No. 45320-7-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

HARTFORD FIRE INSURANCE COMPANY, a Connecticut corporation,

Plaintiff/Appellant,

v.

COLUMBIA STATE BANK, a Washington banking corporation,

Defendant/Respondent.

APPEAL FROM THE SUPERIOR COURT
FOR PIERCE COUNTY
THE HONORABLE GAROLD E. JOHNSON

REPLY OF APPELLANT

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I. INTRODUCTION

Columbia Bank's (the "Bank") Brief in opposition to Hartford's Appeal is entirely based on the false premise that the law set forth in *Westview Investments Ltd. v. U.S. Bank*[1] is not controlling in this case. The Bank fruitlessly attempts to distinguish *Westview* through irrelevant factual distinctions, while arguing that this Court should follow case law from other jurisdictions that involve significantly different factual circumstances. The Bank also asks the Court not to follow the applicable law set forth in *Levinson v. Linderman*[2], likewise in favor of distinguishable case law from other jurisdictions.

The Bank's motives for disregarding the applicable, controlling law are simple to discern when that law is applied to the facts of the case. Under the law of *Westview*, the Bank had a duty to inquire as to whether the funds were trust funds prior to sweeping the funds for its own benefit. Also, pursuant to *Levinson*, Hartford had an equitable lien on those funds, such that the funds could not be assigned to the Bank through any agreement with the Waka Group, Inc. ("Waka"). To put it another way, the Bank's entitlement to the funds was dependent on Waka having proper entitlement to the funds. As Waka, through its General Indemnity Agreement with Hartford, did not have the right to the funds, the Bank could not

[1] 133 Wn.App. 835, 138 P.3d 638 (2006).
[2] 51 Wn.2d 855, 862, 322 P.2d 863 (1958).

lawfully sweep the funds from Waka. Therefore, the Bank's sweep was improper and Hartford is entitled to the funds.

II. ARGUMENTS IN REPLY

1. *Westview* is the Controlling Law for This Case.

Westview Investments Ltd. v. U.S. Bank[3] is the only Washington case that addresses a bank's ability to sweep funds from a contractor's account that should be held in trust by the contractor. This is precisely the issue currently before the Court. Despite this fact, the Bank argues that *Westview* is irrelevant because it did not involve a surety.

The Bank's attempt to distinguish *Westview* is unavailing. *Westview* is controlling in this case and the Bank makes no effort to reconcile the *Westview* holding with the Ninth Circuit's decision in *Reliance Ins. Co. v. U.S. Bank of Wash., N.A.*,[4] – which was decided eight years prior to *Westview*. The Bank argues that *Westview* should not apply because that case did not involve a surety and because the plaintiff-project owners sought to recover the funds after they had already paid the subcontractors and suppliers the funds were intended to benefit. The first point is irrelevant to the *Westview* decision, which turned on whether the contracts between the general contractor and plaintiff-project owners created a trust and whether U.S. Bank should have inquired

[3] 133 Wn.App. 835, 138 P.3d 638 (2006).
[4] 143 F.3d 502 (9th Cir. 1998).

into the nature of the funds prior to sweeping the account.[5] The decision makes no special distinction based on the plaintiffs' position as project owners. What the court focused on was that the language of the contract required the contractor to hold contract payments in trust for the benefit of subcontractors and suppliers who worked on the project. The issue is not determined by the status of the parties, as an owner, surety, or otherwise, but is determined based on whether a trust is created and for whose benefit.

The second point raised by the Bank is confounding, as the facts of the instant case are identical to *Westview* in that the subcontractors and suppliers were not paid until after the sweep occurred. In *Westview*, U.S. Bank continuously swept the account, as such the subcontractors were not paid by the general contractor, and the project owners who subsequently paid the subcontractors brought suit against the bank.[6] Thus, the funds were swept *before* the project owners directly paid the subcontractors and *before* U.S. Bank had actual notice that the funds should have been held in trust. Therefore, the Bank's argument that *Westview* is distinguishable because the funds were swept before Hartford paid out money on the Project has no merit, as that is precisely what occurred in *Westview*. Further, the Bank's focus on the timing of the

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[5] 133 Wn.App. at 846.
[6] *Id.*

sweep is a red herring, as the timing is simply not a factor in the evaluation set forth in *Westview*. The key is that Hartford did sustain losses caused by the Bank's improper seizing of funds that should have been held in trust for the benefit of Hartford and Waka's subcontractors and suppliers.

