SUPERIOR COURT
OF THE
STATE OF DELAWARE

T. HENLEY GRAVES
RESIDENT JUDGE

SUSSEX COUNTY COURTHOUSE
ONE THE CIRCLE, SUITE 2
GEORGETOWN, DE 19947

August 20, 2008

Robert K. Beste, Jr., Esquire
Cohen, Seglias, Pallas, Greenhall & Furman, P.C.
Nemours Building, Suite 1130
1007 Orange Street
Wilmington, DE 19801

K. William Scott, Esquire
Scott & Shuman, LLC
38017 Fenwick Shoals Boulevard
West Fenwick, DE 19975

RE: Nason Construction, Inc. V. Bear Trap Commercial, LLC
C. A. No. 07L-02-014 THG

Date Submitted: August 6, 2008

Dear Mr. Beste and Mr. Scott:

Trial in this case took place May 19 through May 22, 2008. The Court entered a bench ruling concerning the many claims and counterclaims involved in this construction dispute. For the most part, Plaintiff prevailed on its claims. A portion of Defendant's "backcharges" was awarded.

Ultimately, judgment was awarded to Plaintiff in the amount of $189,841.52, plus pre-judgment interest. Following trial, Plaintiff calculated that interest to be $43,253.41. Defendant did not dispute the interest calculations. Therefore, judgment was entered in favor of Plaintiff in the amount of $233,094.93.

Plaintiff also sought attorneys' fees pursuant to Delaware's Prompt Payment Act, specifically 6 *Del.C.* §3506 through §3509. The general purpose of the Prompt Payment Act is to require owners and contractors to make timely and prompt payments for construction work. It is common knowledge that the failure to make timely and prompt payments concerning building projects may have an extremely negative impact on contractors and sub-contractors "down stream". Contractors and subcontractors risk financial collapse when the cash flow tap closes.

Plaintiff seeks recovery of attorneys' fees under 6 *Del.C.* §3506 and §3509. While Defendant does not dispute the legal applicability of §3509, I find that any award of

attorneys' fees under §3509 is limited to arbitration proceedings under §3509(b). Admittedly, §3509(a) is titled "Award of Attorneys Fees and Costs.". However, the body of subsection (a) concerns the sums that have been withheld wrongfully. Only §3509 (b) specifically speaks to allowance of an award of attorneys' fees and it is limited to arbitration proceedings.

Therefore, the focus of the Court's ruling is limited to 6 *Del.C.* §3506 . The relevant portions of that statute are set forth below.

> §3506. Interest penalties on late payments.
> (a) Each construction contract awarded by an owner shall include:
> (1) A payment clause which obligates the owner to pay the contractor for satisfactory performance under the contract within 30 days of the end of the billing period;
> (2) An interest penalty clause which obligates the owner to pay the contractor an interest penalty on amounts due in the case of each payment not made in accordance with the payment clause included in the contract pursuant to subparagraph (1) of this subsection;
> (3) The clause required by this subsection shall not be construed to impair the right of the owner to include in its contracts provisions which permit the owner to retain a specified percentage of each progress payment otherwise due to a contractor for satisfactory performance under the contract without incurring any obligation to incur an interest penalty, in accordance with the terms and conditions agreed to by the parties to the contract. In such a case, the owner must provide written notice to contractor as to why payment is being withheld within 7 days of the date required for payment to the contractor.
> (b) Each construction contract awarded by a contractor shall include:
> (1) A payment clause which obligates the contractor to pay the subcontractor and each supplier for satisfactory performance under the subcontract within 30 days out of such amounts as are paid to the contractor; and
> (2) An interest penalty clause which obligates the contractor to pay the subcontractor and each supplier an interest penalty on amounts due in the case of each payment not made in accordance with the payment clause included in the contract pursuant to paragraph (1) of this subsection.
> (c) The interest penalty shall apply to the period beginning on the day after the required date and ending on the date on which payment of that amount due is made and shall be computed at the legal rate in effect at the time the obligation to pay a late payment interest penalty accrues. Any amount of an interest penalty which remains unpaid at the end of any 30-day period shall

be added to the principal amount of the debt and thereafter interest penalties shall accrue on such amount.

(d) The clauses required by subsection (b) of this section shall not be construed to impair the right of the contractor to include in its subcontracts provisions which permit the contractor to retain a specified percentage of each progress payment otherwise due to a subcontractor and each supplier for satisfactory performance under the subcontract without incurring any obligation to incur an interest penalty, in accordance with the terms and conditions agreed to by the parties to the contract. In such a case, the contractor must provide written notice to the subcontractor or supplier as to why payment is being withheld within 7 days of the date required for payment to the subcontractor or supplier.

