IN THE COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

No. 45320-7-II

HARTFORD FIRE INSURANCE COMPANY,

Plaintiff/Appellant,

v.

COLUMBIA STATE BANK,

Defendant/Respondent.

On Appeal from the Superior Court of Pierce County
Hon. Garold E. Johnson
Superior Court Docket Number 13-2-05483-9

BRIEF OF RESPONDENT

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TABLE OF CONTENTS

I. INTRODUCTION 1

II. RESTATEMENT OF THE ISSUES 3

III. STATEMENT OF THE CASE 3

IV. ARGUMENT 12

A. Hartford Had No Subrogation Rights On June 21, 2012 12

B. Hartford's Conversion Claim Is Fatally Infirm 18

C. The Bank Was Free To Exercise Its Right Of Setoff As To The GSA Progress Payment 22

D. The Court Should Follow The Ninth Circuit's Reasoning In The *Reliance Ins. Co. v. U.S. Bank of Washington, N.A.* Case 23

E. *Westview* Is Not Governing, And It Does Not Support Hartford's Position 28

F. Hartford's Reliance On *Levinson v. Linderman* Is Misplaced 34

G. Hartford Has Failed To Show The Existence Of An Express Trust That Existed For Its Benefit 37

H. The Bank Would Still Prevail Even If There Was An Express Trust Because The GSA Progress Payment Was A General Deposit And Not A Special Deposit 44

I. The Trial Court Did Not Make Factual Determinations 46

J. The Trial Court Was Right To Dismiss Hartford's Claims On Summary Judgment 46

V. CONCLUSION 49

TABLE OF AUTHORITIES

CASES

Allied Sheet Metal Fabricators, Inc. v. Peoples Nat. Bank,
10 Wn. App. 530, P.2d 734 (1974) 17,19

American Cas. Co. of Reading Pa. v. Line Materials Indus.,
332 F.2d 393(10th Cir. 1964) 16, 21

American Fidelity Co. v. National City Bank of Evansville,
266 F.2d 910 (D.C. Cir. 1959).....16

Bainbridge Citizens United v. Washington State Dep't of Natural, Res.,
147 Wn. App. 365, 198 P.3d 1033 (2008).....12

Bank of Arizona v. Nat'l Sur. Corp.,
237 F.2d 90 (9th Cir. 1956) 13, 17, 35

California Bank v. United States Fidelity & Guarantee Co.,
129 F.2d 751 (9th Cir. 1942) 16

Capitol Indem. Corp. v. United States,
41 F.3d 320 (7th Cir. 1994) ..... passim

Colman v. Colman,
25 Wn.2d 606, 171 P.2d 691 (1946).....37

Conner v. First Nat'l Bank of Sedro-Wooley,
113 Wn. 662, 194 P. 562 (1921).....22

Davin v. Dowling,
146 Wn. 137, 262 P. 123 (1927).....19

Eggert v. Vincent,
44 Wn. App. 851, 723 P.2d 527 (1986) 19, 20

In re ADL Contracting Corp.,
184 B.R. 436 (Bankr. S.D.N.Y. 1995).....18

In re Estate of Adler,
116 Wn. 484, 199 P. 762 (1921).....22

In re Kuhn Constr. Co., Inc.,
11 B.R. 746 (Bankr. S.D. W. Va. 1981).....20

In re Massart Co.,
105 B.R. 610 (W.D. Wash. 1989).....21, 27

In re Washington Builders Ben. Trust,
173 Wn. App. 34, 293 P.3d 1206 (2013).....37, 38

In Reliance Insurance Co. v. U.S. Bank of Washington, N.A.,
143 F.3d 502 (9th Cir. 1998) ..... passim

Int'l Fidelity Ins. Co. v. United States,
949 F.2d 1042 (8th Cir. 1991) 14, 36

Kruger v. Horton,
106 Wn.2d 738, 725 P.2d 417 (1986).....18, 20

Levinson v. Linderman,
51 Wn.2d 855, 322 P.2d 863 (1958).....34, 36, 37

Matter of RAH Development Co., Inc.,
184 B.R. 525 (Bankr. W.D. Mich. 1995) 18

Michel v. Melgren,
70 Wn. App. 373, 853 P.2d 940 (1993).....20

National Shawmut Bank v. New Amsterdam Cas. Co.,
411 F.2d 843 (1st Cir. 1969).....13, 36

National Surety Corp. v. Fisher,
317 S.W.2d 334 (Mo. 1958) 13, 36

Pacific Gamble Robinson Co. v. Chef-Reddy Foods Corp.,
42 Wn. App. 195, 710 P.2d 804 (1985) 20

Pearlman v. Reliance Ins. Co.,
371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962).....12, 16, 35, 36

Reliance Insurance Co. v. U.S. Bank of Washington, N.A.,
143 F.3d 502 (9th Cir. 1998) .....passim

Sterling Savings Bank v. Air Wisconsin Airlines Corp.,
492 F.Supp.2d 1256 (E.D.Wash. 2007)..... passim

Townsend v. Walla Walla Sch. Dist.,
147 Wn. App. 620, 196 P.3d 748 (2008).....12

United Pacific Ins. Co. v. United States,
362 F.2d 805 (Ct. Cl. 1966) 13, 36

United Pacific Ins. Co. v. Ripsom,
10 Del. J. Corp. L. 337 (Del. Ch. 1984) 14, 36

United States v. Munsey Trust Co.,
332 U.S. 234 (1947) 16

Westview Investments, Ltd. v. U.S. Bank,
133 Wn. App. 835, 138 P.3d 638 (2006) ..... passim

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Restatement (Second) of Trusts § 30 ..... 31, 34

Restatement (Second) of Trusts, § 86 ..... 31, 32

Restatement (Third) of Trusts, § 10(e) 31, 34

Restatement (Third) of Trusts, § 41 ..... 31, 32

Grant Gilmore, *Security Interests in Personal Property*,
978 (1965) 27

I. INTRODUCTION

This case presents a priority dispute between two competing creditors of failed government contractor WAKA Group, Inc. ("**WAKA**"). The dispute arises from an earned progress payment for $103,410.00 that the United States General Services Administration (the "**GSA**") paid for work WAKA did at the Dalton Cache border station in Haines, Alaska (the "**Project**"). The dispute involves the Appellant ("**Hartford**") and the Respondent (the "**Bank**").

The GSA deposited the progress payment at issue into WAKA's collateral control account at the Bank. Per its agreement with WAKA, the Bank had the right to apply this money to WAKA's outstanding line of credit at the Bank. The Bank regularly applied money from WAKA's collateral control account to WAKA's outstanding line of credit at the Bank.

WAKA's line of credit at the Bank matured on May 30, 2012, WAKA failed to repay and close out this line as required, and on June 21, 2012, the Bank exercised its contractual and common law right of setoff to apply the disbursed progress payment in the collateral control account to WAKA's outstanding line of credit at the Bank. WAKA's surety on the Project, Hartford, later sued the Bank to recover the disbursed progress payment based on principles of subrogation and trust law. This despite the

fact that Hartford (a) made its first demand on the Bank after the setoff was made; (b) the setoff was made prior to the date that the Bank knew that Hartford had issued a bond to WAKA for the Project; and (c) the setoff occurred prior to the date that Hartford paid out any money at all pursuant to its bond with WAKA.

Both parties moved for summary judgment, and the trial court granted the Bank's motion for summary judgment and denied Hartford's motion for summary judgment on August 9, 2013. In doing so, the trial court dismissed Hartford's claims for misappropriation of trust funds, wrongful setoff, conversion, and declaratory relief as a matter of law.

What Hartford is trying to do in this case is prevail on a breach of trust theory that has never been successfully employed by a surety against a construction lender in Washington. Tellingly, Hartford has to some extent backed away from its subrogation claim because it knows it cannot prevail on this theory of recovery, for Hartford did not pay any money out on its Project bond before the June 21, 2012 setoff in question. Such payment is a prerequisite for Hartford to invoke subrogation under applicable case law. The trial court recognized the infirmity of Hartford's position when it dismissed Hartford's claims on summary judgment. The Bank respectfully asks this Court to affirm the trial court's rulings in this case.

