44509-3-II

WASHINGTON STATE COURT OF APPEALS
DIVISION II

FEDWAY MARKETPLACE WEST, LLC, a Washington limited liability company, and GARLAND & MARKET INVESTORS, LLC, a Washington limited liability company, on behalf of themselves and all others similarly situated,

Appellants,

v.

THE STATE OF WASHINGTON,

Respondent.

REPLY BRIEF OF APPELLANTS FEDWAY MARKETPLACE WEST, LLC AND GARLAND & MARKET INVESTORS, LLC

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes

Cases

Other Authorities

I. INTRODUCTION

The State's selective application of I-1183 to the Store Leases was wrongful. I-1183 required the LCB to sell the leases and to auction the right to operate a liquor store upon the premises of each existing state store location. The LCB did neither and asks this Court to excuse its failures as irrelevant. But the provisions in I-1183 that the LCB chose to ignore and violate directly benefit plaintiffs and must be given effect. When the entire law is given effect, it is apparent that the LCB's lease termination was wrongful and in breach of the LCB's duty of good faith and fair dealing. Nor was there any basis for dismissing plaintiffs' alternative constitutional claims for impairment of contract and taking of property. The trial court's orders should be reversed and the case remanded for trial.

II. ARGUMENT

A. The State's Deliberate Misinterpretation of I-1183 is Relevant to the Issue of Lease Termination

The State does not dispute plaintiffs' allegation that the LCB deliberately misinterpreted I-1183 by inventing a Relocation Policy that violated I-1183's express command to auction the right to sell liquor at existing state store locations only. Instead, the State argues that any such deliberate misinterpretation on its part is irrelevant to the issue of lease termination.

The State's position does not bear scrutiny. I-1183 must be read as a whole and effect must be given to all of the language used. The State's position requires the Court to ignore key provisions of the law. When the statute is read as a whole and all provisions are given effect, it is apparent that the State's lease termination was wrongful and that its blatant revision and misinterpretation of the law cannot stand.

1. I-1183 Must Be Read as a Whole

"When we read a statute, we must read it as a whole and give effect to all language used. . . . We give words in a statute their plain and ordinary meaning unless a contrary intent is evidenced in the statute." *State v. Lilyblad*, 163 Wash. 2d 1, 6, 177 P.3d 686, 688 (2008) (citations omitted). Courts try "to give effect to all the language and to harmonize all provisions." *City of Seattle v. Fontanilla,* 128 Wash.2d 492, 498, 909 P.2d 1294 (1996). "Every provision must be viewed in relation to other provisions and harmonized if at all possible." *Rayner v. Neff*, 110 Wash. App. 860, 863, 43 P.3d 35, 37 (2002) (citations omitted).

I-1183 was approved by the voters at the November 8, 2011 general election. The State is relying on one provision of I-1183 – namely, Section 102(2)'s direction to the LCB to close all state liquor stores by June 1, 2012 – to support its

contention that the initiative prevented it from complying with its lease obligations to plaintiffs. (State's Brief at 4-5.) The State asks the Court to look no further and to consider no other provisions of the initiative.

2. I-1183 Required the State to Sell "All Assets," Which Included Store Leases

But Section 102 not only directed the LCB to close state liquor stores, it also required the LCB to sell "all assets of state liquor stores and distribution centers, and all other assets of the state over which the board has power of disposition." Section 102(3) (codified at RCW 66.24.620(3)). Plaintiffs' Complaint specifically alleges that the Store Leases were assets over which the LCB had power of disposition. (Complaint at ¶ 38 [CP 13].) For purposes of the State's motion for judgment on the pleadings, that allegation must be taken as true. *Tenore v. AT&T Wireless Services*, 136 Wash. 2d 322, 330, 962 P.3d 104 (1995).

Thus, for purposes of this Court's review of the trial court's order granting the State's motion for judgment on the pleadings, it must be taken as true that I-1183 required the LCB to sell Store Leases, including the leases the LCB had with plaintiffs. It is undisputed that the LCB did not sell or attempt to sell the leases.

