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No. 87087-0

SUPREME COURT OF THE STATE OF WASHINGTON

STEWART TITLE GUARANTY COMPANY,

Plaintiff/Appellant

v.

WITHERSPOON, KELLEY, DAVENPORT & TOOLE, P.S., AND
DUANE M. SWINTON,

Defendants/Respondents,

STERLING SAVINGS BANK; AND STERLING FINANCIAL
CORPORATION,

Defendants.

BRIEF OF RESPONDENTS

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ORIGINAL

TABLE OF CONTENTS

TABLE OF AUTHORITIES

FEDERAL CASES

STATE CASES

STATUTES

DOCKETED CASES

MISCELLANEOUS

I. INTRODUCTION

In this appeal, Stewart Title Guaranty Company ("Stewart") is trying to expand the doctrine of equitable subrogation by uncoupling it from two of its most fundamental requirements: (1) that it is available only to prevent unjust enrichment, and (2) that it is available only where one party answers for the debt of another. Stewart seeks to expand the doctrine not with any principled justification, but so that it can claim that respondent Witherspoon, Kelley, Davenport & Toole, P.S. ("Witherspoon"), committed legal malpractice by failing to assert the expanded doctrine in defense of one of Stewart's insureds, Sterling Savings Bank ("Sterling"). At its core, this is nothing more than an attempt to shift Stewart's loss to Witherspoon and to avoid the consequences of the admitted errors Stewart made in issuing title insurance to Sterling. However, to accomplish this result, Stewart first needs the help of this Court in fundamentally reshaping the law governing equitable subrogation.

This Court should decline Stewart's invitation to redesign the law and instead apply the long-established principles of equitable subrogation that govern this case. First, and most fundamentally, equitable subrogation is available only to prevent unjust enrichment. There was no danger of unjust enrichment in this case so the defense was not available. This Court has held, in a series of cases stretching back nearly 50 years, that there is nothing unjust about a title insurer paying a claim on a bargained-for insurance contract for which it has accepted a premium, especially where, as here, the claim results from the insurer's own negligence. Second, equitable subrogation is only available when one party answers for the debt of another. That did not happen here: the underlying transaction was a purchase money loan, which involves purchasing property rather than answering for the debt of another.

For these reasons, equitable subrogation was not a valid defense below and Witherspoon did not commit malpractice by failing to raise it. Stewart's invitation to expand the law makes even less sense in light of the fact that, because this is a legal malpractice action, the law governing the standard of care is the law as it existed in 2008, not the law as it might look if this Court expanded it today.

In addition to expanding the law of equitable subrogation, Stewart also needs to expand Witherspoon's duties beyond those to its actual client, Sterling, to give itself standing to sue for malpractice. The dangers of such an expansion are starkly illustrated by this case. Stewart terminated Witherspoon for being too loyal to Sterling, and then sued Witherspoon, claiming that, while its advice may have been in Sterling's best interests, it was not in Stewart's interest. Thus, expanding Witherspoon's duties to include Stewart would create a risk of divided loyalties in violation of multiple Washington Supreme Court holdings prohibiting such conflicts. Such an expansion is also unnecessary given alternative remedies and other protections available to Stewart. As an alternative ground for affirming the dismissal of Stewart's malpractice claims by summary judgment, this Court should reverse the ruling that

Witherspoon owed Stewart a limited duty of care under *Trask v. Butler*, 123 Wn.2d 835, 872 P.2d 1080 (1994).

II. STATEMENT OF THE CASE

Stewart is a title insurance company. This case began in 2010, when Stewart sued its insured and its insured's lawyers to try to avoid liability for a claim that arose under one of Stewart's insurance policies. The only claim on appeal is Stewart's legal malpractice claim, which centers on its allegation that Witherspoon failed to identify equitable subrogation as a defense in an underlying mechanics' lien foreclosure action in which Witherspoon represented Stewart's insured, Sterling. Stewart claims that, as a result of Witherspoon's alleged negligence, it was damaged because it had to pay to remove the lien from title and restore Sterling to its first-position priority, as required under its insurance policy. Stewart now appeals the trial court's grant of summary judgment that equitable subrogation was not an available defense in the underlying litigation and thus that Witherspoon did not fall below the standard of care in its representation of Sterling.