II. RESTATEMENT OF THE ISSUES

1. Does a surety have first priority in an earned progress payment paid by the government to the contractor-borrower when the construction lender receives the payment before the surety notifies the lender of its claim to this payment and before the surety commences performance or makes payment under its bond? Answer: ***No.***

B. Does a bank convert funds that were properly deposited in its contractor-borrower's collateral control account prior to a surety's demand for these funds by offsetting the funds against the borrower's matured indebtedness with the bank? Answer: ***No.***

C. Does the progress payment at issue constitute trust funds that the Bank must disgorge to Hartford? Answer: ***No.***

III. STATEMENT OF THE CASE

On or about June 14, 2011, WAKA executed and delivered a Commercial Line of Credit Agreement and Note (the "**Note**") to the Bank. CP 218. The first page of the Note accurately and correctly states the purpose of the loan evidenced by the Note was to provide WAKA with working capital. *Id.* The Bank loaned WAKA money pursuant to the Note (the "**Loan**"). *Id.*

On or about June 14, 2011, WAKA executed and delivered a Commercial Security Agreement (the "**CSA**") to the Bank to provide

collateral for the Note. CP 218. The CSA provided the Bank with a Uniform Commercial Code Article 9 security interest in all of WAKA's inventory, equipment, chattel paper, accounts, general intangibles, and the products and proceeds thereof, whether then owned or acquired later. *Id.*

The Bank perfected its security interest in its collateral by duly and properly filing a Uniform Commercial Code Financing Statement on June 20, 2011 under File Number 2011-171-3966-3. CP 219. Said financing statement reflects a lapse date of June 20, 2016. *Id.*

On or about June 14, 2011, WAKA executed and delivered to the Bank a Business Loan Agreement regarding the Note. CP 219. On or about June 14, 2011, WAKA also executed and delivered to the Bank an Addendum to Business Loan Agreement regarding the Note. *Id.* Page 2 of the Addendum, entitled Control Account, states WAKA "shall deposit all cash, instruments and other proceeds received from the operation of [WAKA's] business into an account established with [the Bank] within two (2) business days after receipt of such amounts (the "Control Account"). *Id.* Only proceeds received from [WAKA's] non-business operations may be deposited into an account other than the Control Account. [the Bank] is authorized to pay down the unpaid Loan balance, on a daily basis, from funds in the Control Account[.]" CP 244-45.

The Bank provided WAKA with a Control Account in accordance with the parties' Business Loan Agreement and the Addendum thereto. CP 219. Each month, the Bank sent WAKA account statements for the Control Account. *Id.* These statements contained the words "BANK CONTROL COLLATERAL ACCOUNT" in capital letters. *Id.* A true and correct copy of one such statement for the period of June 2012 can be found at CP 247-48.

Page one of the Note accurately reflects that the Note matured on May 30, 2012. CP 220. WAKA failed to repay the Loan evidenced by the Note by the aforesaid maturity date. *Id.* Accordingly, on or about June 10, 2012, the Loan was transferred to the special credits department of the Bank. *Id.* Shortly thereafter, David Stiffler at the Bank met with Andrew Wilson, WAKA's president, to discuss WAKA's situation. *Id.*

During the morning of June 21, 2012, the GSA electronically deposited a progress payment in the amount of $103,410.00 into WAKA's collateral control account at the Bank. CP 220. This payment stemmed from the Project at the Dalton Cache border station in Haines, Alaska. *Id.*

As of June 21, 2012, the Bank had not been provided with an update regarding the status of the Project. CP 220. As of the aforesaid date, the Bank had no idea whether any subcontractors or materialmen on the Project had or had not been paid. *Id.* Moreover, as of June 21, 2012,

the Bank did not know what sureties (if any) had bonded the Project, nor did the Bank have any copies of surety bonds concerning the Project in its files. *Id.*

On June 21, 2012 at 8:58 a.m., David Stiffler at the Bank instructed administrative assistant Christa Maier to apply the $103,410.00 GSA progress payment and other monies from WAKA's collateral control account to the outstanding Loan balance based on the Bank's right of setoff and in accordance with the CSA and Addendum to WAKA's Business Loan Agreement. CP 220. Mr. Stiffler's email correspondence with Ms. Maier reflecting the setoff of the GSA progress payment can be found at CP 252.

The Bank applied a total of $152,910.00 from WAKA's collateral control account to the outstanding Loan balance on June 21, 2012. CP 220. Of this $152,910.00, $103,410.00 came from the GSA's June 21, 2012 progress payment on the Project. *Id.*

When the Bank exercised its setoff rights on June 21, 2012, WAKA owed more than $434,495.79 on its $500,000.00 line of credit with the Bank. CP 221.

On June 21, 2012 at 5:14 p.m., after the close of business at the Bank, Ms. Tiffany Schaak of Hartford sent a letter to Mr. Stiffler via electronic mail. CP 221. To the best of Mr. Stiffler's recollection, he did

not open this email or access this letter on June 21, 2012, but instead opened and read these items the following morning on June 22, 2012. *Id.* A copy of the aforesaid email message and letter is located at CP 256.

Prior to receiving and reviewing Ms. Schaak's letter on June 22, 2012, the Bank had not received any correspondence from Hartford concerning WAKA or the Project. CP 221.

As seen from Ms. Schaak's letter dated June 21, 2012, Hartford stated it was "now undertaking" to perform the balance of its bonded projects with WAKA. CP 221. Said letter does not specifically identify any of these projects, provide any specific bonding information, or include a copy of any bonds that Hartford provided to WAKA. *Id.* Further, said letter does not state that Hartford had paid any money to materialmen or subcontractors on the Project pursuant to its bonds as of the date of the letter. *Id.*

Prior to Mr. Stiffler's review of Ms. Schaak's letter on June 22, 2012, the Bank did not know that Hartford had issued any bonds to WAKA, nor did the Bank know if Hartford had otherwise been involved in the Project or in any other WAKA venture. CP 221.

Immediately after Mr. Stiffler reviewed Ms. Schaak's above-described letter, he sent a copy of this letter to the Bank's attorney via email at 8:49 a.m. on Friday, June 22, 2012. CP 221.

Prior to filing suit in this case, Hartford's attorneys sent two demand letters to the Bank and/or its attorneys. CP 221. One such letter, which is dated August 10, 2012, provides that Hartford believes it is entitled to the subject progress payment because these funds were "trust funds in favor of Hartford, earned in the performance of the Project on which Hartford issued the Bond." *Id.* Said letter further provides that Hartford believes its "right to the Project Funds is superior to that of Columbia Bank under the principle of equitable subrogation" and that "Hartford has an equitable lien on the Project Funds through its rights of subrogation, which are senior to any alleged setoff rights of Columbia Bank." *Id.* A copy of this letter can be found at CP 261-64.

As for Hartford's rendition of events, it claims that around June 20, 2012, WAKA informed it that its principals had retained bankruptcy counsel, but would postpone filing bankruptcy until completion of the Project. CP 153. Hartford's handwritten notes dated June 21, 2012 that were produced in discovery reflect it spoke with WAKA's president, Andy Wilson, on June 21, 2012 and Mr. Wilson said "he would voluntarily default" on the Project. CP 167.

Although Hartford previously claimed it took over the Project on June 21, 2012 (CP 154), it admitted that it did not pay out or advance money on the Project until July 17, 2012. CP 155. Hartford has also

conceded that it did not execute a written takeover agreement for the Project with the GSA until July 13, 2012. CP 156.

According to the recitals in this executed takeover agreement, WAKA notified the GSA by letter dated June 21, 2012 that it could not perform the Project and by letter dated June 25, 2012, GSA made a demand on Hartford under its Project performance bond. CP 169.

