No. 91069-3

SUPREME COURT
OF THE STATE OF WASHINGTON

HARTFORD FIRE INSURANCE COMPANY,

Appellant,

v.

COLUMBIA STATE BANK,

Respondent.

COLUMBIA STATE BANK'S ANSWER TO BRIEF OF AMICUS CURIAE SURETY & FIDELITY ASSOCIATION OF AMERICA

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I. ARGUMENT

The Surety & Fidelity Association of America ("**SFAA**") claims the lower courts erred in this case "because under federal law the progress payment ... was subject to an equitable lien in favor of the unpaid subcontractors and suppliers ... and that Hartford ... was subrogated to the ... superior right to the payment." [1] SFAA is mistaken. Federal law does not provide Hartford with an equitable lien that it can avail itself of in this case. SFAA has noticeably failed to cite to any legal authority in support of this claim.

In contrast, Hartford has said from the start that Washington law governs the outcome of this proceeding. Amicus curiae Liberty Mutual Insurance Company seems to be of the same mind in light of the arguments that it has advanced. [2] Nevertheless, the reality is SFAA has failed to identify any federal law that provides Hartford with an equitable lien or otherwise enables Hartford to lay claim to the earned progress payment at issue.

Henningsen v. United States Fidelity & Guaranty Co., 208 U.S. 404 (1908) does not help Hartford's position. Unlike the instant case, *Henningsen* did not involve an earned progress payment that was paid into

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[1] SFAA's Amicus Curiae Memorandum in Support of Petition for Review at 3-4.
[2] *See* Liberty Mutual Insurance Company's amicus brief at 5-6, 14.

a collateral control account held by the contractor's construction lender. *Henningsen* simply held that after a surety paid laborers and materialmen under its bond, the surety could invoke the doctrine of subrogation to obtain the retainage held by the government. *Id.* at 410. Given that Hartford seeks to recover an earned progress payment from the Bank that was paid to the Bank when Hartford had not paid out any money under its bond, *Henningsen* does not help Hartford's position.

Pearlman v. Reliance Insurance Co., 371 U.S. 132 (1962) does not support Hartford's position either. *Pearlman* involved a dispute between a government contractor's bankruptcy trustee and the contractor's payment bond surety over which had the superior right to retainage held by the government. *Id.* at 133. *Pearlman* noted the "established doctrine that a surety who completes a contract has an 'equitable right' to indemnification out of a retained fund such as the one claimed by the surety in the present case." *Id.* at 138. In *Pearlman*, the surety paid money under its bond and *then* sought to recoup the retainage held by the project owner via subrogation. Again, in contrast, Hartford seeks to recover an earned progress payment from its bonded contractor's construction lender that the lender received before Hartford paid any money out on the Project, and before Hartford could therefore enforce its subrogation rights. As such, *Pearlman* is distinguishable.

The SFAA's claim that the Court of Appeals does not understand subrogation [3] is misguided. First, the SFAA assumes — despite the lack of any evidence to this effect — that there were "unpaid subcontractors and suppliers" on the Project that had an "equitable lien that was superior to the Bank's right of setoff." [4] Even Hartford has tacitly admitted its claim that Project subcontractors were unpaid on the date of the setoff is not supported by sufficient evidence. [5] Regardless, the fact is there is no evidence in the record that shows Project subcontractors or materialmen were unpaid on the date of the setoff, June 21, 2012.

The SFAA seems to suggest that once Hartford assumed control of the Project in July 2012 and then paid money out under its bond, it could then use this performance to lay claim to the earned progress payment that the Bank received and applied to Waka's debt with the Bank on June 21, 2012. [6] But this cannot possibly be the case, as a ruling in this vein would be flatly contrary to the Washington law of bank deposits, which is rooted in decades' worth of Washington Supreme Court jurisprudence.

Under Washington law, if the bank depositor has a debt with the bank that has matured — like contractor Waka did in this case — the bank

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[3] SFAA's amicus brief at 6.
[4] SFAA's amicus brief at 6.
[5] Hartford's Petition for Review at 14, footnote 7.
[6] SFAA's amicus brief at 6 ("When Hartford subsequently paid [the subcontractors], it acquired by subrogation their pre-existing rights in the contract fund.")