2. An Express Trust was Created by the GIA and the GSA Contract.

"An express trust is one created by the act of the parties; and where a person has, or accepts, possession of money, promissory notes, or other personal property with the express or implied understanding that he is not to hold it as his own absolute property, but to hold and apply it for certain specified purposes, an express trust exists."[7] The language of the contract determines whether the parties created an express trust.[8] The Restatement (Third) of Trusts § 10(e) states that a trust may be created by a promise "that creates enforceable rights in a person who immediately or later holds those rights as trustee, or who pursuant to those rights later receives property as trustee"[9]

Waka's General Indemnity Agreement ("GIA") with Hartford states:

> Trust Fund. If a Bond is Underwritten in connection with the performance of any contract, the entire contract price shall be

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[7] *Westview Investments Ltd. v. U.S. Bank*, 133 Wn.App. 835, 845-846, 138 P.3d 638 (2006)
[8] *In re Washington Builders Ben. Trust*, 173 Wn.App. 34, 58, 293 P.3d 1296 (2013).
[9] RESTATEMENT (THIRD) OF TRUSTS § 10(e).

> dedicated to the satisfaction of the obligations of the Bond and this Agreement. All money paid or any securities, warrants, checks or evidences of debt given under contracts relating to or for which a Bond has been issued ***shall be impressed with a trust for the purpose of satisfying the obligations of the Bond Underwritten for said contract and this Agreement and shall be used for no other purpose until all such obligations have been fully satisfied.***[10]

The plain language of the GIA undeniably expresses the intent of Hartford and Waka to create an express trust. The GIA is a legally enforceable agreement, the validity of which has not been raised or questioned by any party. The Bank's argument concerning the applicability of the GIA stems from the fact that it was created prior to Waka's contract with the GSA and, therefore, is purportedly not a valid trust because it involves a "future interest."[11] The Bank further argues that there is no evidence that supports the premise that Waka intended to create a trust. This argument is inaccurate, not supported by the evidence, and is premised on the faulty

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[10] CP 67-77.

[11] With regard to the Restatement (Third) of Trusts § 41, relied on by the Bank, this section is focused on circumstances where there is an expectation to receive property through a future occurrence such as intestate succession. This section does nothing more than create an exception for "promises to create a trust in the future," i.e. an "agreement to agree." Further, §10, Comment *g*, of the Restatement provides:

> If, however, a person makes or causes to be made an enforceable promise to pay money or transfer property to another as trustee, and if the person (with the expressed or implied acceptance of the intended trustee) also manifests an intention immediately to create a trust of the promisee's rights, ***a trust is created at the time of the contract***, with a *chose in action* (the rights under that contract) then being held for the beneficiaries by the trustee.

Therefore, under the Restatement, an enforceable trust was created when the GIA was executed.

assumption that the GIA itself and Waka's execution of the document is not evidence in itself.

Notably, the Bank does not even attempt to address whether Waka's contract with the GSA also created a trust on the funds. The GSA contract incorporated Federal Acquisition Regulation 52.232-5, which specifically mandated Waka to certify to the government with each request for payment:

> All payments due to subcontractors and suppliers from previous payments received under the contract, and **timely payments will be made from the proceeds of this payment** covered by this certification, in accordance with subcontract agreements and the requirements of Chapter 39 of Title 31, United States Code[.][12]

Thus, based on its contract with the GSA, Waka had a specific commitment to hold the payment from the GSA in trust for obligations to Waka's subcontractors and suppliers on the Dalton Project. Accordingly, an express trust also existed under Waka's GSA contract.

The Bank also makes no effort to reconcile its arguments with *Westview*, where the court specifically found a trust was created and the intention of the parties was evidenced by the plain language of the contract. The *Westview* court stated:

> The contract language evinces an express understanding on the part of the general contractor that it is not to hold the progress payments as its own absolute property, but to hold and apply them for certain specified purposes, that is, for the benefit of the subcontractors. Under Washington law,

[12] CP 295-348 (emphasis added).