A. Everyone Involved Documented the Underlying Transaction as a Sale by DAD to JA with Sterling Lending JA the Purchase Price.

On May 9, 2007, Sterling approved a $7,535,000 loan to purchase and develop 19 acres of real estate in Kitsap County known as the Cook Addition. (CP 1475.) Although Stewart disputes the precise nature of Sterling's loan to James Alan, LLC ("JA"), Sterling's loan Credit Approval Sheet specifically identifies its borrower as JA and describes the purpose of the loan as JA's purchase and development of the Cook Addition property:

> James Alan, LLC requests approval of project specific financing in the amount of $7,535,000, for acquisition and development of the project known as Cook Addition. Project is comprised of 90 lots and located in Poulsbo, Kitsap County, Washington.

(CP 1478.) The seller of the Cook Addition was David Alan Development LLC ("DAD") with JA agreeing to pay a $4.5 million purchase price. (CP 1498.) Accordingly, as part of the loan approval process, Sterling agreed that JA could use $3.5 million of its loan to purchase the Cook Addition from DAD with the $1 million balance of the purchase price paid via a promissory note from JA to DAD. (CP 1460; 1479.)

Sterling's loan documents were then all drafted to reflect that JA would borrow money from Sterling to purchase and develop the Cook Addition from DAD. (CP 1523-32.) The deed of trust given to Sterling to secure the loan was granted at closing by JA as the new owner of the Cook Addition. (CP 1505-21.) The primary source of repayment for Sterling's loan was JA's development and sale of the 90 residential lot Cook Addition development. (CP 1482-83.)

Similarly, DAD's transfer of the Cook Addition to JA was documented as a routine purchase and sale of the Cook Addition real estate. For example, DAD and JA entered into a standard Real Estate Purchase and Sale Agreement reflecting DAD's sale of the Cook Addition to JA. (CP 1498-1502.) JA gave DAD a $1 million promissory note in payment of a portion of the $4.5 million purchase price. (CP 1460.) JA secured the note by giving DAD a subordinated deed of trust on the Cook Addition. (CP 1406-09.) At closing, DAD transferred title to the Cook Addition to JA by means of a standard warranty deed which was recorded in a routine fashion. (CP 1496.)

The escrow agent's file for the closing of the Sterling loan and the sale of the Cook Addition on June 11, 2007, likewise reflects Sterling lent money to JA to allow it to purchase the Cook Addition from DAD. For example, the escrow agent prepared a Settlement Statement showing the disposition of all funds which came into or went out of escrow. (CP 1411-12.) At his deposition, the escrow agent explained that this Settlement Statement shows that he applied the proceeds of the loan from Sterling to JA's payment of the purchase price to DAD for the Cook Addition. (CP 1306.)[1] When Stewart tried to get the escrow agent to testify instead that he used Sterling's loan to pay certain obligations which DAD owed to George Brown ("Brown") and Integrated Financial Associates ("IFA"), the escrow agent refused. Instead, the agent reiterated that the funds which Sterling wired into escrow were used by JA to pay the purchase price to DAD, whereas DAD used its own funds (in part sale proceeds) to pay its obligations to Brown and IFA:

[1] This Settlement Statement contains two separate columns, one describing the use of funds belonging to JA, *i.e.*, a "Summary of Borrower's Transaction," and one describing the use of funds belonging to DAD, "Summary of the Seller's Transaction." (CP 1411.) That DAD paid its own obligations to Brown and IFA is reflected about half way down the column on the right side of the first page which summarizes the funds disbursed at closing by the "Seller," *i.e.*, by DAD. *See id.* under "Reductions In Amount Due To Seller, line item nos. 504 & 505.