may exercise its right of setoff as to the deposit. *E.g., In re Estate of Adler*, 116 Wash. 484, 489, 199 P. 762 (1921). This means "the bank may apply the deposit ... to the payment of the debt due it by the depositor[.]" *Sterling Savings Bank v. Air Wisconsin Airlines Corp.*, 492 F.Supp.2d 1256, 1261 (E.D.Wash. 2007). A bank deposit is either general or special; a deposit is *presumed* to be a general deposit, but if a depositor asks a bank to accept a deposit for a specific purpose, and the bank agrees to the request, the deposit is a special deposit. *E.g., Sterling Savings Bank*, 492 F.Supp.2d 1256; *see also Washington Shoe Mfg. Co. v. Duke*, 126 Wash. 510, 514, 218 P. 232 (1923). The title to a general deposit passes immediately to the bank. *Sterling Savings Bank*, 492 F.Supp.2d 1256. In contrast, title to a special deposit does not pass to the bank; instead, the bank becomes a trustee and holds the money in a fiduciary capacity. *Id.* The key inquiry as to whether a bank deposit is special or general is whether the bank knew or should have known that the deposit was tendered in trust for a special purpose. *Id.* at 1261 (internal citations omitted).

Because the title to a general deposit passes immediately to the Bank, Hartford cannot change the character of this deposit after the fact by virtue of subrogation rights that it obtained in the weeks after the setoff. A ruling in favor of Hartford here would be contrary to Washington law,

lead to absurd results, and completely undermine both this state's banking system and established commercial practices.

SFAA asserts that "if the payment status of the subcontractors and suppliers on June 21 or 22, 2012 is a material fact, summary judgment for the Bank must be vacated and this matter remanded to the Superior Court to determine that fact." [7] This claim is misguided for at least three reasons. First, the question of whether Project subcontractors were unpaid on June 21, 2012 is not a genuine issue of material fact. [8] This is because Hartford could not step into the shoes of any such contractors on June 21, 2012 because Hartford had not yet paid any money under its bond. The Court of Appeals was correct when it recognized "[t]he right to be indemnified does not arise until money has actually been expended" by the surety. *Hartford Fire Ins. Co. v. Columbia State Bank*, 183 Wn. App. 599, 611, 334 P.3d 87 (2014). It is undisputed that Hartford did not pay out any money on the Project until weeks after the Bank laid claim to the earned progress payment. Thus, Hartford had no enforceable subrogation rights that it could assert on June 21, 2012, so even if Project contractors were in fact unpaid on that date, this would be of no legal consequence to the Bank.

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[7] SFAA's amicus brief at 6-7.
[8] A material fact is one on which the outcome of the litigation depends. *E.g., Clements v. Travelers Indem. Co.*, 121 Wn.2d 243, 850 P.2d 1298 (1993).

Second, Hartford failed to submit any admissible evidence in support of its motion for summary judgment or in opposition to the Bank's motion for summary judgment that shows subcontractors or suppliers had not been paid on June 21, 2012. *See* CP 46-62; CP 265-278. Hartford had almost seven (7) months to conduct discovery. *See* CP 1, 390. Hartford's failure to introduce admissible evidence regarding allegedly unpaid Project subcontractors did not prevent the dismissal of its claims on summary judgment. CR 56(e); *Meyer v. University of Wash.*, 105 Wn.2d 847, 852, 719 P.2d 98 (1986) (the party opposing summary judgment must demonstrate that a triable issue remains by presenting facts that would be admissible in evidence at trial). Had Hartford sought to invoke the rights of Project subcontractors who had not been paid on the date of the setoff, it could have — and should have — conducted discovery on this topic prior to the summary judgment hearing. Hartford could have also sought a continuance of the summary judgment hearing under CR 56(f) to obtain new evidence, which it failed to do.

Third, contrary to SFAA's claims, the law recognizes a distinction between the surety's ability to recover retainage and its ability to recover earned progress payments that are paid into the free flow of commerce. As seen from the following, cases like *Balboa Insurance Co. v. United States*, 775 F.2d 1158 (Fed. Cir. 1985) do not provide sureties with relief

against construction lenders in cases such as this.

SFAA argues that federal decisions subsequent to *Pearlman* "have rejected the argument that the equitable lien of the unpaid subcontractors and suppliers, and sureties subrogated to their rights, is limited to contract retainage." [9] The only authority that SFAA has cited in support of this assertion is *Balboa*. But *Balboa* does not hold that a surety can lay claim to an earned progress payment that has been paid to the bonded contractor's construction lender. *Balboa* simply recognizes that the federal government may potentially be liable to the surety when the surety notifies the government of the contractor's default and the government does not then reasonably exercise its discretion in disbursing future progress payments. *Id.* at 1165; *see also Admiralty Const., Inc. by Nat. American Ins. Co. v. Dalton*, 156 F.3d 1217, 1222 (Fed. Cir. 1998) (discussing *Balboa* and noting that the surety is subrogated to the contractor's property rights in the contract balance *when the surety finances the contract to completion*) (emphasis in original). Thus, *Balboa* and its progeny are inapplicable here because each of these cases involves a surety's claim against the *government* for the government's wrongful disbursement of progress payments.