(e) If it is determined by a court of competent jurisdiction that a payment withheld pursuant to subsection (a)(3) or (d) of this section was not withheld in good faith for reasonable cause, the court may award reasonable attorneys' fees to the prevailing party. In any civil action brought pursuant to this section, if a court determines after a hearing for such purpose that the cause was initiated, or a defense was asserted, or a motion was filed or any proceeding therein was done frivolously or in bad faith, the court shall require the party who initiated such cause, asserted such defense, filed such motion or caused such proceeding to be had to pay the other party named in such action the amount of the costs attributable thereto and reasonable expenses incurred by such party, including reasonable attorneys' fees.

6 *Del.C.* §3506.

The present dispute requires the Court to determine if the payments withheld by Defendant were "not withheld in good faith for reasonable cause" and/or if any defense asserted "was done frivolously or in bad faith".

The parties agree that the hearing the statute required occurred during the course of the trial testimony, where both parties focused on the factual issues the statute contemplated.

BACKGROUND

As would be expected, there were many change orders in this large construction project. The contract language was specific as to change orders. The contract required written change orders, signed by all parties, and specified that no course of conduct could waive or excuse the requirement of signed, written change orders. Its purpose was to leave a paper trail protecting both parties.

In the initial phases of the litigation, Defendant sought dismissal under Superior Court Civil Rule 12(b). Later, Defendant sought dismissal by way of a summary judgment motion. In both motions, Defendant's position was simple: the absence of written and signed change orders meant Plaintiff's case must be dismissed. These applications to the Court were denied.

In the bench ruling, I found that both parties had modified the language of the contract orally or by their conduct and/or waived or abandoned the written and signed change order process.

To a large extent Defendant confirmed this, as its representatives admitted it paid numerous proposed change orders that did not comply with the contract protocol. Even though Defendant acknowledged it had defacto abandoned the contract protocol, it still took the position that it could use the contract protocol to avoid payment for work it agreed it requested. Defendant's position was that it was able to decide for what it wanted to pay, regardless of the fact that Defendant had asked for the work to be done.

At trial, Defendant argued that it did follow the proper protocol and that Samuel Palmer, Defendant's designated agent to approve change orders, "reviewed, approved and signed" each and every one of the initial group of eleven change orders. When the Court noted that Mr. Palmer only signed the first two change orders, Defendant's position was that since Mr. Palmer testified he signed them, he did, in spite of the written documents with no signatures. Defendant faulted Plaintiff for not providing these written documents in discovery. This was not only an incredulous position, it was illogical, because Defendant's designated person would had to have been the last person to sign the change orders. For Plaintiff to have signed copies, Defendant would had to have signed them, so why would Defendant not have copies of same? Defendant's argument as to this point makes no sense. Finally, there is no logical reason for Plaintiff to have "secreted" signed change orders.

After Change Order No. 2, there were many change orders and the parties did not follow the contract protocol, but Defendant frequently paid unsigned change orders. Defendant established a pattern of conduct: wanting work done promptly (change order paperwork was slow and cumbersome), watching it get done, and then paying for it, all without complying with the contract's change order process.

Then, upon litigation, Defendant attempted to use the change order language as a shield. For the reasons noted earlier, this was wrong and, additionally, Defendant was estopped from taking such a position.

The purpose of discussing this issue is that the argument made throughout this case by Defendant about the eleven "signed" change orders , and reargued in the attorneys' fee

submission by Defendant, shows a pattern of conduct that is not only mistaken and wrong, it is also evidence as to the attorneys' fee issue. These arguments go directly to the issue of whether or not payment was withheld in good faith for reasonable cause and it is evidence of a defense asserted "frivolously or in bad faith".

Defendant had to know that, with all the work done outside the scope of the original contract and then paid for by Defendant, it was in a very weak position to then argue that the change order protocol must be strictly enforced when Defendant only had signed two change orders.

THE "UNDISPUTED" CHANGE ORDERS

At the trial, Defendant admitted that a majority of the requests for payments made by way of change orders Plaintiff submitted were valid. Nevertheless, Defendant did not pay them. The "why" has not been addressed by Defendant, but a reasonable inference is the change orders remained unpaid as leverage as to other disputed issues.

BEAR TRAP'S FAILURE TO MAKE PAYMENT APPLICATIONS IN FULL

The contract called for Bear Trap to make payment within thirty days of Nason's payment application.

Nason argues the trade practice is for an owner to require a ten percent retainage on payment applications until the project is fifty percent completed, and then the retainage drops to five percent.