> Q. And the entire portion of that 3.5-plus million [loan by Sterling] is used to pay off preexisting loans?
>
> A. Well, it was used to complete the purchase of the property by James Alan, LLC.
>
> Q. Okay. What do you mean by that?
>
> A. I mean the loans themselves [Brown and IFA] that were paid off were under David Alan Development -- by the seller, I meant. So the funds that Action Mortgage [i.e., Sterling] wired to us were used to pay the 4.5-million-dollar purchase price plus the cost of the transaction.

(CP 1306:16-25.)

B. Stewart's Role in the Transaction.

Among other conditions for closing its loan to JA, Sterling required that it obtain sufficient security including a deed of trust from JA giving Sterling first-position priority in the Cook Addition. (CP 1475-1480.) To be sure it was adequately secured, Sterling also conditioned the loan on acquiring title insurance guaranteeing that title would vest in JA, and that the deed of trust granted by JA would have priority over any other encumbrance on the Cook Addition. (CP 1523-24.) Sterling contacted Stewart's local agent, Stewart of Kitsap, to obtain an appropriate lender's title insurance policy. (CP 1362.)

Stewart's May 2007 preliminary commitment identified several encumbrances of record, including deeds of trust DAD had given in favor of two of its creditors, IFA and Brown. (CP 1044.) Thus, to convey clear title to JA, DAD was required to pay off its outstanding obligations to IFA and Brown. (CP 80-82.) DAD's proceeds from its sale of the Cook Addition accounted for approximately $3.5 million of the $6.6 million it paid to discharge its obligations to IFA and Brown, and DAD obtained the balance needed to satisfy these two obligations from other sources, including refinancing unrelated real estate. (CP 104; 90-91; 100; 106; 84-85.)

Stewart initially offered Sterling title insurance that excluded unrecorded interests such as mechanics' liens. (CP 1366; 983-84; 969; 1435-36.) However, that exclusion was not acceptable to Sterling. (CP 1049 ¶¶ 3-4; 1523-24; 1435-36.) Accordingly, Stewart ultimately provided "extended" title coverage which includes coverage for mechanics' liens. (CP 1378 ¶ 7; 985-86; 968; 1436.) Before extended coverage can be issued, Stewart's internal procedures require a site inspection of the property to see if construction has started. (CP 974-980; 1437; 2951-56.) As Stewart instructs its agents:

> Mechanics' lien coverage is a contract of indemnity insuring the lender against loss or damage due to the lack of priority of its mortgage lien over mechanics' liens. This kind of coverage has become a source of enormous loss for title insurance companies. Extreme care must be exercised when deleting the mechanics' lien exception from any title insurance policy.

(CP 978; 1030.) If a site inspection reveals that construction has started, Stewart requires an indemnification agreement for liens or a subordination agreement from the contractor before issuing extended coverage for unrecorded mechanics' liens. (CP 1437-38; 2953-56.)

Here, Stewart's local agent, Stewart of Kitsap was responsible for arranging the inspection. However, Stewart of Kitsap failed to inspect the property. (CP 1437; 1102.)

C. Mountain West Starts Work Before Sterling Records Its Deed of Trust.

Stewart's failure to conduct the required site inspection was unfortunate because JA's contractor, Mountain West, started development work on the Cook Addition on or about May 14, 2007. (CP 886; 1184.) In contrast, Sterling's loan to JA and the sale of the Cook Addition property closed almost a month later on June 11, 2007. (CP 861-64.) The deed of trust given by JA to secure Sterling's loan was recorded on the same day—June 11, 2007. (CP 1083.) When a mechanics' lien is recorded, all of the contractor's work relates back to the date services were first provided, i.e., to May 14, 2007, approximately a month before Sterling's deed of trust was recorded. *See* RCW 60.04.061. As Stewart's in-house lawyer concluded, if Stewart of Kitsap had inspected the property, Stewart (and Sterling) could have avoided the loss of priority. (CP 1437; 2953-56.) However, because it failed to conduct the required site inspection, Stewart issued coverage for unrecorded mechanics' liens nearly a month after Mountain West's lien attached.