3. I-1183 Required the State to Sell the Right at Each State Store Location to Operate a Liquor Store Upon Those Premises

Section 102 of I-1183 further required the LCB to sell at public auction "the right at each state-owned store location of a spirits retail licensee to operate a liquor store upon the premises." Section 102(4)(c) (codified at RCW 66.24.620(4)(c)) (emphasis added). The same subsection provided that (a) acquisition of the operating rights was a precondition to receiving a license "at the location of a state store" and (b) the operating rights would be freely alienable and "subject to all state and local zoning and land use requirements applicable to the property." (Emphasis added.)

These several provisions make it crystal clear that I-1183 required the LCB to sell and auction the right to operate a liquor store upon – and only upon – the premises of each existing state store location. LCB management freely acknowledged this Existing Location Requirement in internal communications following voter approval of the initiative. LCB management also admitted in testimony that I-1183 contained no provision authorizing a deviation from the Existing Location Requirement or the adoption of a Relocation Policy. (See Opening Brief at 9-14.)

It is thus undisputed, for purposes of this appeal, that (a) I-1183 imposed the requirement that the LCB auction the right to

operate a liquor store upon the premises of each state store location and (b) the LCB altered this requirement.

4. The State's Position Asks the Court to Disregard the Foregoing Provisions

The State asks the Court to endorse its termination of plaintiffs' leases based on the portion of Section 102 that directed the LCB to close state liquor stores. But the State asks the Court to ignore the fact that Section 102 simultaneously required the LCB to sell all Store Leases and to auction the right to operate a liquor store upon the premises of each existing state store location. This selective approach to the statute is not only improper, it violates I-1183. "When we read a statute, we must read it as a whole and give effect to all language used." *State v. Lilyblad*, 163 Wash. 2d at 6.

Section 102 required the LCB to sell the Store Leases and auction the right to operate a liquor store at each existing store location. Given these express directions, the LCB was not free to terminate rather than sell the leases. Further, the LCB was not free to auction the right to operate a liquor store at any location within an arbitrary distance from the existing store locations, rather than upon the existing store location premises themselves. It was not free to revise and remodel the statutory scheme to suit its own purposes and its conduct in doing so is not "irrelevant" to whether

the law provided the predicate for it to terminate the leases. The State cannot pick and choose what portions of the law to implement.

I-1183 must be read in its entirety and all of its provisions harmonized. The LCB itself read the law this way, before it did an about-face and sacrificed the statutorily-protected interests of state store landlords in order to drive higher auction returns. In an internal Auction Issue Paper presented to the Board on February 1, 2012, LCB senior management first acknowledged that I-1183 required the agency to auction the right to sell liquor "at the existing location of each State Liquor Store." [CP 349] Management then went on to recommend that landlords be allowed to "opt out" of leasing to bid winners only where the landlord is contractually prohibited due to restrictions in leases with other tenants. (Id. [CP 350] and see McLaughlin Dep. at 45:25-46:15 [CP 175].) This recommendation was reflected in minutes of a February 2, 2012 meeting stating that the auction team wanted to have a strategy in place to "incorporate information from landlords re: bundling and selling store contents **and lease**." (Meissner Exh. 7 [CP 383], emphasis added.) This recommended approach was also incorporated into the presentation given to landlords. (Lewis Exh. 31 at 456 [CP 451].)

The LCB was therefore poised in February 2012 to implement I-1183 in a way that effected the sale of Store Leases in accordance with Section 102(3) and the auction of liquor rights upon existing store premises in accordance with Section 102(4). Had this planned rollout occurred, the LCB would have been relieved of its lease obligations but the leases would have been sold as assets and would not have terminated, and the law's requirements would have been fully met.

It is thus apparent that the law did not prevent the LCB from complying with or carrying out the terms of the leases; rather, the LCB's own reinterpretation of the law, manufactured out of thin air, is what prevented it from doing so. Appellate action is needed to correct the substantial prejudice caused by the LCB's cavalier disregard of I-1183's express requirements.

