

SLDF ANALYSIS MEMORANDUM

TO: SLDF Task Force

FROM: Eric Travers

DATE: March 8, 2019

RE: *SK Builders, Inc. v. Smith*, 2019 Ariz. App. LEXIS 73, From the Court of Appeals of Arizona, Division Two, On Appeal to the Supreme Court of Arizona.

I. DISPUTE BACKGROUND.

This case involves a reversal on appeal of a trial court judgment to a home builder against home owners on a claim under the Arizona Prompt Pay Act. In reversing the trial court, the Court of Appeals of Arizona held that the Contractor's failure to prove the work for which it sought payment in the Pay Application in question (Pay Application #19) was billed within the 30 day billing cycle specified in the Prompt Pay Act text was fatal to its entitlement to the available statutory remedies under the Act.

A. Facts.

1. *The Project and Parties*

The dispute arose out of a September 2010 construction contract (the "Contract") entered into by Michael and Sandi Smith (the "Owner") and SK Builders, Inc. ("Contractor") to build a new home (the "Project") for \$1,632,804 in Oro Valley, Arizona. DC Concrete ("Concrete Subcontractor") was hired by Contractor to perform the concrete work on the Project. Robinette Architects ("Architect") was the architect and the Owner's designee to certify applications for payment.

Construction proceeded from the Fall of 2010 through March 2012. Throughout the construction period, the Contractor had submitted for the Architect's approval, and the Owner's had paid 18 monthly payment applications, totaling \$1,506,314.76.

2. *The Dispute*

In early 2012 the Owner discovered cracks in the interior concrete on the back patio. On investigation, the Architect determined that the Concrete Subcontractor had not (as required by the specifications) installed reinforcing steel or wire meshing in the concrete before pouring the back patio.

When the cracks appeared, the Owner had already paid the full amount for the concrete work via progress payments that were billed and paid in December 2010, March 2011, and March 2012.

As part of looking at the work, the Concrete Subcontractor repaired the cracks by injecting epoxy into them. Engineers retained by the Contractor tested the repaired concrete and concluded that while it deviated from the plans (in not having the required reinforcement), it was stronger than required.

After some back and forth on the concrete issue, the parties reached a stalemate: based on the Contractor's engineer's report, the Concrete Subcontractor refused to completely replace the back patio. On March 22, 2012, the Architect wrote the Contractor, advising that no further payments would be made until outstanding issues were resolved. In that letter, the Architect indicated that the Contractor actually owed the Owner money for the defects.

On May 1, 2012, the Contractor submitted Pay Application #19 to the Owner, seeking payment of \$180,289.61. Pay App 19 did not seek payment for any concrete work, all of which had been previously billed and paid in full.

On May 2, 2012 the Owner terminated the Contract without (1) paying the final pay application, or (2) objecting in writing to any of the items for which payment was sought in Pay Application 19. The Owner's withholdings were not based on any contention that the work in Pay App 19 was defective, but on its issues with the concrete work.

The Contractor sued the Owner, claiming a violation of the Arizona Prompt Pay Act, breach of Contract, and unjust enrichment. The Owner counter-claimed and also filed a third party complaint against the Concrete Subcontractor.

3. The Law

Arizona's Prompt Pay Act (the "APPA") has separate requirements for payments by an owner to contractor (found at A.R.S. § 32-1129.01) and payments by contractors, subcontractors, or material suppliers to their lower tiers (found at A.R.S. § 32-1129.02).

Here the dispute involved owner payments. Thus, the relevant APPA sections are found at A.R.S. § 32-1129.01, which:

- Requires an owner to (unless the contract provides otherwise) make progress payments to a contractor "on the basis of a duly certified and approved billing or estimate of the work performed and the materials supplied **during the preceding thirty day billing cycle.**" A.R.S. § 32-1129-01(A) (Emphasis added).
- Requires payment "within seven days after the billing ... is certified and approved." Id.
- Specifies that the "billing or estimate **shall be deemed approved and certified fourteen days after the owner receives [it]**, unless before that time the owner or the owner's agent prepares and issues a written statement stating in reasonable detail the owner's reasons for not certifying or approving all or a portion of the billing or estimate" A.R.S. § 32-1129.01(D) (emphasis added).
- Allows an owner to withhold from progress payments for a variety of reasons including but not limited to unsatisfactory job progress, disputed or defective work, and damage to the owner. " A.R.S. § 32-1129.01(D).

4. The Decision and Appeal

After a bench trial, the trial court held:

- 1) the Owner violated the Prompt Pay Act by failing to object in writing to any of the items in Pay Application 19 within fourteen days of the submission of the Payment Application;
- 2) the Owner was entitled to judgment on the Contractors' breach of contract and unjust enrichment claims.;
- 3) the Concrete Subcontractor was entitled to summary judgment on the Owner's third-party complaint.

Based on the above, the trial court entered judgment:

- (1) for the Contractor on its Prompt Pay Act claims (only) for the full amount of Pay Application #19 (\$180,289.61) plus \$60,000 in attorney fees; and
- (2) dismissing the Owner's claims against the Concrete Subcontractor, awarding the Concrete Subcontractor \$294,956.04, consisting of \$264,392.04 in attorneys fees and costs, plus \$30,564 as sanctions under an Arizona Statute that allows for imposing sanctions against a party who rejects an offer of judgment but then fails to obtain a more favorable judgment).

On Appeal, as to the Concrete Subcontractor the Appeals Court affirmed the trial court in its entirety, noting that the Owner's breach of contract and fraudulent misrepresentation claims against the subcontractor were both premised on a contractual relationship and there was none, therefore summary judgment was appropriate and it was not an abuse of discretion to award fees.