D. Mountain West's Lien Foreclosure Action.

What happened next comes as no surprise. As the real estate market collapsed in late 2007, suspicions arose that David Milne, one of JA's owners, was diverting funds advanced by Sterling to pay construction costs on other projects. (CP 885; 1211.) By late 2007, JA was falling behind in paying invoices from Mountain West. (CP 1176-82.) In April of 2008, Mountain West recorded an $832,000+ mechanics' lien against the Cook Addition. (CP 4.) By statute, the entire amount of the lien then related back to the first day of work, May 14, 2007, approximately one month before the deed of trust was recorded. *See* RCW 60.04.061. In June of 2008, Mountain West filed suit in Kitsap County Superior Court (the "Lien Foreclosure Action")[2] against Sterling (and others) to establish that its construction lien had first priority and to foreclose against the Cook Addition. (CP 2145.)

E. **Sterling Retained Duane Swinton of the Witherspoon Firm, Who Tendered Defense to Stewart.**

Sterling retained its long-time counsel, Witherspoon, to represent it in the Lien Foreclosure Action. (CP 1000.) After reviewing the Policy, Witherspoon's Duane Swinton tendered the defense to Stewart on July 18, 2008. (CP 1140.) Four days later, one of Stewart's in-house claims lawyers, Kelly Rickenbach, acknowledged receipt of the tender and said she would respond after Stewart conducted its investigation. (CP 2150.)

On August 28, 2008, more than six weeks after Sterling tendered and after Sterling had filed an answer, Ms. Rickenbach finally wrote on behalf of Stewart, retaining Witherspoon to continue representing Sterling in the Lien Foreclosure Action. (CP 210.) Notably, Stewart's retention letter refused to tell Witherspoon whether it was reserving rights to dispute coverage:

> [i]n certain cases (but not necessarily in this case), Stewart's ultimate obligation to your client may be the subject of a Reservation of Rights communicated or to be communicated to your client by Stewart. Stewart does not intend that you should ever become knowledgeable of such a reservation, if one exists.

---

[2] *Mountain West Constr. LLC v. James Alan LLC, et al.*, Kitsap County Superior Court No. 08-2-01804-2.

(CP 210.) Moreover, Stewart instructed Witherspoon that it was to treat Sterling as its only client, such that its loyalty and allegiance was owed "solely and exclusively" to Sterling:

> You have been retained to represent the interests of your client, with whom your privileged relationship of attorney to client will [be] solely and exclusively. Your client shall at all times be entitled to your full and undivided professional loyalty through exercise of competence and preservation of confidences.

Id. Stewart emphasized that Witherspoon should "confine your representation solely to the interests of your client." Also, Stewart explained that "payment of your fees shall in no way be interpreted as representation of Stewart." (CP 211.)

Nevertheless, Stewart's letter said that, under the terms of the title policy issued to Sterling, "[t]he pertinent policy provisions entitle Stewart to control and direct the litigation affecting the interest[s] of your client." *Id.* Accordingly, Witherspoon was informed that its staff attorney, Ms. Rickenbach, should be "kept well advised of all major developments and progress in the case." *Id.*

F. **Stewart's in-House Lawyer Agreed That Sterling Should Stipulate to the Priority of Mountain West's Lien.**

Almost immediately, Mountain West filed a motion for summary judgment that its mechanics' lien was superior to Sterling's deed of trust. (CP 2453.) Shortly thereafter, on October 31, 2008, Witherspoon wrote Ms. Rickenbach to outline its investigation to date of several possible defenses. (CP 1899-900.) Witherspoon reported that, based on these possible defenses, it could not articulate a basis for opposing Mountain