Hartford deposed WAKA's president, Mr. Wilson, on May 8, 2013. CP 177. During his deposition, Mr. Wilson testified that WAKA's loan with the Bank matured on May 30, 2012 (CP 186), and that the only thing that Mr. Wilson told the Bank about his relationship with Hartford was "[j]ust that they were the bonding company." CP 186. Mr. Wilson also testified that WAKA never provided a copy of its Hartford performance bond to the Bank, WAKA never discussed with the Bank its general indemnity agreement with Hartford or provided a copy of this agreement to the Bank, and WAKA did not discuss its outstanding bills from suppliers or subcontractors when it met with Bank representatives on June 18, 2012. CP 186.

During his deposition Mr. Wilson also testified that WAKA and the Bank did not discuss the fact that WAKA would not be able to complete the Project during their meeting on June 18, 2012, that approximately $50,000 to $60,000 of the money that WAKA borrowed

from the Bank went toward wages and travel expenses that were incurred on the Project, and that without WAKA's line of credit at the Bank, WAKA could not have completed as much of the Project as it did. CP 186. Hence, the Bank advanced money on the Project before Hartford ever did. *See id.* Mr. Wilson also testified that WAKA could not have done the work that it did on multiple projects other than the Project without the money that it borrowed from the Bank. CP 294.

After Mr. Wilson's deposition, both parties moved for summary judgment. The trial court began the summary judgment hearing by stating it "read the entire file" and "really paid attention to ... *Reliance vs. US Bank of Washington*, and the ... *Westview Investments vs US Bank*" case. Verbatim Report of Proceedings at 2, lines 9-15. The trial court also correctly recognized during the August 9, 2013 summary judgment hearing that the course of dealings between the Bank and WAKA was such that the Bank would regularly apply money that was deposited into WAKA's collateral control account at the Bank to WAKA's outstanding line of credit at the Bank. Verbatim Report of Proceedings at 4, lines 17-20; *see* VRP at 13, lines 2-7; VRP at 16, lines 10-15.

The trial court granted the Bank's motion for summary judgment and denied Hartford's motion for summary judgment. In doing so, the trial court dismissed Hartford's claims for misappropriation of trust funds,

wrongful setoff, conversion, and declaratory relief as a matter of law. Hartford filed its notice of appeal regarding these rulings on September 9, 2013.

Regarding certain factual assertions set forth in Hartford's Brief of Appellant, Hartford claims "[t]he Bank was also aware that Hartford served as Waka's bonding company." Brief of Appellant at 6. The Bank has denied this assertion from the start of this case, and the Bank has submitted evidence to the effect that it did not know that Hartford was WAKA's bonding company prior to June 21, 2012. CP 221. Hartford has also asserted that during a meeting on June 18, 2012, the Bank "advised that it would be calling Waka's line of credit." Brief of Appellant at 6. This statement is not accurate, as WAKA's Loan with the Bank matured on May 30, 2012 and was due and payable in full. CP 225.

Hartford also incorrectly states on Page 24 of its Brief of Appellant that "[t]he Bank had not swept Waka's account prior to June 21, 2012." There is no citation to the record in support of this assertion. Further, this assertion is not true, as the Bank regularly applied funds deposited in WAKA's control collateral account to WAKA's line of credit with the Bank. *See* CP 245; CP 248; Verbatim Report of Proceedings at 4, lines 17-20; *see* VRP at 13, lines 2-7; VRP at 16, lines 10-15. The collateral control account was separate and apart from WAKA's checking account at

the Bank. *See* CP 247, 248. Moreover, the June 2012 collateral control account statement shows that $2,940.00 was taken from that account to pay down the Loan on June 19, 2012, two (2) days before the setoff in question. CP 248. This statement also shows that of the $322,817.83 that was deposited into this account in June 2012, $283,150.00 was applied to WAKA's line of credit with the Bank by way of three (3) separate transactions on three (3) different dates while the remaining $39,667.83 was transferred to WAKA's checking account at the Bank. CP 248.

IV. ARGUMENT

When reviewing a summary judgment grant, an appellate court engages in the same inquiry as the trial court, viewing the facts and all reasonable inferences in the light most favorable to the nonmoving party. *Townsend v. Walla Walla Sch. Dist.*, 147 Wn. App. 620, 196 P.3d 748 (2008). On an appeal from summary judgment, the standard of review is de novo. *Bainbridge Citizens United v. Washington State Dep't of Natural Res.*, 147 Wn. App. 365, 198 P.3d 1033 (2008).

A. Hartford Had No Subrogation Rights On June 21, 2012.

The landmark United States Supreme Court case of *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962) established a surety's equitable right, through subrogation, to construction retainage funds. The instant case, in contrast, addresses the relative

priorities of a contractor's secured creditor and its surety not to retained funds, but to *earned progress payments previously disbursed by the government*. Once funds are disbursed by the project owner, subrogation no longer supports a surety's claim to those funds because "[f]unds intended from the inception of a contract to settle potential claims [retainages] differ vastly from progress payments, which belong to the free flow of commerce from the time they are properly paid over." *Capitol Indem. Corp. v. United States*, 41 F.3d 320, 325 (7th Cir. 1994); *see also Bank of Arizona v. Nat'l Sur. Corp.*, 237 F.2d 90, 93-94 (9th Cir. 1956).

Because progress payments disbursed by the government enter the "free flow of commerce," courts for decades have rejected the notion that a surety's equitable rights divest a contractor's creditors of those payments. The general rule was well stated in *National Shawmut Bank v. New Amsterdam Cas. Co.*, 411 F.2d 843, 848 (1st Cir. 1969) when the First Circuit Court of Appeals stated that "[p]rior to default, the contractor had the right to assign progress payments and had the Bank received payment, it could not (absent circumstances amounting to fraud) have been divested by the surety." *See also Capitol*, 41 F.3d at 327 (surety's equitable lien did not attach to earned progress payment approved for disbursement); *United Pacific Ins. Co. v. United States*, 362 F.2d 805, 808 (Ct. Cl. 1966); *National Surety Corp. v. Fisher*, 317 S.W.2d 334, 345 (Mo. 1958); *United*

Pacific Ins. Co. v. Ripsom, 10 Del. J. Corp. L. 337, 343 (Del. Ch. 1984).

The policy reason for allowing creditors like the Bank to keep earned progress payments already disbursed by the government is obvious: "The animating principle behind the general rule is the free flow of commerce: parties which receive the progress-payment funds from the contractor should not have to concern themselves with potential future claims to the money." *Int'l Fidelity Ins. Co. v. United States*, 949 F.2d 1042, 1046 (8th Cir. 1991); *see also Capitol*, 41 F.3d at 325.

In contrast, the rule of law proposed by Hartford — that a surety prevails over a bank once the bank has notice of a surety's potential claims or simply because the bank knows its borrower is a government contractor that works on bonded projects — is self-serving and without limit. Hartford's indemnity contracts with WAKA give it much latitude in declaring and orchestrating a default. If Hartford has a right to disbursed progress payments, why limit this right to the June 21, 2012 progress payment? With the help of a creative accountant's tracing, Hartford could force the Bank (and WAKA's other creditors) to disgorge every other progress payment on WAKA's bonded jobs with Hartford. Were this Court to place a contractor's non-surety creditors in such an uncertain position, it is likely that few lenders would continue doing business with contractors, and as a result, few contractors would be able to remain in

business. The trial court understandably expressed this concern during the summary judgment hearing. Verbatim Report of Proceedings at 23, lines 20-25.

At this hearing the trial court questioned Hartford about the effect of adopting the rule that Hartford has advanced, and Hartford acknowledged at that time that it would be entitled to receive all Project proceeds at any point in time under its theory of recovery. Verbatim Report of Proceedings at 7-8.

Moreover, Hartford's rule allows the surety to avoid the very risk of loss it was paid to assume. By granting itself the discretion to declare default and decide when to inform other creditors of the default, Hartford is in a position to strategically cover its losses. The better rule, as adopted by numerous courts, is to limit a surety's equitable right to funds retained by the project owner. The Tenth Circuit Court of Appeals could have been describing the instant case when it held almost 50 years ago as follows:

> This is simply a case where the owner of a project paid a sum of money due on the contract to the contractor at a time when the contractor was not in default. It was free money and the contractor had the right to use it in any way he chose without it being subject to any claim or equity of his surety. [The contractor] did use it to pay an obligation that did not arise from his performance of the contract in question. But, he had a legal right to do so as the appellant surety company, at that time, was not subrogated to the rights of anyone concerned with the contract and had no valid

claim to the money.