Therefore, when Nason made payment applications on its first four payment applications, it deducted ten percent from the sum it expected as Defendant's retainage. Bear Trap apparently agreed, as Bear Trap paid each of these payment applications.

On the fifth payment request, Nason deducted five percent retainage and that sum was paid.

Again, these retainage figures were sums set aside for the protection of Bear Trap in the event Nason did not complete the job.

On the remaining payment applications, Nason continued to subtract five percent as to the amount then due, but beginning with the sixth payment, Bear Trap withheld additional sums without explanation.

On the sixth application, which was for work through July 31, 2005, Defendant withheld $30,689.00.

On the seventh application, which was for work through August 31, 2005, Defendant withheld $37,686.00.

On the eighth application, which was for work through September 30, 2005, Defendant withheld $79,107.00.

Bear Trap did not initiate any contact with Nason to provide any reason for not making payment in full. Nothing ever was provided in writing from Bear Trap until January 20, 2006. As these shortfalls were posted within Nason, bells and whistles started going off and the shortfalls came to the attention of Mr. William Burke, Nason's Chief Financial Officer. He communicated with Mr. Richard Lipsky, Defendant's Director of Finance, and was told the extra shorting was because Nason had exceeded the schedule on certain line items.

Mr. Burke informed Mr. Lipsky that, in a guaranteed maximum contract, there might be some line items over the schedule and/or some line items under the schedule, but that the contract price was a total package price. Mr. Burke implored Bear Trap to pay.

Defendant's position was that each line item had to be met, and if any line item was over the schedule, that potentially would be Nason's problem. In other words, Defendant took the position that each line item was basically a guaranteed maximum contract price instead of considering all the line items in the schedule as a whole. As I ruled earlier, this is an unreasonable interpretation. Defendant wanted buildings constructed and wanted to guarantee it would pay no more than the total agreed upon amount. To then slice and dice the contract in an effort to "line item" the maximum guaranteed prices was wrong. I am satisfied from the testimony that this ruling is consistent with the building community's interpretation of a guaranteed maximum price contract.

Things got worse.

On December 23, 2005, Mr. Burke corresponded with Mr. Lipsky and noted that the shorting of the payments involving significant sums was unfair to Nason and its sub-contractors. Mr. Burke referenced their earlier conversation and reiterated Nason's position that the total guaranteed maximum price controlled, not individual line items.

By correspondence of January 20, 2006, Mr. Lipsky informed Mr. Burke of Defendant's rationale for withholding payment. He gave new and different reasons for not paying Nason. This change of story is a factor to be considered in determining the

reasonableness of Defendant's position, as well as whether it was acting in good faith or attempting to justify its conduct.

For the first time, Defendant informed Plaintiff that it was backcharging Plaintiff $84,149.00 for work Defendant had to have done that it claimed was Nason's responsibility, pursuant to the contract. Also, Defendant advised it was not going to pay $85,770.00, which was the "general conditions" expense for the change order involving the liquor retail store, i.e., "the market fit out".

The "market fit out" involved Change Order No. 6, which constituted a huge change in the scope of the work being performed by Nason. The original contract was for the construction of two commercial buildings that were basically to be shells. The retail space would be "fitted" later, based on the retailer taking possession or entering into a lease with Defendant. Defendant wanted Nason to "fit out" one store as a market and liquor store. Nason's proposed change order was for approximately $699,000.00, including the first line item $82,910.00 as "general conditions". These "general conditions" expenses were for general expenses attributable to the project that, rightly or wrongly, I have interpreted to be general overhead.

Defendant argues that neither of its key people saw the change order. Factually, I find Defendant is wrong. The testimony satisfies me that there was a review by one or more of Defendant's key people because they suggested "value engineering", which caused Plaintiff to reduce the change order from $699,000.00 to $673,000.00.

Again, for the reasons noted in the bench ruling, I am satisfied that Defendant knew of and accepted this portion of Change Order No. 6. Defendant even made installment payments towards the general conditions and it was not until the January 20, 2006, letter that Defendant raised this issue. Interestingly, in the request for admissions, Defendant admitted the value of this work was $673,000.00, which included the $82,910.00 in general conditions.

Thus, based on the factual record, Defendant initially decided not to pay for one reason. Then, after an explanation by Plaintiff as to why Defendant's position was incorrect, Defendant adopted a different rationale. Then, in the litigation, Defendant admitted the value of the amount being sought but still opposed payment.

This is troublesome for the Court in considering whether Defendant acted in good faith for reasonable cause and/or asserted defenses frivolously or in bad faith.