West's motion to establish the priority of its construction lien. *Id.* Witherspoon's letter concluded by asking Ms. Rickenbach whether Witherspoon should agree to Mountain West's priority to avoid further fees and costs and whether she agreed that there was no basis for opposing Mountain West's motion for summary judgment on priority. *Id.*

After receiving no response, Witherspoon emailed Ms. Rickenbach again on November 3, 2008, to remind her that it was waiting for her direction: "I am assuming you are in agreement that there is no basis for opposing Mountain West's motion for partial summary judgment on the issue of priority." (CP 1151.) Her response, on behalf of Stewart, was "Yes. I agree with that. Thanks." *Id.* Accordingly, on November 7, 2008, Witherspoon stipulated that Mountain West's lien had priority over Sterling's deed of trust. (CP 1153-54.)

G. When Witherspoon Sought Settlement Authority, Stewart Tried to Shift Costs to Sterling.

In February 2009, after trying to reduce the amount of Mountain West's lien, Witherspoon asked Stewart for settlement authority to resolve Mountain West's lien claim. (CP 2475-80.) Instead, in March of 2009, Rickenbach retained coverage counsel, Steve Sirianni, to see whether Stewart could shift some of the loss to Sterling. In particular, Rickenbach asked whether Stewart could force Sterling to incur more than $400,000 of the $800,000 loss on the theory that Sterling had eventually declared JA's loan to be in default and thus had not fully funded the loan amount. (CP 2158.)

After reviewing Stewart's file, coverage counsel was not very encouraging about Stewart's chances in this regard. However, in passing, Mr. Sirianni suggested that the doctrine of "equitable subrogation" might be a defense to the priority of Mountain West's lien. (CP 3131-36.) In this regard, coverage counsel suggested that JA's payment of the Sterling loan proceeds to DAD, which DAD used in turn to pay prior obligations to IFA and Brown, might entitle Sterling to be subrogated to the deeds of trust securing the obligations to Brown and IFA. (CP 3136.)

H. Stewart Intervenes in the Lien Foreclosure Action.

At approximately the same time it retained Mr. Sirianni to explore ways to shift its loss to Sterling, Stewart also retained "recoupment counsel," attorney Laurin Schweet, to intervene in the Lien Foreclosure Action to pursue claims for indemnification against Sterling's borrower, JA, and against David Milne. (CP 2769-73.) In moving to intervene, Ms. Schweet told the Court that it was not Sterling's (i.e., Witherspoon's), job to protect Stewart's interests. *Id.* at 2772:9-12. Ms. Schweet also began advising Stewart's in-house lawyers how to shift losses to its insured by blaming Sterling for delay in recording its deed of trust, a theory Stewart later asserted against Sterling in this action. (CP 1472; CP 6 ¶ 25.) Ms. Schweet also promoted raising the "equitable subordination" (sic) defense, explaining that "anything we can do to delay the onset of the foreclosure works somewhat in our favor." (CP 1472.)

I. When Stewart Wanted to Pursue Equitable Subrogation, Witherspoon Disagreed.

On May 5, 2009, following up on her coverage counsel's suggestion, Rickenbach asked Witherspoon about the applicability of the equitable subrogation defense. (CP 1931.) Shortly after he was retained, Swinton made an initial determination that he did not believe equitable subrogation was a viable defense. (CP 2739-42.) However, when Rickenbach asked specifically about the availability of the defense, Swinton agreed to amend Sterling's answer to assert the defenses. (CP 1006.) Swinton then investigated the issue in greater depth only to conclude again that equitable subrogation was not a defense. (CP 2218; 2749-52.)