B. The State Breached Its Duty of Good Faith When It Terminated the Store Leases

The evidence of the State's bad faith in terminating the Store Leases is compelling and admissible. As noted above, the LCB did not initially contemplate terminating Store Leases; rather, it understood that it was obligated under I-1183 to sell them along with the other assets it controlled. But the LCB was concerned that the law created a "landlord oligarchy" because, as written, the law "give[s] the landlords a lot of control." (McLaughlin Exh. 7 at

3391 [CP 347]; Kohler Dep. at 38:25-39:4 [CP 150].) This "leverage" on the part of landlords, LCB management felt, would "lessen[ ] the value of the license" being auctioned by the State. (McLaughlin Dep. at 24:13-25:2 [CP 172]; McLaughlin Exh. 7 at 3391 [CP 347].)

Regardless of these perceived concerns, the LCB was obligated to implement the law as written. See *ASARCO, Inc. v. Puget Sound Air Control Agency*, 51 Wash. App. 49, 53, 751 P.2d 1229, 1231-32 (1988) ("an agency does not have the power to promulgate rules that amend or change legislative enactments") (citing *Fahn v. Cowlitz County,* 93 Wn.2d 368, 383, 610 P.2d 857 (1980)). The LCB violated this duty when it chose to abandon I-1183's express directives and rejigger the statutory scheme in order to eliminate what it perceived as landlord leverage and drive up auction prices.[1] (See McLaughlin Exh. 17 at 006 [CP 361]: "Allowing for alternate locations could be interpreted as violating the intent of I-1183.") (See also Meissner Exh. 5 at 032 [CP 380]; McLaughlin Dep. at 44:19-45:4 [CP 176-177] (Q: "If the bidder

[1] The agency's concern about "landlord leverage" was unfounded. Had leases been sold and assigned as I-1183 required lease terms would not have changed but landlords would have lost an existing creditworthy tenant experienced in operating a liquor store (the LCB) and received in its place an inexperienced and potentially non-creditworthy substitute tenant. In fact, Fedway's tenant defaulted after two months. [CP 122 at ¶ 5.]

can move the liquor rights to another location, that takes away from the amount of landlord control and gives control to the bidders, do you agree? A: I can see that, yes. Q: And that's what you were referencing here at this February 1st meeting? A: Yes."); and Kohler Dep. at 53:17-19 [CP 154] ("the goal" of the auction was to generate maximum reasonable value).)[2]

Not only did the LCB take it upon itself to alter and violate the statutory scheme, it deliberately kept state store landlords in the dark for more than six months, and the commitments it did make were not honored. After I-1183 passed, LCB Store Leasing Manager Suzanne Lewis began getting calls from landlords. She reported to McLaughlin and Kohler that landlords were "starting to panic" and wanted information, and prepared a letter to send them. (Lewis Exh. 16 at 233 [CP 433].) Her November 2011 draft stated: "The initiative directs the Board to 'sell at auction the right to operate a private liquor store at the location of any existing state liquor store.' We are working at how to implement this direction and we will contact all of our state landlords with further

[2] Under the CR 12(c) standard, the facts in the complaint and all hypothetical facts must be viewed in the light most favorable to the nonmoving party. *M.H. v. Corporation of the Catholic Archbishop of Seattle,* 162 Wash. App. 183, 189, 252 P.3d 914 (2011). Under the CR 56 standard, all evidence and inferences from the evidence must be considered in the light most favorable to the non-moving party. *Atherton Condo. Apartment-Owners Ass'n Bd. of Directors v. Blume Dev. Co.*, 115 Wn.2d 506, 516, 799 P.2d 250 (1990).

information in the near future when we have defined a process." (Kohler Exh. 12 at 462 [CP329].) McLaughlin responded positively, saying "I think this letter is at an appropriate level of detail given what we know and should be sent to officially engage this stakeholder group." (Lewis Exh. 16 at 233 [CP 433], emphasis added.) The next day, however, Lewis' boss Chris Liu stated, "We are not sending a letter to the landlords at this time," and instructed Lewis that in communications with landlords she should "not embellish any other details that have not been defined at this time." (Lewis Exh. 19 [CP 439].) Lewis testified that she later spoke to landlords "[b]ut I couldn't give them any information." (Lewis Dep. at 110:17-19 [CP 225].) Director Kohler confirmed that "the decision to put the brakes on" the letter was hers. (Kohler Dep. at 66:23-25 [CP 161].)