It is rare that the state of mind of a person involved in decision making is known by direct testimony. State of mind findings usually are made by inference based upon the conduct of the individual. That is done by the Court and by juries all the time.

Judge Stokes has recently summarized the meaning of "bad faith." I quote from his opinion in *Brittingham v. Board of Adjustment of City of Rehoboth Beach*, 2005 WL 1653979 (Del.Super. Apr. 26, 2005), at length:

> [Plaintiffs] cite to Black's Law Dictionary for the definition of bad faith as "[t]he opposite of 'good faith,' generally implying or involving actual or constructive fraud, or a design to mislead or deceive another, or a neglect or refusal to fulfill some duty or some contractual obligation, not prompted by an honest mistake as to one's rights or duties, but by some interested or sinister motive." Black's Law Dict. 139 (6th ed. 1990). The definition goes on to say, however, " 'bad faith' is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity, it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will." The seventh edition of Black's Law Dictionary defines "bad faith" as "[d]ishonesty of belief or purpose." Black's Law Dict. 134 (7th ed. 1999).
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> Other than in cases involving administrative bad faith and costs, Delaware Courts have addressed bad faith in many different situations, including leases and contracts, at-will employment, partnership agreements, prosecutor mistake or misconduct and as an exception to the American Rule regarding attorneys [sic] fees. *See Seaford Assocs. Ltd. P'ship v. Subway Real Estate Corp.,* 2003 WL 21309117 (Del. Ch.) (Lease agreement); *E.I. DuPont de Nemours & Co. v. Pressman,* 679 A.2d 436 (Del.) (Breach of employment at-will contract); *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.,* 624 A.2d 1199 (Del.1993); *State v. Morris,* 2002 WL 31520508 (Del.Super.Ct.) (prosecutorial mistake or misconduct as grounds for finding double jeopardy for retrial); *Johnston v. Arbitrium (Cayman Islands) Handels AG,* 720 A.2d 542 (Del.1998) (exception to American Rule for attorney's fees).
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> At times, Courts have either given no definition of bad faith, stated there is no definition or quoted Black's law Dictionary. *See, e.g., Johnston,* 720 A.2d at 546 ("there is no single definition of bad faith conduct," and giving examples of when courts have found a party litigated a case in bad faith); *Desert Equities, Inc.,* 624 A.2d at 1208 n. 16 (quoting the fifth edition of Black's Law Dictionary). Generally, a determination of bad faith turns on the specific facts of a particular case. *Cantor Fitzgerald, L.P. v. Cantor,* 2001 WL 536911, at *4 (Del. Ch.).
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> Two cases in Delaware have specifically addressed this issue of administrative costs and bad faith of the Board. In *Chem. Indus. Council of*

Delaware v. State Coastal Zone Indus. Control Bd., 1994 WL 274295, at *15 (Del. Ch.), the Chancery Court refused to award costs and to find the Board had acted in bad faith for withholding public records for a period of time. It reasoned, "[the Board's] decision to do that had a colorable-albeit erroneous-legal basis." An award of costs was also denied in *4th Generation Ltd. v. Bd. of Adjustment of Rehoboth Beach,* 1987 WL 14867 (Del.Super.Ct.) because the Court found the appellants' allegations of inequitable or unlawful conduct by the City were either irrelevant or unsubstantiated by the record. Neither case required a definition of bad faith.

> The common thread in all of the definitions of bad faith given is that there is some kind of dishonest motive or purpose. There is, thus, the implication of an element of scienter. For example, in *Desert Equities, Inc.,* 624 A.2d at 1208, the Court stated, "a claim of bad faith hinges on a party's tortious state of mind." There the Court examined bad faith in the context of the pleadings. Since it found that a claim of bad faith required an averment of a state of mind, it was not necessary for it to be pleaded with particularity.
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> In order to prove bad faith on the part of the [Defendant], [Plaintiffs] would have to show from the facts that the [Defendant] had a dishonest purpose or "a state of mind affirmatively operating with furtive design or ill will." Black's Law Dict. (6th ed.). .... Bad judgment by itself is not equivalent to a sinister motive or dishonest purpose.

Brittingham v. Board of Adjustment of City of Rehoboth Beach, 2005 WL 1653979, at **1 -2 (Del.Super. Apr. 26, 2005) (footnote omitted).

It is reasonable to infer from the shifting reasons which Defendant advanced that bad faith was present and that Defendant was attempting to avoid paying its contract obligation for a dishonest or improper purpose.