> therefore, an express trust is created by the contract language.[13]

Similarly, in *Washington Builders* the court found an express trust was created by contract language that required one party to accept funds on another's behalf and to hold those funds and apply them to a specific purpose.[14] In making this finding and upholding the same finding from the trial court, the court rejected arguments that there was evidence that the parties did not intend an express trust to be created and stated:

> That the individual Participants, in their responses to deposition questions, denied their intent to create a trust has no bearing on the trial court's finding that the enrollment agreements created an express trust ***because the Participants' intent to create the trust was embodied in the enrollment agreements***. Thus, on summary judgment the trial court properly found that the enrollment agreements were valid trust instruments. Accordingly, the ROII enrollment agreements created an express trust.[15]

Based on the law set forth in *Westview* and *Washington Builders*, no other evidence beyond the GIA is needed to find that Waka and Hartford intended to, and actually did create, an express trust at the time the parties entered into the GIA. However, the Bank still argues there is a lack of evidence of Waka's intent to create a trust. In making this argument the Bank ignores the plain language of the GIA, as well as the letter Waka sent to the GSA on June 21, 2012

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[13] *Westview* at 847.
[14] *Washington Builders,* 173 Wn.App.at 58.
[15] *Id.* at 62. (Emphasis added.)

directing the GSA to forward all payments directly to Hartford.[16] The letter specifically acknowledges that the direction is "in accordance with our agreement covering certain arrangements made between the undersigned and Hartford Casualty Insurance Company."[17] Further, during his deposition, Waka President Andrew Wilson testified the purpose of this letter was to prevent the funds that should properly go to Hartford from being deposited in Waka's bank account:

> Q [by Ms. Tavella]: And can you describe what the purpose of the letter was?
>
> A [by Mr. Wilson]: It was just to advise Sue Saucier [GSA Contracting Officer] that Hartford was basically taking over the completion of this contract and the future funds that were going to be paid to this contract be paid to the Hartford because Columbia had UCC-1 filing on Waka Group.[18]

Mr. Wilson plainly acknowledged Hartford's right to the Project funds and specifically attempted, pursuant to the GIA and the Bond, to ensure that Hartford would receive those funds. Both the June 21, 2012 letter and Mr. Wilson's testimony establish that Waka understood its obligations under the GIA and intended the payment to be sent to Hartford.

3. The Bank Had a Duty to Inquire About the Funds.

The Bank's transparent attempts to minimize its knowledge of Waka's business and the nature of the funds are unconvincing. For

[16] CP 380.
[17] *Id.*
[18] CP 100 at 14 ln. 12-17.

example, the Bank argues that it did not know Hartford had issued specific bonds to Waka or whether the Dalton Project was a bonded project. At the same time, the Bank does not deny that it knew Waka was a general contractor who used subcontractors and suppliers on every project[19], nor does the Bank deny it was aware the Dalton Project was being performed for the Federal Government. Construction bonds are universally required on public construction projects. Similarly, the Bank maintains it was not aware whether there were unpaid subcontractors or suppliers on the Project. However, the Bank knew full well that Waka would not be able to complete its ongoing Projects once the Bank stopped extending Waka's line of credit.[20]

The Bank's carefully choreographed dance regarding its knowledge of the situation mirrors the Bank's actions prior to the sweeping of the funds. While the Bank had every reason to know that the Dalton Project was a bonded Project and that the Project involved Waka's suppliers and subcontractors – it failed to make any inquiry prior to sweeping the contract funds.

It is significant that the Bank was aware as of June 18, 2012 that Waka would not be completing its contracts.[21] The Bank's arguments regarding a surety's right to contract funds ignore that default by the contractor is the precondition to the assertion of the

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[19] CP 98 at 7, ln. 13-15.
[20] CP 185 at 27, ln. 22-24.
[21] *Id.*

surety's rights and of the equitable claim of the subcontractors and suppliers. That is, as long as the contractor abides by its contractual commitments to use contract funds to pay contract obligations, the surety has no basis to object to its payments. Here, the Bank knew Waka was in financial difficulty and not meeting its obligations. Indeed, that is why the Bank made the set off. The Bank acted in an attempt to get itself to the head of the line in front of the subcontractors and suppliers whose work earned the progress payment.