American Cas. Co. of Reading Pa. v. Line Materials Indus., 332 F.2d 393, 395 (10th Cir. 1964), *cert. denied*, 379 U.S. 960 (1965) (footnote omitted).

The rule denying a surety equitable rights over disbursed progress payments is mandated by the nature of subrogation. As recognized in *Pearlman*, "[t]he equitable lien of a surety is nothing more than a right to be subrogated." *American Fidelity Co. v. National City Bank of Evansville*, 266 F.2d 910, 914-15 (D.C. Cir. 1959); *Pearlman*, 371 U.S. 136-39. "One cannot acquire by subrogation what another whose rights he claims did not have." *United States v. Munsey Trust Co.*, 332 U.S. 234, 242 (1947).

Here, Hartford was subrogated to no one when the Bank offset the progress payment on June 21, 2012 because Hartford had not agreed in writing with the GSA to take over the Project, Hartford had paid nothing out on the bond on that date, and none of Hartford's potential subrogors (the government, unpaid subcontractors, or WAKA itself) could provide Hartford with sufficient legal or equitable priority to override the Bank's first position claim to the progress payment on that date.

Further, even if one of WAKA's subcontractors had a ripe claim against WAKA on June 21, 2012, such a claim would not extend against WAKA's bank. *E.g.*, *California Bank v. United States Fidelity &*

Guarantee Co., 129 F.2d 751 (9th Cir. 1942); *Bank of Arizona v. National Surety Corporation*, 237 F.2d 90, 94 n. 10 (9th Cir. 1956).

As against WAKA, the Bank possessed the superior right to the earned progress payment that was disbursed by the GSA. When the Bank exercised its setoff rights on June 21, 2012, WAKA owed more than $434,495.79 on its $500,000.00 matured line of credit, including funds that the Bank advanced on this Project. CP 187. Further, as of that date, WAKA had effectively assigned its rights to all progress payments to the Bank. WAKA had also agreed that all such payments would be deposited into its collateral control account at the Bank, and that the Bank could immediately apply such funds to the Loan balance. There is no question that Washington law allows a bank to offset the depositor's account balance against the depositor's debt. *E.g., Allied Sheet Metal Fabricators, Inc. v. Peoples Nat. Bank*, 10 Wn. App. 530, 537, 518 P.2d 734, *rev. denied*, 83 Wn.2d 1013, *cert. denied*, 419 U.S. 967 (1974). WAKA simply had no right to the progress payment as against the Bank on June 21, 2012.

In sum, Hartford lacks any entity in whose shoes it can stand to recover the progress payment via the doctrine of subrogation. Hartford had no right to the progress payment on June 21, 2012 because it had not yet paid out money under its Project bond. It is a well-recognized rule that "[t]he right of subrogation, which entitled [surety] to 'step into the shoes'

of any party whose obligations it assumed, would not take effect until [surety] actually assumed these obligations." *Capitol*, 41 F.3d at 326; *see also Matter of RAH Development Co., Inc.*, 184 B.R. 525, 532 (Bankr. W.D. Mich. 1995) ("the surety's right to equitable subrogation does not arise until those laborers and materialmen are fully paid"); *In re ADL Contracting Corp.*, 184 B.R. 436, 441 (Bankr. S.D.N.Y. 1995) ("once a surety satisfies its obligation under either of the [performance or payment] bonds, the surety accedes by the equitable doctrine of subrogation to the rights of the party").

Given the undisputed fact that Hartford paid no claims on the Project and did not assume its performance obligations until July 2012, this surety could not have been entitled to legal or equitable subrogation on June 21, 2012. As such, the trial court correctly determined that Hartford cannot prevail against the Bank on a subrogation theory of recovery.

B. Hartford's Conversion Claim Is Fatally Infirm.

In Washington, conversion is the "act of willfully interfering with any chattel, without lawful justification, whereby any person entitled thereto is deprived of the possession of it." *Kruger v. Horton*, 106 Wn.2d 738, 743, 725 P.2d 417 (1986). To prevail on its conversion claim, Hartford must prove at the time of the alleged conversion that: (1) the

Bank *wrongfully received* the subject progress payment; (2) Hartford possessed some *property interest* in the converted funds; and (3) Hartford's interest in the funds *entitled it to immediate possession. E.g., Davin v. Dowling*, 146 Wn. 137, 140-41, 262 P. 123 (1927) (*en banc*) (emphasis added) (analyzing viability of conversion claim arising from bank deposit). It is Hartford's burden to establish each of these three elements. *Eggert v. Vincent*, 44 Wn. App. 851, 854, 723 P.2d 527 (1986), *rev. denied*, 107 Wn.2d 1034 (1987).

The Bank can claim numerous independent sources for its right to the progress payment at issue. First, under WAKA's contractual arrangements with the Bank, all funds deposited into its collateral control account immediately became the legal property of the Bank. Second, it is a basic rule of banking that "in the case of a general deposit of money in a bank, the moment the money is deposited it actually becomes the property of the bank, and the bank and the depositor assume the legal relation of debtor and creditor." *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wn. App. 530, 537, 518 P.2d 734, *rev. denied*, 83 Wn.2d 1013, *cert. denied*, 419 U.S. 967 (1974). Finally, the Bank also had a prior perfected security interest in all payments to WAKA and their proceeds. Thus, the Bank did nothing wrongful by accepting the deposit of the progress payment and applying this money to WAKA's outstanding and

matured line of credit.

A conversion action also "requires plaintiffs to prove that they have some property interest in the goods allegedly converted." *Michel v. Melgren*, 70 Wn. App. 373, 376, 853 P.2d 940 (1993). Any property interest created by Hartford's general indemnity agreement and other agreements with WAKA is subordinate to the Bank's first position security interest. *See in re Kuhn Constr. Co., Inc.*, 11 B.R. 746, 749 (Bankr. S.D. W. Va. 1981) (surety's general indemnity agreement subject to U.C.C. filing requirements). Likewise, as discussed above, Hartford can claim no property interest in the subject progress payment through subrogation.

In addition, when Hartford made its demand for the GSA Project payment at issue, it did not have a right to *immediately possess* these funds. "[T]he rule in this state is that in order to maintain an action for conversion, the plaintiff must either have been in possession or have an immediate right to possession at the time the goods were converted." *Eggert v. Vincent*, 44 Wn. App. at 855; *see also Kruger v. Horton*, 106 Wn.2d at 743; *Pacific Gamble Robinson Co. v. Chef-Reddy Foods Corp.*, 42 Wn. App. 195, 202, 710 P.2d 804 (1985), *rev. denied*, 105 Wn.2d 1008 (1986). Hartford's inability to support this element of its conversion claim is fatal.

Hartford had no right to immediate possession of the progress payment because the Bank's prior perfected security interest trumped any legal right to possession claimed by Hartford. Likewise, Hartford had no equitable right of immediate possession. As pointed out by *In re Massart Co.*, 105 B.R. 610 (W.D. Wash. 1989), a surety's rights are inchoate and unenforceable until the surety suffers an actual loss on the bond: "[T]he lien arises upon the execution of the bond *but does not become enforceable* until the surety suffers a loss by making payments pursuant to the obligation under the bond." 105 B.R. at 612 (citations omitted) (emphasis added); *see also American Cas. Co.*, 332 F.2d at 395 ("there is a clear distinction between the right of subrogation, which exists from the date the bond is executed, and actually being subrogated, which occurs when payments are made upon the principal's default").

Here, Hartford made no payments under the Project contract and failed to perform under its bond until July 2012, approximately one (1) month after the Bank applied the GSA project payment to WAKA's outstanding line of credit. Given the inchoate nature of any equitable lien and Hartford's failure to show a right of immediate possession, Hartford's claim for conversion fails right out of the gate, and the trial court rightly dismissed this claim on summary judgment.