THE "BACKCHARGES"

Mr. Lipsky, in his January 20, 2006, letter to Mr. Burke, claimed $84,149.00 in back charges against money due Plaintiff because it was for work which was solely the contract responsibility of Plaintiff or because Defendant had to remedy some of Plaintiff's work. At trial, back charges were awarded Defendant in the amount of $16,505.48. The fact that one makes a claim for "X" dollars but only proves "Y" dollars does not give rise to an inference of bad faith. But the problem concerning bad faith is that the testimony of Defendant's own trial witnesses established knowledge on the part of Defendant that it knew significant portions of the back charges were not Plaintiff's responsibility. Nevertheless, these charges were pursued as a set-off in pre-litigation communications and

as a part of the counterclaim. These facts support an inference of bad faith by way of using false claims to reduce the money Defendant owed to Plaintiff.

Considering the totality of the evidence, I am satisfied that Defendant failed to comply with the Prompt Payment Act in that Defendant withheld payments and those payments were "not held in good faith for reasonable cause". 6 *Del.C.* §3506(e).

The statute places the burden of proof on the entity withholding payments to establish it was done in good faith. The Supreme Court of Vermont, in construing similar language, placed the burden on the homeowner to establish the withholding of dollars for alleged defects was done in good faith. *Naylor v. Cusson*, 940 A.2d 717, 722 (Vt. 2007) But, even if Nason had the burden of proof to show bad faith, I am satisfied it has been established.

I note that, as to retainages in excess of the ten percent and five percent contained in the payment applications, 6 *Del.C.* §3506 requires Defendant to provide Plaintiff timely written notice as to the "why". Defendant did not ever do this.

Also, the statute allows attorneys' fees if the Court determines a defense was asserted frivolously or in bad faith. Clearly the assertion of a set-off for a significant portion of the back charges meets this test when Defendant's witness admitted same were not Nason's responsibility. Also, the continued litigation of claims that Defendant admitted were due is troublesome.

For these reasons, reasonable attorneys' fees are awarded Plaintiff pursuant to 6 *Del.C.* §3506. When considering all of the evidence presented in this case, I am satisfied that a pattern has been established as to Defendant's conduct, warranting the application of 6 *Del.C.* §3506.

The difficulty now is to try to be fair to both parties in determining reasonable attorneys' fees and costs. Plaintiff seeks $139,931.04 for attorneys' fees and costs. Defendant has not contested the reasonableness of Plaintiff's attorneys' fees but did contest any entitlement at all under the Prompt Payment Act. The case was hard fought with an extensive amount of discovery. Both parties were represented by at least two attorneys each.

The Delaware Supreme Court recently has reiterated the factors that a trial court must consider when weighing the "reasonableness" of attorneys' fees.

> To assess a fee's reasonableness, case law, *see, e.g., All ProMaids, Inc. v. Layton*, 2004 Del. Ch. LEXIS 116, at *3, (Aug. 9, 2004), directs a judge to consider the factors set forth in the Delaware Lawyers' Rules of Professional Conduct,

which, include:

(1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;

(2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;

(3) the fee customarily charged in the locality for similar legal services;

(4) the amount involved and the results obtained;

(5) the time limitations imposed by the client or by the circumstances;

(6) the nature and length of the professional relationship with the client;

(7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and

(8) whether the fee is fixed or contingent.

Del. Lawyers' Rules of Prof'l Conduct R. 1.5(a)(1).

Mahani v. EDIX Medai Group, Inc., 935 A.2d 242, 245-46 (Del. 2007).

Experience teaches us that in these types of construction cases, neither party has a monopoly as to the facts. In the bench ruling, I awarded Plaintiff $206,347.00. I awarded Defendant back charges of $16,5050.48, resulting in a judgment in Plaintiff's favor of $189,841.52, plus interest.

Also, I note that both parties share some of the blame that allowed the problems to develop, in that neither party followed the contract protocol for change orders.

To award Plaintiff its entire requested attorneys' fees would therefore be unreasonable. I also note that the statute's intent is remedial and perhaps to level the playing field. There is a price to be paid if one violates the statute and that price is to pay the "victim's" attorneys' fees.

Therefore, I award the sum of $85,000.00 in attorneys' fees to the Plaintiff and require Plaintiff to bear the remaining approximately $55,000.00 in attorneys' fees expenditures.

This determination is guided by the reasonable attorneys' fee factors as contained in *Mahari*, as well as the fact that Defendant has not contested the amount of time involved, nor the hourly rate, as being unreasonable.

IT IS SO ORDERED.

Very truly yours,

T. Henley Graves

cc: Prothonotary