In January 2012, Lewis again tried to send an informative letter to store landlords and was again shot down. (See Lewis Exh. 22 [CP 440]: "Do not disseminate and [sic] written documents or make any verbal statements until Mrs. Kohler approves.") At the Landlord Informational Forum given February 1, 2012, however, the LCB told landlords that "Landlords have the option of allowing their premise to be included in the auction process." (Lewis Exh. 31 at 456 [CP 451].) The LCB also told landlords that "LCB will

pay for remaining unamortized tenant improvement expenses." (Id. at 454 [CP 449].)

This was the state of information until May 15, 2012, when the LCB finally sent an official notice to the landlords. The notice did not say that I-1183 had caused the leases to terminate automatically, as the State now contends. Rather, the notice stated that the LCB "is **exercising its right to terminate** said lease." (Lewis Exh. 26 [CP 441-442], emphasis added.)

Moreover, although I-1183 required the LCB to close all state liquor stores by June 1, 2012 and the State now contends that the leases automatically terminated on that date, in fact the LCB chose to terminate leases on a variety of dates. Some notices advised that the lease would be terminated as of May 31, 2012 (see notice to Fedway [CP 41]); others advised that the lease would be terminated as of July 31, 2012 (see notice to Garland [CP 42]). The termination dates chosen also included June 4, 5, 8, 10, 12 and 30, 2012, and at least 31 were terminated on July 31, 2012. (See Lewis Exh. 4 at right hand column [CP 387-391].)

This answers the State's argument that its termination did not involve discretion. (See Respondent's Brief at 24-25.) Not only did the LCB's own notices of lease termination expressly state that the LCB was "exercising its right" to terminate, the LCB

selected a variety of different dates upon which termination would occur. This was an exercise of discretion on its part, although wrongfully exercised in violation of I-1183's express requirements. The LCB's discretionary exercise of its asserted right to terminate breached its duty of good faith to plaintiffs and other similarly situated state store landlords. See *Wells v. Chase Home Finance, LLC*, 2010 WL 4858252 at *10-11 (W.D. Wash. 2010) (denying motion for judgment on the pleadings as to plaintiffs' claim for breach of duty of good faith and fair dealing based on allegation that defendants violated statutory and contractual duties).

For the same reason, plaintiffs' evidence on this issue is relevant and admissible because it shows how the LCB interpreted its own contract. See *Roats v. Blakely Island Maint. Comm'n, Inc.*, 169 Wn. App. 263, 274, 279 P.3d 943, 948 (2012) (extrinsic evidence of parties' subsequent conduct and respective contract interpretations is admissible). LCB's current attempt to distance itself from the interpretation it adopted in its May 2012 termination notices provides no basis for excluding relevant evidence. The evidence is relevant to determining the meaning of specific terms in the leases: namely, whether I-1183 "prevent[ed]" the LCB from "complying with or carrying out the terms" of the leases and caused them to terminate automatically.

In addition, the State's textual argument lacks consistency. The State argues that I-1183 prevented the LCB from "complying with or carrying out" the terms of the leases, and places much emphasis on the "or carrying out" language. But it also relies on another provision in the same paragraph 3 regarding release from liability "for any damage or loss which may result from *such inability to comply* therewith." (See Brief of Respondent at 33, emphasis added.) Notably, this provision omits the "carrying out" language. If the "carrying out" language means something more than "complying with," however, as the State insists, omitting the "carrying out" language from this provision makes no sense. It would be anomalous to have the release of liability apply only to damage resulting from an "inability to comply" with lease terms but not have it also apply to damage resulting from an "inability to carry out" lease terms. Yet that is the logical extension of the State's argument.

The only interpretation that harmonizes the contract terms is that the "carrying out" language in paragraph 3 adds nothing to the "complying with" language and is mere surplusage. See *Fagan v. Walters*, 115 Wash. 454, 458, 197 P. 635 (1921) ("redescription" of term was "mere surplusage"). This conclusion is strengthened when it is remembered that the leases included no covenant of

continuous operation by the LCB and such restriction cannot be implied. See *Fuller Market Basket, Inc. v. Gillingham & Jones, Inc.*, 14 Wash. App. 128, 134, 539 P.2d 868 (1975).