The Bank's attempt to "bury its head in the sand" and act as if it had no way of knowing the trust fund nature of the swept proceeds is precisely why the *Westview* court included a duty to inquire in its holding – as otherwise the Bank could easily avoid obtaining "actual knowledge" the funds were trust funds. The Bank was fully aware of: (1) the nature of Waka's business as a general contractor; (2) Waka's continuing obligations to subcontractors and suppliers; and (3), through its audit of Waka's financial records, the process in which Waka paid its subcontractors and suppliers. At the very least, the Bank had enough information to put it on inquiry notice regarding the nature of the funds received from a federal government project. Like in *Westview*, the Bank's access to and evaluation of Waka's records should have made it apparent that payments received from the GSA were trust funds that Waka would use to pay its subcontractors and suppliers. A bank is denied the

right to set off "where it lacks actual knowledge or notice that the sums belong to a third person, but has knowledge of the circumstances sufficient to necessitate inquiry concerning the sums."[22] The Bank failed in its duty to inquire as to the nature of the funds and, as such, the sweeping of the GSA payment was wrongful.

There is no dispute between the parties regarding the Bank's knowledge that Waka was a general contractor who always used subcontractors and suppliers and that the Bank was also aware the Dalton Project was for the federal government. Under *Westview* this should be sufficient to determine that the Bank had a duty to inquire. However, if *Westview* is disregarded and the Bank's entitlement to these funds is entirely based on an "actual knowledge" standard, then this is a question of fact that should be remanded to the trial court and additional discovery permitted to determine what the Bank actually knew when the deposit was made. Discovery on this issue was not conducted prior to summary judgment, as it was not required under the holding of *Westview*. Such additional inquiry should be permitted if an "actual knowledge" standard is imposed.

4. Whether the Funds were a "General" Versus a "Special" Deposit is Not a Separate Issue.

The Bank's arguments regarding whether the funds were a

[22] *Westview* at 849.

"general" or a "special" deposit are merely an attempt to distract from the true issue – whether the Bank should have inquired prior to sweeping the funds. Essentially, the question of whether the funds were trust funds and whether the deposit was "special" is the same evaluation. The Bank cites to the factually distinguishable case *Sterling Savings Bank v. Air Wisconsin Airlines Corp.*[23] support its argument. But as set forth in *Sterling*, relying on *Westview*, the question is whether the Bank ***should have known*** that the deposit was made for a special purpose, i.e. whether the funds were tendered in trust.[24] Thus, the evaluation of whether the funds were trust funds is the same evaluation to determine if the funds should be considered a "special" deposit. As explained in the previous section, and further below, the Bank had adequate knowledge to inquire and determine whether the funds should have been set aside for the specific purpose of paying Waka's subcontractors and suppliers.

The Bank argues that at the time it seized the funds it was not aware that Hartford claimed an interest in the money or whether any subcontractors or suppliers were unpaid at that time. But, this is not the standard discussed by the *Westview* court.[25] As explained in the prior section, the Bank possessed more than

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[23] 492 F.Supp.2d 1256 (E.D. Wash. 2007).
[24] 492 F.Supp.2d at 1261.
[25] The Bank need only have "knowledge of circumstances sufficient to necessitate inquiry concerning the sums." *Westview* at 850 (*citing Change v. Redding Bank of Commerce*, 29 Cal.App.4th 673, 35 Cal.Rptr.2d 64 (1994)).

enough knowledge to give rise to its duty to inquire into the nature of the funds prior to sweeping the funds for its own benefit. Therefore, the Bank's failure to determine the deposit was "special" was caused by the Bank's own willful ignorance.

Moreover, placing a duty to inquire on the Bank, as the court did in *Westview*, provides a commonsense approach to this issue. In contrast, the *Reliance* holding only serves to encourage banks to be purposefully ignorant in similar situations. *Reliance*, which only requires "actual knowledge" by the bank and does not discuss a duty to inquire, provides no incentive to banks to inquire as to the nature of funds – even if the bank has every indication the funds are trust funds. Essentially, the Bank's position is that as long as a bank can deny actual knowledge of a trust, it is entitled to sweep any funds in the contractor's account for its own benefit. Therefore, banks have absolutely no incentive to ascertain the nature of funds prior to conducting a sweep and, in fact, the bank's entitlement to the funds is created by its own purposeful ignorance of the nature of the funds. This result is both absurd and inequitable.