The Appeals Court, however, reversed the trial court's judgment for the Contractor.

The Appeals Court noted that the trial court had failed to address the Owner's argument that Pay Application 19 did not comply with the requirements for a progress payment under the APPA "because most of the work in PA 19 was completed outside the preceding thirty-day billing cycle." The Appeals Court noted that the "APPA **unambiguously provides** that a contractor **must** base a progress payment "billing or estimate" on "the work performed and the materials supplied during the preceding thirty day billing cycle."

The Court noted that it was undisputed that Pay Application 19 "included many items that were undisputedly outside the thirty-day [billing] cycle." In fact, the Contractor "failed to present any evidence refuting [the Architect's] testimony that none of the items billed in PA 19 occurred within the previous thirty-day cycle."

Though the Court recognized that "[n]either the APPA nor Arizona cases discussing it expressly assign the burden of proof concerning the thirty-day billing cycle" it found that the burden of proof in

this regard “falls on the contractor submitting a payment application.” The Appeals Court thus reversed the trial court judgment for the Contractor under the APPA, noting that while the Contractor “met its burden of proving that PA 19 was submitted to the Smiths and not objected to or paid, [it]t failed to prove compliance with the thirty-day billing cycle requirement.”

The Concrete Subcontractor was obviously happy with the result. The Contractor, however, was equally displeased.

The Contractor has filed a Motion to Reconsider with the Appeals Court, and asked ASA to enter an amicus appearance asking the Arizona Supreme Court to accept review of the Appeals Court decision to the extent that decision reversed the trial court on the Contractor’s APPA claim.

B. The Issue/Policy Interests.

The Contractor’s issue on appeal is whether, for purposes of an action under the APPA, the burden of proof of compliance with the 30-day billing cycle rests with the contractor seeking payment or the owner who receives payment.

(*NOTE: If the Owner cross-appeals the judgment for the Concrete Subcontractor, there may be additional issues raised jeopardizing the Concrete Subcontractor’s judgment against the Owner.)

C. Is the issue presented preserved for appeal? What is the certainty that the issues will be decided on appeal?

The issues are preserved and if the Arizona Supreme Court takes the case, there is substantial certainty the billing cycle issue will be decided.

II. Factors and Considerations for SLDF Involvement.

A. Generally.

ASA’s Board of Directors requires the SLDF Task Force to consider the following factors, namely whether:

(a) The issue(s) specifically interest construction Subcontractors and suppliers.

Preservation and enforcement of Prompt Pay Act protections is a core issue for ASA members at large but the real issues here (the terms and burden of proof under the statute and the Contractor’s claims) are not specifically limited to subcontractors and suppliers.

(b) The issue is focused and clearly presented.

The issue is focused and clearly presented.

(c) There is a consensus among ASA members on the issue(s).

In the overall scheme of things this may be more tricky than it appears. Here the Concrete Subcontractor obtained a favorable decision on the issue of an owner's right to reach beyond privity to assert defective work and related claims directly against a subcontractor. If the Supreme Court accepts review, these good results may be jeopardized.

Regarding the Contractor's claims, the ultimate dispute seems very fact specific on whether the Contractor could prove billing within the 30 day cycle. Subcontractors and suppliers may have difficulty with ASA taking a position in court that substantiating billing in this fashion is an undue burden.

Finally, there are always unintended consequences to consider. Here, the Owner indisputably paid the progress payments timely throughout the Project, withholding payment only at the end of the Project after it discovered issues with the concrete work.

The APPA allows for some exceptions to its terms where the parties "agree" so if the Arizona Supreme Court accepts review and reverses the Appeals Court on the APPA claim, the unintended consequence of such a decision may be to set in motion considerably more stringent owner contracts and payment terms allowing for the Contractor's agreement to a more detailed and time consuming review process of progress payment applications, and far greater likelihood of delayed payments that ripple through the trades.

Finally, as noted in the discussion to subsection (e) below, the specifics of this dispute may make it far less likely to have an impact across state lines than other cases that more clearly fall into the core issues of ASA concern.

(d) ASA could have a meaningful impact in the judicial proceedings.

There is already an amicus brief being prepared by the Arizona Builders Alliance ("ABA", an alliance of Arizona's AGC builder chapter, so the construction industry voice will be heard.

(e) Is the proceeding likely to result in setting favorable judicial precedent (or avoiding setting unfavorable judicial precedent) primarily in appellate level court proceedings or other reported formats.

Because this appeal is pending before the Arizona Supreme Court it will have great precedential weight in Arizona. However, the fact specific nature of the dispute here, the state specific payment statute, and the relatively narrow issue the Contractor is appealing on (e.g., burden of proof on compliance with the statutory billing cycle) seems to limit the possible 'broader' impact beyond Arizona borders.

(f) The issue or forum is of high visibility from a public relations standpoint.

Prompt Pay Act enforcement is high visibility.

(g) Whether a party seeking ASA's intervention has agreed to indemnify ASA for its expenses incurred should the case be settled prior to a final decision in the proceeding.

The Contractor has agreed to this.

B. Amicus Brief Deadline and Procedure.

There is no timeline yet on a Petition for Review by the Arizona Supreme Court because a Motion to Reconsider the appellate court decision was filed by the Contractor on February 12, 2019. The Contractor's Motion to Reconsider tolls the Petition for Review deadline. If the Contractor's Motion is granted, Supreme Court review at least at this point may be moot.

If it is denied, the Contractor would have 15 days to file a Petition for Review. It is not clear if the Arizona Rules of Appellate Procedure will require that any amicus brief be filed with a motion for leave. If ASA approves filing a brief, then ASA will ask amicus counsel to provide ASA General Counsel with a draft of the brief three (3) business days before the brief is due.