C. The Bank Was Free To Exercise Its Right Of Setoff As To The GSA Progress Payment.

Under Washington law, if the bank depositor has a debt with the bank that has matured, the bank may exercise its right of setoff as to the deposit. *E.g., In re Estate of Adler*, 116 Wn. 484, 489, 199 P. 762 (1921). This means "the bank may apply the deposit, or such portion thereof as may be necessary, 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) (citing *Conner v. First Nat'l Bank of Sedro-Wooley*, 113 Wn. 662, 665, 194 P. 562 (1921)).

Here, the Bank rightly exercised its common law and contractual right of setoff as to the subject GSA progress payment on June 21, 2012. This setoff occurred three (3) weeks after WAKA's Loan matured and went into default. There is no question that the Loan was in default on the date of the setoff. Nor is there any question that the Bank was free to exercise its right of setoff as to the subject progress payment in light of applicable case law, the Bank's contract with WAKA regarding its bank collateral control account, and the Addendum to WAKA's business loan agreement with the Bank. Again, the Addendum to WAKA's Business Loan Agreement with the Bank provides the Bank "is authorized to pay down the unpaid Loan balance, on a daily basis, from funds in the Control

Account[.]" That is exactly what the Bank had done from the start of its relationship with WAKA. *See* CP 248 (showing three payments made from collateral control account to WAKA's line of credit in June 2012 alone); Verbatim Report of Proceedings at 4, lines 17-20. And that is exactly what happened here on June 21, 2012.

D. The Court Should Follow The Ninth Circuit's Reasoning In The *Reliance Ins. Co. v. U.S. Bank of Washington, N.A. Case.*

In *Reliance Insurance Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502 (9th Cir. 1998), the Ninth Circuit Court of Appeals dealt with an almost identical set of facts as are present in this case. In *Reliance*, a surety for a government contractor brought an action against a bank into which the contractor's progress payments were deposited by the government, claiming a superior interest in a progress payment that the bank used to offset the contractor's loan following the contractor's default on the government contract. *Id.*

The contract in *Reliance* arose from a U.S. Coast Guard project in Ilwaco, Washington. The United States District Court for the Western District of Washington granted the surety's motion for summary judgment, and the bank appealed. The Ninth Circuit Court of Appeals held that (1) Washington law governed the dispute; (2) the bank was not liable for conversion; (3) under Washington law, as predicted by the Ninth

Circuit Court of Appeals, the surety was not subrogated to the contractor's right to payment as of the time the bank received the progress payment and set off that payment against the contractor's loan; and (4) under Washington law, as predicted by the Court of Appeals, the bank was entitled to the progress payment. A copy of *Reliance* was made available to the trial court and can be found at CP 210-217.

The bank in *Reliance* knew on the date that the progress payment was deposited into the contractor's bank account that the contractor was having financial problems, but did not know that subcontractors had not been paid. *Id.* at 504. Several days later, the surety notified the bank of its claim that the deposited progress payment should be disbursed to laborers and materialmen. *Id.* At that time, however, the surety had not yet paid any subcontractors. *Id.* at 506. The bank took the position that it had first claim on the money and set off the deposit against the contractor's debt to the bank *after it received the surety's demand. Id.* (Emphasis added). On these facts, the Ninth Circuit Court of Appeals held that the bank was entitled to keep the progress payment at issue under Washington law. *See id.*

The *Reliance* court's ruling is consistent with controlling Washington case law concerning bank deposits. Under Washington law, 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 (applying Washington law and holding bank need not disgorge advance payments made by buyer of aviation fuel to seller because these deposits were general deposits as opposed to special deposits) (emphasis added).

The title to a general deposit passes immediately to the bank. *Id.* 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).

There is no question that the GSA progress payment at issue in this case was a general deposit. Further, unlike the bank in *Reliance*, the Bank set off the progress payment *before* it received the surety's demand and *before* the Bank even knew that the surety was involved in the Project. Even Hartford does not deny that the Bank had no idea prior to the setoff that Hartford claimed an interest in this money. Moreover, the Bank had no knowledge about any Project materialmen or subcontractors being unpaid on the date of the setoff. Thus, under *Reliance* and Washington

case law concerning general deposits, there is no question that the Bank is entitled to keep the subject progress payment despite Hartford's claims to the contrary.

Hartford has previously argued that the Bank has a duty to inquire about "the nature of the funds received from a federal government project" (CP 271) because the Bank knew that WAKA was a general contractor, WAKA had continuing obligations to subcontractors and suppliers, and WAKA's line of credit at the Bank would be used for WAKA's business. CP 270-71. However, the effect of such a rule would mean that the Bank would have to inquire as to the source of *all proceeds* deposited into WAKA's collateral control account at the Bank before the Bank could ever apply any of these proceeds to WAKA's Loan in accordance with the parties' contract and applicable commercial law. As seen from the Ninth Circuit Court of Appeals' ruling in *Reliance* and the cases cited therein, the law does not require such of the Bank.

Harford's previous claim that the *Reliance* court "did not evaluate whether the bank should have known the funds received should have been held in trust" is not accurate. CP 274. In addition to asserting subrogation, the surety in *Reliance* also sought to recover against the bank based on a constructive trust theory of recovery. *Reliance*, 143 F.3d at 507. Nevertheless, the *Reliance* court held that the bank was entitled to keep

the money that the surety sought to recover and that "the bank was entitled to summary judgment." *Id.* at 508. In reaching its ruling, the *Reliance* court noted that "[a]ll of the surety's authorities are distinguishable" and that "[t]he authorities, in cases where the money has been paid to the bank by the government, favor the bank against the surety." *Id.* (internal citations omitted). The *Reliance* court also noted that "Professor Gilmore's great treatise likewise says that the cases generally hold that once the money has been paid over to the bank, the bank prevails against the surety[.]" *Id.* (citing Grant Gilmore, *Security Interests in Personal Property*, 978 (1965)). The *Reliance* court reasoned that "[t]hough no controlling case is entirely on point, holding for the bank, where the money has been paid into the bank, is more consistent with what the parties would likely predict based on past cases" and that "[a] predictable result has the advantage that the parties can make reasonable financial calculations based upon it, and contract for a different result if they find that more efficient."

The *Reliance* court contrasted *In re Massart Co.*, 105 B.R. 610 (W.D.Wash. 1989), a case that Hartford relies upon, by noting that case "is a claim by the surety against the contractor's bankruptcy estate, so it establishes a right against the defaulting contractor rather than against the lending bank." *Id.*

E. *Westview* Is Not Governing, And It Does Not Support Hartford's Position.

Hartford continues to argue that a decision rendered by Division One of the Washington Court of Appeals entitled *Westview Investments, Ltd. v. U.S. Bank*, 133 Wn. App. 835, 138 P.3d 638 (2006) should carry the day for the surety. *Westview* held that a contract for progress payments between a project owner and its general contractor created an express trust, and that an issue of fact existed as to whether the general contractor's bank should have known of or inquired about such a trust. *Id.*

Westview presented the situation where (a) the project owner made progress payments to the general contractor with the *specific understanding* that most of this money would be used to pay *project subcontractors* for labor and materials *that they had already provided on the job;* (b) the general contractor then deposited these progress payments into its bank account; (c) the bank exercised its right of setoff and applied these payments to the general contractor's loan balance; (d) the subcontractors subsequently recorded lien claims against the property; and (e) the project owner then paid the subcontractors directly and later sought to recover this money from the general contractor's bank. *See id.* at 842-43 (emphasis added).

Westview is different from this case, as no professional surety like

Hartford was involved therein. Further, the project owners in *Westview* submitted evidence indicating that the bank knew that most of the general contractor's accounts receivable were comprised of payments made by property owners *for the benefit of subcontractors*. In addition, the project owners in *Westview* sought to recover from the general contractor's bank only after they themselves had stepped up to pay subcontractors on the projects, whereas in this case, Hartford seeks to recover from the Bank an earned progress payment that was made before the GSA declared the Project to be in default, before Hartford took over the Project, before Hartford paid out any money at all on its Project bond, and before the Bank knew that Hartford claimed an interest in the progress payment. Finally, the progress payment at issue in this case was made by the Project owner directly to the Bank at a time when the Bank had no knowledge of any subcontractors on the Project not being paid. Thus, in sum, *Westview* is not applicable to this case, nor is *Westview* controlling legal authority.