The LCB's lease termination notices did not give landlords the option of including their lease and premises in the auction process, although at the Landlord Informational Forum the LCB told landlords this would occur. Nor did the notices to plaintiffs offer to pay unamortized tenant improvement expenses, again as the LCB said would occur. This is further evidence of a lack of good faith – and of an interpretive about-face – on the part of the LCB.

The State also contends that plaintiffs' request for relief is barred because they did not bring an action under the APA. (See Brief of Respondent at 6, 10 n.6, 26 n.17.) The State's argument ignores RCW 34.05.010(3), which excludes from the definition of "agency action" subject to APA review "the . . . lease . . . of real estate, as well as all activities necessarily related to those functions . . . ." Thus, the LCB's actions with respect to plaintiffs' leases did not constitute agency action subject to judicial review under the APA. Further, RCW 34.05.510 makes clear that the APA's provisions for review of agency action "do not apply to litigation in which the sole issue is a claim for money damages or

compensation and the agency whose action is at issue does not have statutory authority to determine the claim." The State's APA argument is a red herring.

There are genuine issues of material fact as to whether the LCB breached its duty of good faith and fair dealing in terminating plaintiffs' leases. The trial court erred in holding otherwise.

C. Plaintiff's Alternative Claims for Impairment of Contract and Taking Should Not Have Been Dismissed

Even though the trial court itself noted that "I haven't seen briefing on the constitutional claims" the State was asking it to dismiss (RP 35:17-18), the State contends that the court's dismissal of those claims was proper. The State is mistaken; the absence of briefing alone warrants reversal of the court's dismissal of these claims. See *State v. Chichester*, 141 Wn. App. 446, 462, 170 P.3d 583 (2007) (review of dismissal "hampered" by absence of briefing in lower court). Reversal is also justified on the merits.

I-1183 did not provide for or direct the termination of state store leases. To the contrary, it expressly directed the LCB to sell the leases and to auction the right to operate liquor stores upon the leased premises, both of which directives the LCB rescinded by executive fiat and failed to implement.[3] The State ignores these

[3] The LCB provided no public notice of rule-making when it abandoned the Existing Location Requirement in I-1183, abandoned the directive to

express statutory requirements again in arguing that the LCB's lease termination was permissible and that no impairment of contract or taking of property occurred.

1. Plaintiffs' Contract Claim Should be Reinstated

> "No ... law impairing the obligations of contracts shall ever be passed." Wash. Const. art. 1, § 23. This provision is substantially similar to its federal counterpart: "No state shall ... pass any ... law impairing the obligation of contracts". U.S. Const. art. 1, § 10. The two clauses are given the same effect. *Washington Fed'n of State Employees v. State,* 101 Wash.2d 536, 539, 682 P.2d 869 (1984).

Birkenwald Distrib. Co. v. Heublein, Inc., 55 Wash. App. 1, 5, 776 P.2d 721, 723 (1989)

A three-part test is used to determine if there has been impairment of a public contract: "(1) does a contractual relationship exist, (2) does the legislation substantially impair the contractual relationship, and (3) if there is substantial impairment, is it reasonable and necessary to serve a legitimate public purpose." *Pierce County v. State*, 159 Wn.2d 16, 28, 148 P.3d 1002 (2006) (citation omitted). Moreover, "when a state interferes with its own contracts, those impairments 'face more stringent examination under the Contract Clause than would laws regulating

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sell "all assets," and invented a Relocation Policy for which there was no support in the initiative.

contractual relationships between private parties.'" Id. (citation omitted).

The State contends in its brief that I-1183 prevented it from complying with or carrying out its obligations under the leases. Plaintiffs disagree with that contention, for the reasons set forth in their opening and this reply brief. The leases did not terminate automatically by their own terms, as the State now contends. They *were terminated by* the LCB when it gave notice stating that it was "exercising its right to terminate" and selected various dates on which terminations would be effective. I-1183 instead directed the LCB to sell the leases and to auction the right to operate liquor stores upon the leased premises, but the LCB elected to violate I-1183 by not fulfilling either of these directives.