Moreover, in contrast to Stewart's "recoupment counsel" Ms. Schweet, Swinton believed that it was not in Sterling's interest to assert a defense that was not viable but that would have the effect of delaying the resolution of Mountain West's lien claim. Because the value of the Cook Addition was dropping along with the general real estate market, Sterling needed to get the property foreclosed as quickly as possible in order to realize on its collateral. (CP 2728-29.) Accordingly, Swinton concluded that pursuing the defense of equitable subrogation was contrary to Sterling's best interest. (CP 2753.) On June 2, 2009, Swinton conveyed this to Rickenbach in writing, saying he had given further thought to an equitable subrogation defense and doubted that the doctrine would apply, given that the transaction involved a purchase and sale rather than a refinance. (CP 1935-37.)

J. Stewart Fires Witherspoon for Being Too Loyal to Sterling.

When Swinton disagreed with Stewart that the defense should be pursued, Stewart fired Witherspoon. (CP 1939.) In doing so, Stewart's in-house lawyers explained that they had decided to fire Witherspoon because Duane Swinton was too loyal to his client, Sterling. Thus, Ms. Rickenbach explained to her supervisor, Derek Matthews:

> Duane clearly cannot be neutral to the situation. He is acting as counsel for the bank, and doesn't understand the difference between covered title claims and being the Insured's personal counsel . . . . I think he's probably decent counsel for the lender individually, but he won't be able to assist in our resolution of the claim or minimize any loss.

(CP 1468-69.) Mr. Matthews, Stewart's Regional Claims Counsel, agreed:

> We haven't been overly impressed and have felt on several occasions that his closeness to Sterling Savings as a long time client has impacted his ability to fulfill his obligations to us.

(CP 1469.)

Thereafter, with the assistance of replacement counsel, Stewart pursued the equitable subrogation defense in the Lien Foreclosure Action. However, because of Witherspoon's stipulation to entry of Mountain West's motion for summary judgment on priority of its lien (with Rickenbach's consent), the trial court refused to allow the assertion of equitable subrogation as a means of circumventing Mountain West's priority, and that determination was affirmed on appeal. (CP 2019-33.)

K. Stewart Sued Sterling and Witherspoon.

In July 2010, while Stewart directed Sterling's appeal of that ruling, Stewart filed this loss-shifting lawsuit against Sterling and Witherspoon in King County Superior Court. (CP 1-10.) Using theories developed by its coverage counsel and recoupment counsel, Stewart sued Sterling seeking declaratory relief that its insured caused its own loss because Sterling (i) allegedly knew that Mountain West had started construction on the Cook Addition prior to the recording of the Deed of Trust, (ii) allegedly delayed filing the Deed of Trust, and (iii) failed to fully fund the loan from which JA would pay Mountain West. (CP 6-7.)

At the same time, Stewart sued Witherspoon for legal malpractice, claiming that Witherspoon should have asserted a defense that, because DAD paid its obligations to IFA and Brown in part with funds JA borrowed from Sterling, Sterling was equitably subrogated to their priority. (CP 7-8.) In this regard, Stewart alleged it had standing to assert Sterling's malpractice claim through the doctrine of subrogation. *Id.* Alternatively, Stewart also claimed it sued in its own name as an intended beneficiary of Witherspoon's legal services. *Id.*

L. Stewart Blames Its Agent for Committing Either Negligence or Gross Negligence in Issuing the Policy.

As discovery moved forward, Witherspoon learned Stewart had blamed its own agent, Stewart of Kitsap, for mistakes in issuing extended coverage to Sterling. (CP 2266-68.) When Witherspoon sought discovery, Stewart objected. *Id.* Ultimately, after Stewart was sanctioned (CP 2979-80), Witherspoon obtained Stewart's internal analysis, written by two of its senior in-house lawyers, of Stewart of Kitsap's errors in connection with issuing the Policy. (CP 1435-38.) In a scathing critique, Stewart concluded that its agent had been at least negligent and perhaps grossly negligent in issuing extended coverage to Sterling without first conducting the required site inspection or getting an adequate indemnity:

> STK [Stewart of Kitsap] failed to follow underwriting guidelines in several respects. They failed to get underwriter approval before providing coverage for mechanic's liens. In doing so, they substituted their own judgment for what the underwriting requirements should be for providing this coverage (an inspection and indemnity). The first of these self-imposed requirements was not met as an inspection was not done. The second self imposed requirement, an indemnity, was done but was done in a manner that would not have been approved by an underwriter . . . . [w]hen combined together in one transaction a decent argument can be made that these mistakes rise to the level of gross negligence.