During the August 9, 2013 summary judgment hearing the Bank also explained how the contract that gave rise to the trust in *Westview* was materially different from the WAKA / Hartford General Indemnity Agreement (the "**GIA**") that Hartford's breach of trust claim is based on. Verbatim Report of Proceedings at 19, lines 10-21. As seen from the following, standing alone, the GIA is not enough to create an express trust

or give rise to an issue of material fact on this topic.

Westview involved a contract that was materially different from the GIA, as the contract in that case did not rely on the expectation of acquiring a property interest in the future, and the project owner was a party to the contract. Specifically, the property owner in *Westview* signed a contract with a general contractor that contained a declaration of trust regarding progress payments made by the owner. *Id.* at 841. The general contractor agreed to hold progress payments in trust for the benefit of its subcontractors. *Id.* Unlike Hartford's GIA, the *Westview* contract simultaneously contained both the settlor's right to payment and a declaration of intent. Because the general contractor in *Westview* possessed a property interest in the progress payments at the time of the trust declaration, no subsequent manifestation of intent was required to create the trust. The court in *Westview* was therefore able to rely on the declaration in the contract as the sole required manifestation of intent needed to create the trust.

Unlike the property owner in *Westview*, Hartford, as a surety, cannot simply rely on its GIA as a manifestation of intent by WAKA to create a trust regarding earned progress payments from the Project. Since WAKA did not possess an interest in any right to payment from the GSA Contract at the time the GIA was executed, the GIA with its trust verbiage

was merely a contract to create a trust in the future.

The corpus of the alleged trust at issue (*i.e.*, the subject GSA progress payment that the Bank received on June 21, 2012) was not in existence when the claimed trust was allegedly created by way of the GSA that was signed on June 13, 2011. It is well settled that where a trust is created by a contract regarding property to be acquired at a later date, the trust and the trustee's fiduciary duties ordinarily come into existence at the time of the trust settlor's performance and not at the time of the contract. Restatement (Third) of Trusts, § 10(e), cmt. g (2003); *see also* Restatement (Second) of Trusts § 30, cmt. b (1959) ("Whether a promise made by the owner of property to become trustee thereof in the future or to transfer the property in the future to another person in trust creates in the promisee a right to recover damages for breach of the promise is determined by the law governing contracts."). Thus, a mere expectation or hope of receiving property in the future cannot be held in trust. Restatement (Third) of Trusts, § 41 (2003); Restatement (Second) of Trusts, § 86 (1959). Moreover, the expecting party does not have a present interest in which he can hold such an expectancy in trust. Restatement (Third) of Trusts, § 41, cmt. a (2003); Restatement (Second)

of Trusts, § 86, cmt. a (1959). [1]

Thus, even if the contract that purports to create a trust in an expectancy [the expectancy being the right to receive the GSA progress payment at issue herein] is phrased as a declaration of trust as opposed to a promise to create a trust in the future, the expecting party cannot effectively create a trust in the expectancy. Instead, the purported beneficiary [Hartford] merely has a contractual promise to create a trust until such time as the expecting party [WAKA] receives the property and demonstrates an intent to hold the property in trust.[2]

Here, given the trust verbiage in the GIA, Hartford cannot properly claim the creation of an express trust whose corpus includes the subject progress payment without demonstrating the clear intent of WAKA to create a trust *at the time it actually received a right to payment from the GSA.* Any manifestations of intent to create a trust that WAKA might have expressed to Hartford prior to entering into the

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[1] The parties thoroughly briefed the relevant Restatement of Trusts sections to the trial court. CP 353-60; CP 384-387.

[2] Restatement (Third) of Trusts, § 41, cmt. c ("If consideration is received for a purported declaration of trust or assignment in trust of a bare expectancy or nonexistent property, the purported declaration or transfer is treated as a contract to create a trust even though it is worded as a present declaration or transfer."); Restatement (Second) of Trusts, § 86, cmt. c ("If a person promises to declare himself trustee of property which he hopes to acquire in the future or to transfer such property to another in trust, or if he purports to declare himself presently trustee of such property or to transfer such property to another in trust, no trust arises even when he acquires the property in the absence of a manifestation of intention at that time.").

contract with the GSA were merely promises to create a trust in the future, which would require a *subsequent manifestation of intent by WAKA to do so.*

Hartford's own summary judgment declarations demonstrate why Hartford cannot properly lay claim to the GSA progress payment that the Bank received on June 21, 2012, for neither WAKA's actions nor Hartford's actions were consistent with the idea that earned progress payments concerning the Project were to be held in trust for Hartford. *Further, Andrew Wilson, WAKA's president, never testified in his deposition that WAKA intended to create a trust in Project funds for Hartford's benefit.*

Although Hartford asserts that the GIA created a trust for the benefit of Hartford, the fact is that at best, this is merely a contract to create a trust, as WAKA had no present contractual right to payment from the GSA on the Project at the time it executed the GIA in June of 2011. CP 169 (showing WAKA entered into the GSA Contract on February 24, 2012).

Tellingly, Hartford has not presented any facts that demonstrate a manifestation of intent by WAKA subsequent to the execution of the GSA Contract to hold those Project funds in trust for the benefit of Hartford. To the contrary, WAKA's actions subsequent to the execution of the GIA

were focused on the payment of its obligations to the Bank. After all, WAKA entered into the Addendum the day after executing the GIA, under which it promised the same progress payments to the Bank without limitation or reference to the GIA. During the course of the Project, WAKA allowed the bank to apply progress payments from the collateral control account to its general line of credit, and made no attempt to segregate the Project funds for Hartford. Without a clear manifestation of intent subsequent to the execution of the GSA Contract, WAKA did not create a trust for the benefit of Hartford. Absent the trust, Hartford has no right to possess the subject progress payment, and Hartford is limited to a cause of action for damages against WAKA for its failure to create a trust. Restatement (Third) of Trusts, § 10(e), cmt. g (2003); *see also* Restatement (Second) of Trusts § 30, cmt. b (1959).

F. Hartford's Reliance On *Levinson v. Linderman* Is Misplaced.

Hartford's reliance on *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958) in its motion for summary judgment and on appeal is misplaced. In *Levinson*, the Washington Supreme Court held that a surety that performed under its bond was entitled to money deposited into the court registry based on the principle of subrogation. *Id.* at 868, 322 P.2d 863. This money was "the unpaid balance on the construction contracts"

as opposed to earned progress payments. *Id.* at 858, 322 P.2d 863. The *Levinson* court noted that "[t]he surety's claim to the withheld funds ... rests upon the doctrine of equitable subrogation that where a surety performs under a performance bond after the default of the contractor, it is entitled to an equitable lien on funds previously withheld by reason of the contractor's default, at least to the extent of the surety's expenses." *Id.* at 869, 322 P.2d 863.

As seen from the foregoing, the landmark United States Supreme Court case of *Pearlman v. Reliance Insurance Company*, 371 U.S. 132 (1962) established a surety's equitable right, through subrogation, to construction retainage funds. The instant case, in contrast, addresses the relative priorities of a contractor's secured creditor and its surety not to retained funds, but to *earned progress payments previously disbursed by the government*. Once funds are disbursed by the project owner, subrogation no longer supports a surety's claim to those funds because "[f]unds intended from the inception of a contract to settle potential claims [retainages] differ vastly from progress payments, which belong to the free flow of commerce from the time they are properly paid over." *Capitol Indemn. Corp.*, 41 F.3d at 325; *see also Bank of Arizona*, 237 F.2d at 93-94.