5. There is No Evidence the Account was Swept "Regularly."

The Bank's brief makes much of the fact that the Bank had swept Waka's account prior to June 21, 2012. This fact has little significance under *Westview*, as U.S. Bank had been sweeping the contractor's account in that case for months with no indication from any party that the funds should have been held in trust. However, in

order to clarify the record, it is worth noting that the only evidence on this question in the present case is a two-page statement of account for Waka's collateral control account for June 2012.[26] Contrary to the Bank's repeated assertions that Waka's account had been swept "regularly", the statement of account only reflects one sweep prior to June 21 on June 19, 2012 for the amount of $2,940.[27] In fact, the statement shows that Waka received a payment from the GSA on June 4, 2012 and that same day the payment was transferred to Waka's checking account for Waka's use. As stated above, the frequency of the Bank's account sweeps is not relevant to the issue under *Westview*. But to the extent the Court does consider this to be a pertinent fact, the record should accurately reflect the evidence, which only shows one sweep prior to June 21, 2012 of an amount that is 35 times smaller than the amount currently in dispute.

6. Hartford is Also Entitled to the Funds by its Right of Subrogation.

Contrary to the Bank's assertion, Hartford has not altered its position that its entitlement to the funds is also supported by the doctrine of equitable subrogation. The Bank's arguments to the contrary represent a misunderstanding of the rights of subrogation.

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[26] CP at 247-248. Waka's loan with the Bank did not mature until May 30, 2012, thus the account was not swept prior to June 2012.

[27] In addition to the statement of account, which only reflects one sweep prior to June 21, 2012, the Bank supports this assertion by citing to the Verbatim Report of Proceedings, which is not evidence.

Subrogation allows the surety to stand in the shoes of one or more other parties to a transaction. That is, the surety pays a debt which in equity and good conscience should have been paid by someone else (in this case, Waka), and in return the surety can then stand in the shoes of the party it paid and the party who should have paid. The rights the surety asserts are the rights formerly held by the subrogor. Thus, it does not matter when the surety paid the subcontractors and suppliers whose work earned the progress payment that GSA mistakenly released to Waka's account at the Bank. The priority right or equitable lien on the fund belonged to the subcontractors and suppliers, who possessed the interest on the date the Bank swept the funds. The date when the surety paid the subcontractors and suppliers, and thus succeeded to their interest, is irrelevant.

The Bank supports its arguments regarding Hartford's right to subrogation by citing distinguishable cases from other jurisdictions. Further, the Bank's arguments regarding the applicability of the prevailing Washington law, as set forth in *Levinson,*[28] are unavailing. The Bank argues that *Levinson* should not apply because the case involved retained funds versus progress payments. The Bank fails, however, to provide any explanation as to how such a difference would have altered the court's holding. As

[28] 51 Wn.2d 855, 862, 322 P.2d 863 (1958)

explained below, this minor factual difference is insignificant and this argument has been routinely rejected by courts.

Levinson involved funds that were the unpaid contract balance for a contract that was completed by the surety upon the contractor's default and not funds specifically retained by the owner for potential claims.[29] *Levinson* establishes that, in Washington, a surety that completes a contract for a defaulting contractor has an equitable lien and right of subrogation to the project funds. The Bank makes no effort to reconcile the *Levinson* court's statement that: "Assignees of a contractor of funds to be earned in public work take with notice of the terms of the contract and of the undertaking of the contractor's surety."[30] The court further stated:

> It is a well settled doctrine that, where the sureties on a contractor's bond complete the contract on his abandonment of it, they stand in the position of the owner of the property to which the contract relates, to the extent at least that they are entitled to sufficient of the money to be paid on the contract to save themselves from loss on their contract of suretyship, and the contractor cannot make a valid contract, by assignment or otherwise, the effect of which is to deprive the sureties of this right.[31]

Thus, under *Levinson*, the agreements between Waka and the Bank cannot override Hartford's right to recover the Project funds.