On page 8 of its amicus brief, SFAA again claims that federal law

[9] SFAA's amicus brief at 7.

governs this case when it states "[t]he existence of an equitable lien against such a progress payment is a matter of federal law, and pursuant to well-established precedent, the unpaid subcontractors and suppliers had a right to be paid ahead of Bank as Waka's assignee." [10] However, SFAA has failed to specify exactly what "well-established precedent" it is relying upon to back up its claims. As seen from the foregoing, *Balboa* does not support Hartford's claims against the Bank. And, contrary to SFAA's assertion, Hartford is not able to recover the progress payment that was applied to Waka's Bank debt on June 21, 2012 once "Hartford paid the subcontractors" [11] in July of 2012 because the progress payment at issue was a general deposit on June 21, 2012, and title to this deposit passed to the Bank on that date. *See, e.g., Sterling Savings Bank*, 492 F.Supp.2d 1256.

In addition, even if Hartford somehow had an enforceable right of subrogation on June 21, 2012, the Court of Appeals recognized that Hartford still could not lay claim to the progress payment at issue, for "[p]rogress payments differ from retained funds because progress payments are funds that belong to the free flow of commerce once they are properly paid over." *Hartford*, 183 Wn. App. at 94 (citing *Capitol Indem. Corp. v. U.S.*, 41 F.3d 320, 325 (7th Cir. 1994)); *see also Bank of Arizona*

[10] SFAA's amicus brief at 8.
[11] SFAA's amicus brief at 8.

v. Nat'l Sur. Corp., 237 F.2d 90, 93-94 (9th Cir. 1956) (holding contractor's bank could keep earned progress payments that it received despite surety's subrogation rights). SFAA has not explained why the reasoning of *Capitol Indem. Corp.* or the cases cited therein should not be followed here.

As for Hartford's breach of trust theory of recovery that has been briefed in this forum, SFAA has chosen not to examine any of the analogous cases that the Bank has cited, which uniformly hold that the general agreement of indemnity between the surety and the bonded contractor does not create an express trust that enables the surety to lay claim to earned progress payments. *E.g., In re Construction Alternatives, Inc.*, 2 F.3d 670, 677 (6th Cir. 1993) (holding general agreement of indemnity did not create a trust under Ohio law when contractor wasn't required in agreement to keep any portion of progress payments as a separate trust fund); *Acuity v. Planters Bank*, 362 F.Supp.2d 885, 892 (W.D. Ky 2005) (dismissing surety's claims against contractor's bank on summary judgment and holding neither project contract nor general indemnity agreement created express trust under Kentucky law); *In re Eastern Paving Co.*, 293 B.R. 704 (Bankr.E.D.Mich. 2003) (holding general indemnity agreement was insufficient to create an express trust under Michigan law and denying intervenor Hartford's claim to the

payments at issue).

SFAA has also not explained why this Court should not, in the event review is granted, follow the reasoning of *Reliance Insurance Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502 (9th Cir. 1998), which applied Washington law. *Reliance* held that a contractor's construction lender could keep an earned progress payment that it received even though the contractor's surety demanded this payment from the bank before the bank exercised its right of setoff. *Id.* In ruling for the bank, the Ninth Circuit noted "that the cases generally hold that once the money has been paid over to the bank, the bank prevails against the surety[.]" *Id.* at 508 (citing Grant Gilmore, *Security Interests in Personal Property*, 978 (1965)).

II. CONCLUSION

SFAA's arguments in support of Hartford's position are unavailing. The Court should deny Hartford's petition for review.

RESPECTFULLY SUBMITTED this 18 day of February, 2015.

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DECLARATION OF SERVICE

I, Jennifer Fernando, am a legal assistant with the firm of Eisenhower Carlson PLLC, and am competent to be a witness herein. On February 18, 2015, at Tacoma, Washington, I caused a true and correct copy of Columbia State Bank's Answer to Brief of Amicus Curiae Surety & Fidelity Association of America to be served upon the following in the manner indicated below:

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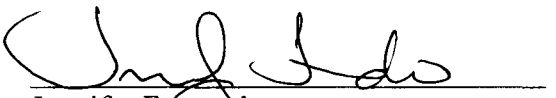
I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 18th day of February, 2015, at Tacoma, Washington.



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