Because progress payments disbursed by the government enter the

"free flow of commerce," courts for decades have rejected the notion that a surety's equitable rights divest a contractor's creditors of those payments. The general rule was well stated in *National Shawmut Bank*, 411 F.2d at 848, when the First Circuit Court of Appeals stated that "[p]rior to default, the contractor had the right to assign progress payments and had the Bank received payment, it could not (absent circumstances amounting to fraud) have been divested by the surety." *See also Capitol*, 41 F.3d at 327 (surety's equitable lien did not attach to earned progress payment approved for disbursement); *United Pacific Ins. Co.*, 362 F.2d at 808; *National Surety Corp.*, 317 S.W.2d at 345; *United Pacific Ins. Co.*, 10 Del. J. Corp. L. at 343.

The policy reason for allowing creditors like the Bank to keep earned progress payments already disbursed by the government is obvious: "The animating principle behind the general rule is the free flow of commerce: parties which receive the progress-payment funds from the contractor should not have to concern themselves with potential future claims to the money." *Int'l Fidelity Ins. Co.*, 949 F.2d at 1046; *see also Capitol*, 41 F.3d at 325.

Levinson is different from this case because it concerns retainage, not earned progress payments. As seen from the United States Supreme Court's decision in *Pearlman* and the other decisions set forth above, this

is an important distinction. Moreover, the surety in *Levinson* performed under its bond and *then* used this performance to successfully argue its right of subrogation entitled it to the retainage. In contrast, Hartford seeks to recover the subject GSA progress payment from the Bank even though the payment was made to the Bank and applied to WAKA's Loan before Hartford performed under its bond, and before Hartford had any subrogation rights. As seen from *Reliance* and the other legal authority cited herein, the bottom line is a surety like Hartford cannot force its contractor's construction lender to disgorge an earned progress payment when the surety has not yet performed under its bond and the lender has no knowledge of the surety's claim to the funds at the time the setoff is made.

G. Hartford Has Failed To Show The Existence Of An Express Trust That Existed For Its Benefit.

"Express trusts" are those trusts which are created by contract of the parties and intentionally. *E.g., In re Washington Builders Ben. Trust*, 173 Wn. App. 34, 293 P.3d 1206 (2013). An express trust is created only if the settlor properly manifests an intention to create a trust. *Colman v. Colman*, 25 Wn.2d 606, 171 P.2d 691 (1946). An express trust exists where a party has, or accepts, possession of money, 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. *In re Washington Builders Ben. Trust*, 173 Wn. App. at 58, 293 P.3d 1206.

Here, Hartford failed to prove the existence of an express trust as a matter of law because WAKA never testified that it intended to create a trust for Hartford's benefit in connection with the Project. In light of WAKA's actions and inactions toward the Bank that are more fully described above, and were described in great detail to the trial court in the Bank's summary judgment pleadings, the GIA by itself is not enough to establish the existence of an express trust as a matter of law. Nor is the GIA by itself enough to create a genuine issue of material fact as to the existence of an express trust when taken together with the other evidence in the record and the inferences that can be drawn from this evidence. As such, the trial court was right to enter summary judgment in favor of the Bank.

Hartford's breach of trust theory of recovery also fails because Hartford has not established that the purported settlor and trustee of the alleged trust, WAKA, ever had or accepted the GSA progress payment with the express or implied understanding that it was to turn this money over to Hartford as opposed to ensuring that this money was deposited into

WAKA's Bank Control Collateral Account. In fact, such an understanding would be directly contrary to the language in WAKA's Addendum to Business Loan Agreement with the Bank, which WAKA appears to have executed on June 14, 2011, just one (1) day after WAKA executed the GIA with Hartford.

WAKA's Addendum, a copy of which is located at CP 244-45, shows WAKA and the Bank agreed that WAKA "shall deposit all cash, instruments and other proceeds received from the operation of [WAKA's] business into an account established with [the Bank] within two (2) business days after receipt of such amounts (the "Control Account"). Only proceeds received from [WAKA's] non-business operations may be deposited into an account other than the Control Account. [The Bank] is authorized to pay down the unpaid Loan balance, on a daily basis, from funds in the Control Account[.]"

The fact that WAKA executed the Addendum and other loan documents with the Bank after it executed the GIA with Hartford demonstrates that WAKA intended for the Project proceeds to be deposited into the Control Account and then credited to WAKA's line of credit with the Bank. This cuts against the notion that WAKA had an "express or implied understanding" that it was obligated at any point in time to turn over any Project payments to Hartford as opposed to the

Bank.

Tellingly, nowhere in the Addendum or in WAKA's other loan documents with the Bank does it state that WAKA and the Bank recognize and agree that proceeds from the Project may be subject to a trust in favor of Hartford. Further, WAKA's actions with respect to the control account do not demonstrate any intent to segregate assets for the benefit of Hartford at any point prior to the date of the setoff, June 21, 2012. As for WAKA's June 21, 2012 letter to Hartford, which WAKA prepared with Hartford's input according to Mr. Wilson's deposition testimony, the Bank finds it quite telling that Mr. Wilson makes *no mention whatsoever* therein of any alleged trust or trust funds. *See* CP 292-93.

What Hartford is really trying to accomplish with its trust theory of recovery is to lay claim to WAKA's earned progress payments when it could not otherwise do so through the traditional vehicle of subrogation. As seen from the Bank's legal authority and argument herein, given the Bank's earlier and senior perfected security interest in all of WAKA's Project proceeds and in light of the collateral control account, Hartford cannot obtain any superior right to the Project proceeds through Uniform Commercial Code priority rules or through subrogation. As for its right of subrogation, the progress payment at issue was already placed into the free flow of commerce when it was applied to WAKA's line of credit with the

Bank. This payment was no longer available for recovery by Hartford via subrogation, one reason being that Hartford did not pay out any money on its Project bond until after the June 21, 2012 setoff. None of the parties that Hartford was subrogated to could assert a greater interest in the funds when this money was applied to WAKA's debt to the Bank.

Undoubtedly, it was because of these known limitations that Hartford included in the GIA a brief reference to a "Trust Fund" that Hartford might attempt to use as an additional theory for recovery. Out of the ten-page GIA, only one short paragraph makes reference to the idea that WAKA was to hold its contract proceeds in trust for the benefit of Hartford. CP 71. This trust provision is incredibly broad; on its face, it suggests that no funds received from any WAKA project can be used for any purpose other than completion of the bonded project. In theory, apparently, WAKA could not use any proceeds on a bonded project to fund any other ongoing project, capital expenditure, or other general business expense without breaching its "fiduciary" obligations to Hartford. Hartford essentially admitted at the summary judgment hearing that if it had its druthers, these immensely broad terms would subject any party that ever received a payment from WAKA to liability to Hartford.

During the summary judgment hearing, Hartford admitted that under its reading of the law, the Bank did in fact have a duty to inquire

about the nature and source of *each and every deposit that was made into WAKA's collateral control account*. *See* Verbatim Report of Proceedings at 7, lines 1-10; VRP at 8, lines 15-21.

Nevertheless, by allowing proceeds from the Project, without qualification or limitation, to be used to pay down its line of credit with the Bank, WAKA did not demonstrate any intent to hold assets in trust for the benefit of Hartford. Even Hartford has acknowledged that WAKA's line of credit with the Bank was used to complete other projects in addition to the Project. CP 48. As for the actions of Hartford, it also took no actions consistent with the notion that it believed WAKA was holding funds in trust for its benefit until after the Bank's setoff of the progress payment at issue.

In addition, despite knowing that WAKA maintained an account and line of credit with the Bank, Hartford took no action until after the June 21, 2012 setoff to (i) identify for the Bank that Hartford was the beneficiary of a trust created by WAKA; (ii) contest the application of "trust" funds to WAKA's line of credit; or (iii) direct the application of proceeds received from the Project to any specific party. This despite the fact that the Bank filed its Uniform Commercial Code Financing Statement on June 20, 2011, over one (1) year before the setoff in question, thereby putting the world on notice of the Bank's perfected

security interest in all of WAKA's then existing and thereafter acquired accounts, general intangibles, and the proceeds thereof. CP 236. From the reasonable perspective of the Bank on June 21, 2012, Hartford had no interest in the Project proceeds whatsoever.