The Bank appears to argue that its entitlement to the funds is somehow supported by the fact that Waka signed its agreements

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[29] 51 Wn.2d at 858.
[30] *Id.* at 860.
[31] *Id.* at 862 (emphasis added).

with the Bank one day after executing the GIA. To the contrary, if this timing argument bolsters either party's position, it is that of Hartford and not the Bank. The agreements and commitments set forth in the GIA, including the establishment of any bonded project funds as trust funds and the assignment of all rights to such funds to Hartford, could not be altered without a written modification signed by Hartford.[32] No modification of Hartford's rights under the GIA was ever made. Accordingly, any agreements made between Waka and the Bank could not possibly override the terms of the GIA.

The Bank's arguments confuse Hartford's right to the funds with Hartford's right of enforcement. The Bank argues that Hartford did not have a right to enforce its equitable lien when the funds were deposited. But as established in *In re Massart*, 105 B.R. 610 (W.D. Wash. 1989), a surety's equitable lien on the project funds is *created* when the payment and performance bonds were issued for the project and the lien becomes *enforceable* once the surety suffers a loss.[33] It is undisputed that Hartford suffered losses caused by Waka's default on the Dalton Project. Hartford did not initiate the instant case until these losses had been incurred. The Bank's position that the right of enforcement had to exist on June 21, 2012 in order to have a claim to the funds, is not supported by

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[32] CP 67-77.

[33] *In re Massart*, 105 B.R. at 612.

the applicable law. Hartford's equitable lien on the funds was created when Waka entered into a contract with the GSA and, therefore, already existed on June 21, 2012. As such, Hartford had a superior right over those funds on the date they were swept by the Bank. Simply put, the question of enforcement is a non-issue as Hartford did not seek to enforce its lien until January 2013, well after it had assumed Waka's obligations and sustained associated losses.

7. The Bank Relies on Cases That Are Not Controlling Or Persuasive.

Much of the Bank's brief is spent citing cases from other jurisdictions that are distinguishable from the instant case. Additionally, the Bank fails to explain why these cases should be followed over established Washington law. The main failing of these cases is that they involve situations where the contractor's default occurred well after the payment at issue was made to the creditor.

As an initial matter, the Bank continuously attempts to make a distinction between contract funds that are specifically retained by the owner versus an earned progress payment based on *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962), however this argument has been rejected by numerous courts. As explained by the Court of Claims:

> Secondly, it has often been recognized that a surety's claim to the unpaid contract balance is not limited to the 10

> percent retainage as the third-party defendant Boulevard State Bank contends. *See, e.g., Argonaut Insurance Co. v. United States*, 434 F.2d at 1369-1370, 193 Ct.Cl. at 496-497; *Framingham Trust Co. v. Gould-National Batteries, Inc.*, 427 F.2d 856, 857 (1st Cir. 1970); *National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*, 411 F.2d 843, 848-849 (1st Cir. 1969); *In re Dutcher Construction Corp.*,378 F.2d 866, 869-871 (2nd Cir. 1967); *Reliance Insurance Co. v. Alaska State Housing Authority*, 323 F.Supp. 1370, 1373 (D. Alaska 1971); *National Surety Corp. v. United States*, 319 F.Supp. 45, 49-50 (N.D. Ala.1970). Here, the surety's monetary obligation to the laborers and materialmen exceeded the total unpaid balance on the contract (including the retainage) and the plaintiff has priority over the assignee for the entire contract balance.[34]

The other arguments relied on by the Bank are similarly unpersuasive, as the cases the Bank relies on are wholly distinguishable from the instant dispute. For example, in *American Cas. Co. of Reading, Pa. v. Line Materials Industries*, 332 F.2d 393 (10th Cir. 1964) the owner paid the contractor directly on February 5, 1960 and then the contractor made a payment to a creditor on February 12, 1960.[35] As of February 12, 1960 the contractor had not breached any of its contracts.[36] The court stated:

> As long as the contractor is performing as agreed, the owner must pay as agreed; and the sureity [sic] has no right, by subrogation, that the payments shall be withheld. After breach by the contractor, the situation changes.[37]

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[34] *Great American Insurance Co. v. United States*, 492 F.2d 821, 825-826 (Ct.Cl. 1974).
[35] 332 F.2d at 394.
[36] *Id.*
[37] *Id.* at 395 (emphasis added).

