Lamb*, there is no prejudice to Weitz, because Weitz knew when it started working that its lien rights were subordinate to a loan and they still are. Finally, they likely will contend that equitable subrogation is now settled law in Arizona, has been for many years, and that the court should not reconsider *Lamb*. Thus, Defendants will argue the Court of Appeals should reverse the trial court, find that equitable estoppel does apply here and direct that judgment be entered in their favor.

V. Regardless of the Outcome, Certainty Will Improve the Situation for All Parties by Allowing them to Take All Appropriate Steps to Protect Their Rights.

In reviewing this article, you will likely note that we have not argued that any particular position is correct, nor advocated that the Court should rule one way or the other. This was deliberate, as all we were trying to do was highlight the underlying issue for all parties and frame the issue in such a way that made it clear that both sides had a valid legal position—meaning that different courts in different cases could come to different conclusions. And this uncertainty is problematic for parties evaluating whether to get involved in particular projects, as that makes it harder to judge risk. As a result, it would be prudent for those involved in the industry to consider this issue before they "invest" in a particular project and do all they can to protect their interests. For instance, a financial institution that is providing funds to a person buying a portion of a larger residential or commercial project (and the title insurance company providing a policy) may wish to require that the developer provide certain assurances, in the form of lien waivers or other items, from a contractor related to a particular unit before the sale goes through. Similarly, the lender and the purchaser should ensure that they have adequate title insurance on a project. Contractors, on the other hand, may want to be more conscientious in requiring payment for specific units before turning them over to developers for sale, or may require the developer to agree to allocate

valuations of work to units that are unencumbered.

We will continue to monitor this case and provide an update if a conclusion is reached on this important issue.

Notes:

[1] The appeal also raised an issue with regard to *res judicata* that is unrelated to this article. [back]

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