If the LCB's decision to abandon the statutory requirements and terminate the leases is nonetheless approved by the Court as consistent with I-1183, then plaintiffs' contract rights have been substantially impaired by the law. Parties are deemed to contract in reliance on existing law. *Vine St. Commercial Partnership v. City of Marysville*, 98 Wash. App. 541, 550, 989 P.2d 1238, 1243 (1999). And, when a party contracts in a regulated field, the party is "deemed to have 'purchased subject to further legislation upon the same topic.'" *Birkenwald Distrib. Co. v. Heublein, Inc.*, 55

Wash. App. at 7. Plaintiffs have a right to rely on the law – here, the provisions in I-1183 that directly protect their interests by requiring the State to sell the leases and to auction the right to operate liquor stores upon leased premises only.

"[W]hen the State impairs its own contracts, the reviewing court must apply an independent analysis to determine if the impairment was 'reasonable and necessary.'" *Carlstrom v. State*, 103 Wash. 2d 391, 394, 694 P.2d 1, 4 (1985) (citing *United States Trust Co. v. New Jersey,* 431 U.S. 1 (1977). Given I-1183's directive that the LCB sell all assets (including store leases) and auction the right to operate liquor stores upon existing state store premises, it was neither reasonable nor necessary for the State to terminate the Store Leases.

Section 303 of I-1183 specifically directed the Department of Revenue to "develop rules and procedures to address claims that this act unconstitutionally impairs any contract with the state and to provide a means for reasonable compensation of claims it finds valid, funded first from revenues based on spirits licensing and sale under this act." (Appendix 1 at 60.) No such rules and procedures were ever developed. (Kohler Dep. at 70:4-71:13 [CP 162].) The Court should reject the State's invitation to deprive plaintiffs of a

remedy expressly contemplated by I-1183. Plaintiffs' claims for impairment of contract should be reinstated.

2. Plaintiffs' Takings Claim Should Be Reinstated

Agency regulation may constitute a taking "if it 'goes beyond preventing a public *harm* [to] actually enhance [ ] a publicly owned right in property.'" *Sintra, Inc. v. City of Seattle*, 119 Wash. 2d 1, 14, 829 P.2d 765 (1992) (citing *Presbytery of Seattle v. Seattle*, 114 Wash. 2d 320, 329, 787 P.2d 907 (1990) (emphasis in original)). Here, the LCB enhanced public ownership of the liquor rights it was directed to sell at auction by diminishing the property rights of state store landlords.

The LCB understood that it was a zero sum game and that, in order to increase the value of the rights being sold to bidders at auction, it had to reduce the value of the rights retained by the landlord stakeholder group. (See McLaughlin Dep. at 44:19-45:4 [CP 176-177] (Q: "If the bidder can move the liquor rights to another location, that takes away from the amount of landlord control and gives control to the bidders, do you agree? A: I can see that, yes. Q: And that's what you were referencing here at this February 1st meeting? A: Yes.").)[4]

[4] The trial court's order striking this evidence was error. (See Notice of Appeal [CP 540-545].)

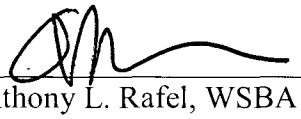
The evidence shows that the LCB took away rights conferred on landlords by I-1183 for the purpose of enhancing the rights it was selling at public auction. The record also shows that this strategy generated what LCB Chair Sharon Foster said was "a $32 million windfall for the state." (Marr Exh. 13 [CP 289].) That windfall was obtained by stripping plaintiffs and other state store landlords of their rights under I-1183. Plaintiffs should be allowed to pursue their proper remedies: either invalidation of I-1183 or just compensation. (See Complaint, Prayer for Relief ¶¶ B & C [CP 18].)

III. CONCLUSION

The trial court's orders should be reversed and the case remanded for trial.

DATED: November 4, 2013.

RAFEL LAW GROUP PLLC

By 

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44509-3-II

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CERTIFICATE OF SERVICE

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The undersigned hereby certifies as follows:

1. I am over 18 years of age and a U.S. citizen. I am employed as a legal assistant by the law firm of Rafel Law Group PLLC.

2. I certify that on Monday November 4, 2013, I caused a copy of the following documents to be served via the method(s) listed below on the following parties:

DOCUMENTS

1. Reply Brief of Appellants Fedway Marketplace West, LLC and Garland & Market Investors, LLC; and
2. Certificate of Service.

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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 and that this certificate was executed on November 4, 2013, at Seattle, Washington.

Leah Katzer, Legal Assistant