The Bank relies on several other cases that discuss rights of subrogation and priority of a surety's equitable lien in various scenarios, but, again, these cases involve factually distinguishable situations where the default occurred after the funds were received and the creditors who received the funds had no reason to know the funds should have been held in trust. It is for this reason that the Bank cannot rely on *Reliance Ins. Co. v. U.S. Bank of Wash., N.A.*, 143 F.3d 502 (9th Cir. 1998), as the court in that case did not evaluate whether the bank should have known the funds received should have been held in trust. These cases are inapplicable because Waka was unquestionably in default prior to June 21, 2012 when the Bank swept the project funds. Further, the Bank does not provide any basis, other than irrelevant factual distinctions, as to why *Reliance* should be followed instead of *Westview* – particularly in light of the fact that *Reliance* was decided eight years before *Westview* when there was no Washington law for the Ninth Circuit to follow.

Similarly, the Bank's reliance on *California Bank v. U.S. Fidelity & Guaranty Co.*, 129 F.2d 751 (9th Cir. 1942) is misplaced. *California Bank* involved a situation where the contractor had completed the contract, but had failed to fully pay its suppliers and subcontractors who were paid by the surety. The contractor received a partial payment of retainage funds (not a progress payment) from the owner and then used a portion of that amount as

payment to a bank for partial repayment of a loan.[38] There was no issue with the bank sweeping the funds and, as the payment specifically came to the bank from the contractor, there was no issue as to whether the bank should have known another party may have a superior right to the funds.[39] The Bank's reliance on *Bank of Arizona v. National Surety Corporation*, 237 F.2d 90 (9th Cir. 1956) fails for the same reasons as that case also involved a contract that was completed by the contractor, rather than the surety, and the court's ruling was entirely based on its prior ruling in *California Bank*.[40]

Finally, the Bank offers no reasonable explanation as to why these cases should be followed, particularly given the numerous factual differences, rather than the law in Washington established by *Westview* and *Levinson*.

8. Hartford's Conversion Claim is Valid and Supportable.

Conversion is the act of willfully interfering with any chattel, without lawful justification, whereby any person entitled thereto is deprived possession of it.[41] Conversion can occur when money is wrongfully received or when the party charged with the conversion is under obligation to return the money to the person claiming it.[42] In *Westview*, discussed above, the court held there was sufficient

[38] 129 F.2d at 754.
[39] *Id.* at 755.
[40] 237 F.2d at 96.
[41] *Westview*, supra, at 852.
[42] *Id.*

evidence to support the claim of conversion, though a question of fact existed in that case regarding damages.

In the present case, the Bank received funds that it knew or should have known should be held in trust for the benefit of others. The only reason the Bank received these funds is because the Project owner, the GSA, was not able to stop payment on the transfer of the funds. Accordingly, the Bank's receipt of the funds was wrongful, as the GSA did not intend for the funds to be transferred following Waka's default. Even if it could be argued that Bank's receipt of the funds was not wrongful, the Bank had an obligation to return the funds when it learned of Hartford's superior interest in the funds.

The Bank's argument against Hartford's conversion claim is premised on the Bank's position that Hartford has no legitimate right to the funds either as trust funds, under Hartford's equitable lien, or under Hartford's right of subrogation. As explained above, the Bank's position is meritless and, therefore, its arguments against the conversion claim also fail. The Bank has willfully retained possession of funds to which it has no legal right; hence, the elements of conversion have been satisfied. Lastly, unlike in *Westview* there is no question of fact as to whether Hartford has been damaged by the Bank's actions. It has expended considerable funds completing the Project, without the benefit of

the payment the Bank has wrongfully retained.[43] Moreover, there is no dispute as to the amount of Hartford's damages, which is simply the $103,410.00 in Project funds that were included in the Bank's sweep.

9. The Balancing of Equities Entails Judgment in Hartford's Favor.

As the Bank's main arguments for its entitlement to the funds are predicated on distinguishable, out-of-state cases, the Bank also attempts to argue that it should be permitted to retain the funds based on equitable principles. The main problem with this argument is that it falsely presumes that the Bank and Hartford are similarly situated with regard to which party is entitled to the funds. Also, in maintaining this position, the Bank misrepresents itself as a "construction lender" and misunderstands the nature of the surety business.