Moreover, after the execution of the GSA Contract, neither WAKA nor Hartford actually took any actions that were consistent with the idea that Project proceeds were to be placed in an express trust for the benefit of Hartford. Therefore, Hartford cannot establish that it has any rights in the Project proceeds that either prime the perfected security interest of the Bank or defeat its right of setoff. Once the subject progress payment was placed in the free flow of commerce and sent to the Bank without limitation or objection by WAKA or Hartford, the Bank was free to apply this money to WAKA's delinquent line of credit pursuant to the Addendum and its right of setoff.

Unlike the property owner in *Westview*, Hartford, as a surety, cannot simply rely on its GIA as a manifestation of intent by WAKA to create a trust regarding earned progress payments from the Project. Since WAKA did not possess an interest in any right to payment from the GSA Contract at the time the GIA was executed, the GIA with its trust verbiage was merely a contract to create a trust in the future.

Moreover, unlike the bank in *Westview*, the Bank had no actual

knowledge that the subject payment from the project owner *was made to* the general contractor with the *specific understanding* that this money was to be used to pay subcontractors on the job. *Westview*, 133 Wn. App. at 842-43, 138 P.3d 638 (emphasis added).

In addition, as seen from Hartford's discussion of *Westview* on Page 17 of its Brief of Appellant, the bank in *Westview* "tied the contractor's bank account to a sweep account" only when it "became concerned about the contractor's financial condition[.]" In contrast, the Bank and WAKA agreed right from the start of their relationship that WAKA would maintain a bank collateral control account at the Bank that was separate and apart from WAKA's checking account, and that the Bank had the right to apply deposits made in the control account to WAKA's outstanding line at the Bank. CP 245.

In sum, there is no question that Hartford failed to show the existence of an express trust regarding Project proceeds. The trial court was right to dismiss Hartford's claims on summary judgment.

H. The Bank Would Still Prevail Even If There Was An Express Trust Because The GSA Progress Payment Was A General Deposit And Not A Special Deposit.

Even if Hartford was somehow able to demonstrate the existence of a valid, express trust, the Bank must nevertheless prevail in this case because it neither knew nor should have known that Hartford claimed an

interest in the June 21, 2012 progress payment until after the setoff was made on that date. As seen above, 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. The title to a general deposit passes immediately to the bank. *Id.* 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).

The GSA progress payment at issue in this case was a general deposit. Unlike the bank in *Reliance*, the Bank in this case set off the subject GSA progress payment *before* it received the surety's demand and *before* the Bank even knew that Hartford was involved in the Project. The record reflects the Bank had no idea prior to the setoff that Hartford claimed an interest in this money. Moreover, the Bank had no knowledge about any Project materialmen or subcontractors being unpaid on June 21, 2012, the date of the setoff at issue. Given these facts, under *Reliance* and Washington case law concerning general deposits, there simply is no

question that the Bank is entitled to keep the subject progress payment as a matter of law. *This would be the case even if Hartford was able to demonstrate that this money was made up of trust funds.* In such a case, Hartford's recourse would be against WAKA for breach of trust, not the Bank.

I. The Trial Court Did Not Make Factual Determinations.

Hartford is mistaken when it asserts the trial court "made certain factual determinations[.]" Brief of Appellant at 32. The order granting the Bank's motion for summary judgment and dismissing Hartford's complaint does not contain any factual determinations or findings. CP 390-01. Nor does the record reflect the existence of written factual findings elsewhere. The reality is the trial court made no factual determinations in this case.

J. The Trial Court Was Right To Dismiss Hartford's Claims On Summary Judgment.

There never was a valid express trust among WAKA and Hartford regarding the Project. Regardless, even if there had been such a thing, the Court should still affirm the trial court's entry of summary judgment in favor of the Bank; for even if the progress payment at issue was comprised of trust funds, the Bank is still be entitled to keep this money because it was a "general deposit" as opposed to a "special deposit." That is because

the Bank had no reason to believe that this money might have been trust funds at the time of the June 21, 2012 setoff. This case is similar to *Sterling Savings Bank*, which was properly resolved on summary judgment in favor of the bank therein, because there is no genuine issue of material fact as to what the Bank knew or should have known about the nature of the GSA progress payment the morning of June 21, 2012.

Moreover, to the extent the equities may be relevant to the outcome of this case, according to WAKA, the Bank contributed approximately $50,000 to $60,000 to the Project. CP 293. Thus, Hartford is not the only party that invested in the completion of the Project.

In addition, in this case there is literally no evidence in the record to the effect that anyone ever informed the Bank prior to the June 21, 2012 setoff that the subject GSA progress payment was tendered in trust or that Hartford claimed an interest in this money. It is also undisputed that the Bank did not even receive Hartford's demand to the funds until after the setoff was made. On this record, there is no genuine issue of material fact as to whether the Bank knew or should have known on the morning of June 21, 2012 that the subject progress payment was tendered in trust. Further, Hartford has failed to show that it could ever possibly overcome the presumption that the deposit at issue was a general deposit as opposed to a special deposit. As such, the Court should affirm the trial court's

entry of summary judgment in favor of the Bank pursuant to *Reliance* and *Sterling Savings Bank.*

As for Hartford's claim that the only reason the Bank received the subject funds is because the Project owner, the GSA, was not able to stop payment on the transfer of the funds, even if this assertion was true (Hartford never deposed Sue Saucier at the GSA or provided a declaration from her), it is legally irrelevant. The fact is the GSA paid WAKA's earned progress payment directly into WAKA's collateral control account at the Bank, and Hartford never even tried to recover this money or its equivalent via legal or administrative channels from the federal government, WAKA, or Andrew Wilson.

As for Hartford's public policy arguments, they are not persuasive. If Hartford's proposed rule was the law of the land, construction lending would grind to a halt. No rational lender would provide credit to contractors. The trial court was understandably mindful of this at the summary judgment hearing. Verbatim Report of Proceedings at 23.

Contrary to Hartford's assertion, there simply is no way that sureties will "lose their entitlement to the contract funds upon a contractor's default" if the Bank prevails on appeal. Brief of Appellant at 43. Sureties have subrogation rights under state and federal law. They also regularly bargain for guarantors or indemnitors prior to issuing a

bond, as seen from this case, in which WAKA's president, Andrew Wilson, and his wife Susan Wilson agreed to personally indemnify Hartford for any loss that Hartford incurred from bonding WAKA. CP 68.

Further, sureties like Hartford are also free to charge higher bond premiums to account for their risk or perceived risk. Sureties are also free to enter into an agreement — prior to the commencement of work on the project — with the contractor and its construction lender, in which the parties could agree up front that all or certain proceeds from the project should be paid into an account that is controlled by the surety as opposed to the lender or contractor.

Finally, unlike Hartford in this case, sureties can also protect themselves by regularly monitoring public records such as Uniform Commercial Code Financing Statements to see if any parties have claimed a security interest in their principal's accounts, in which case the surety may promptly notify the contractor-principal and the secured party of the surety's claimed interest in this same property.

V. CONCLUSION

The setoff at issue in this case occurred before the Bank received Hartford's demand, before the Bank knew Hartford was involved in the Project, before the GSA declared the Project to be in default, before Hartford took over the Project, and before Hartford paid out any money at

all under its bond. Taken together, there is simply no question that the subject progress payment was a general deposit the morning of June 21, 2012, at which time title to this deposit passed to the Bank. As such, the Court should affirm the trial court's entry of summary judgment in favor of the Bank.

RESPECTFULLY SUBMITTED this 23rd day of December, 2013.

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I, Jennifer K. Fernando, am a legal assistant with the firm of Eisenhower Carlson PLLC, and am competent to be a witness herein. On December 23, 2013, at Tacoma, Washington, I caused a true and correct copy of the Brief of Respondent to be served upon the following in the manner indicated below:

Todd William Blischke, Esq. Watt, Tieder, Hoffar & Fitzgerald 1215 4th Avenue, Suite 2210 Seattle, WA 98161	■ by Legal Messenger ■ by Electronic Mail

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

DATED this 23rd day of December, 2013, at Tacoma, Washington.

Jennifer K. Fernando