The Bank's position is based on a false premise that the evaluation of this case should be made from the understanding that the funds were rightfully in Waka's possession when the Bank swept Waka's account. That is, the question from the Bank's perspective is whether Waka should have paid the money to Hartford or the Bank once it was received from the GSA. However, this perspective wholly ignores the fact that pursuant to the terms of the GIA and the GSA Contract, the funds were never rightfully the

[43] CP 65; 374.

property of Waka. To look at the question from another perspective, if the GSA had been able to stop the transfer of funds and had redirected the payment to Hartford, this case would not exist. The Bank would have no standing, whatsoever, to assert a claim for the funds. The fact that the transfer could not be stopped by the GSA should not change Hartford's entitlement. As Waka had no legal entitlement to the funds, it could not legitimately assign the funds to the Bank – as specifically recognized by the court in *Levinson*. Thus, the Bank's entitlement to the funds is specifically predicated on Waka's entitlement, and Waka itself through the testimony of Mr. Wilson, acknowledged that Hartford was entitled to the payment.

Additionally, throughout its brief, the Bank consistently refers to itself as a "construction lender". However, a construction lender is a term of art in the construction industry and refers to a lender, often a commercial bank, that provides a loan to a contractor to facilitate the construction of a specific project.[44] These loans are generally used on private construction projects, are short term, and are often secured by a first-priority lien or mortgage on the property.

In contrast, Waka had a general line of credit with Columbia Bank that was not tied to any specific project. As such, the Bank has no special entitlement to the Dalton Project funds by virtue of the Bank's position as Waka's primary lender.

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[44] See David A. Schmudde, *What You Should Know About Construction Financing*, 20 NO. 5 PRAC. REAL. EST. LAW 51, 51-52 (2004).

The Bank also argues that as a surety, Hartford was compensated for the risk of issuing the Bond to Waka through the payment of the bond premium (the Bank further argues Hartford could also charge higher premiums to more adequately cover its potential losses). This position demonstrates a fundamental misunderstanding of the business of suretyship. While suretyship is similar to the business of insurance in certain respects, there are fundamental differences. Most notably, bond premiums are not calculated in the same manner as insurance policy premiums and are not intended to compensate the surety in the event of the contractor's default.[45] Rather, sureties rely on indemnity agreements, which, as here, often require contract funds to be held in trust for the benefit of the surety, to help cover potential bond-related losses.[46] These indemnity agreements are often the only security for the surety in the event of the contractor's default, whereas banks generally have various other forms of security available to secure the contractor's debt. For example, in this case, the Bank had a security interest in all of Waka's inventory, equipment, etc.[47] Lastly, the Bank's suggestion that Hartford should simply increase its premiums to protect against its losses is contrary to the public interest. Construction bonds are largely used

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[45] *See* Udelman, Surety Contractors: Are Sureties Becoming General Liability Insurers? 22 Ariz. St. L.J. 469, 478 (1990).
[46] KEVIN LYBECK, ET AL., THE LAW OF PAYMENT BONDS 2-3 (2nd ed. 2011).
[47] CP at 229-230.

on public projects and the cost of the bonds is incorporated into the contract price and passed on to the public owner and, by extension, to tax payers. The price increase necessary to compensate for the loss of a surety's contractual right to contract funds would be drastic and likely unacceptable to public owners. Moreover, increasing the cost of public construction projects to allow banks to improperly sweep trust funds for their own benefit cannot be sound public policy.

III. CONCLUSION

This Court should reverse and remand with instructions that the trial court shall enter judgment in favor of Hartford.

Respectfully submitted this 22nd day of January, 2014.

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By: _____

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CERTIFICATE OF SERVICE

The undersigned certifies under penalty of perjury under the laws of the state of Washington that on the 22nd day of January, 2014, I caused true and correct copy of the REPLY OF APPELLANT to be delivered to counsel in the manner indicated as follows:

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DATED this 22nd day of January, 2014 in Seattle, Washington.

/s/ Lana Ramsey