(CP 1438.) As John Martin, the owner of Stewart of Kitsap, put it after reviewing Stewart's notice of a potential claim: "I've been sick about this claim since it arose. . . ." (CP 2797.)

M. <u>The Court Granted Summary Judgment on Alternate Grounds.</u>

Witherspoon then sought summary judgment on two different theories that equitable subrogation was not an available defense and thus Witherspoon had not committed malpractice:

1. Equitable subrogation is available when one answers for the debt of another, whereas in the Cook Addition loan, Sterling lent money so that its borrower could purchase real property. Because neither Sterling nor its borrower ever answered for DAD's obligations owed to IFA and Brown, Sterling could not be subrogated to their position; and

2. Equitable subrogation is available only to prevent unjust enrichment, whereas here, there was nothing unjust about Stewart making good on its contractual duty to clear title to Sterling's property because the duty to pay was triggered by Stewart's own negligence in issuing coverage.

The Superior Court granted Witherspoon's motion on both grounds. (CP 1753-61.)

At the same time, Witherspoon also moved for summary judgment that it owed no duty of care to Stewart, which had separate counsel and had specifically instructed that Witherspoon represented only Sterling. (CP 2506-30.) The trial court agreed that Stewart could not assert Sterling's rights against Witherspoon on a subrogation theory while it was simultaneously suing Sterling. (CP 526.) Stewart has not appealed this ruling. The trial court also agreed that Stewart's retention letter limited Witherspoon's obligations to Stewart to a duty to keep it informed. (CP 523.) Nevertheless, the court viewed Witherspoon's report letters requesting direction from Ms. Rickenbach on Mountain West's motion for summary judgment on priority as containing "specific recommendations" and concluded that, to this extent, "Witherspoon had a limited duty to provide competent advice" under *Trask v. Butler*, 123 Wn.2d 835, 872 P.2d 1080 (1994). (CP 523.)

Stewart then abandoned its claims against Sterling through a CR 41 dismissal with prejudice, and filed this appeal.

III. STATEMENT OF ISSUES

(1) Can a title insurer use the doctrine of equitable subrogation to avoid paying a claim caused by its own error where there is no danger of unjust enrichment?

(2) Was Sterling equitably subrogated to the position of DAD's creditors IFA and Brown where neither Sterling nor JA answered for DAD's obligations to those creditors?

(3) Does a law firm representing an insured owe the insurer a duty of care under *Trask v. Butler*?

IV. STANDARD OF REVIEW

If the facts are not disputed, whether equitable subrogation applies is a question of law. *Kim v. Lee*, 145 Wn.2d 79, 85-86, 31 P.3d 665 (2001). On summary judgment, this Court engages in the same inquiry as the trial court, affirming summary judgment as long as there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. *Dowler v. Clover Park Sch. Dist. No. 400*, 172 Wn.2d 471, 484, 258 P.3d 676 (2011).

V. LEGAL AUTHORITY AND ARGUMENT

A. Equitable Subrogation Is Available Only If There Is a Danger of Unjust Enrichment.

Stewart claims equitable subrogation should have been asserted below despite that its most basic requirements were not met. Subrogation is an equitable doctrine borrowed from English courts of equity. *See, e.g., Bank of Am., N.A. v. Prestance Corp.*, 160 Wn.2d 560, 564, 160 P.3d 17 (2007); *Dunsmuir v. Port Angeles Gas, Water, Elec. Light & Power Co.*, 30 Wash. 586, 593, 71 P. 9 (1902) ("peculiarly involves equitable principles"). It allows one who pays the debt of another to step into the position of the person whose obligation is discharged and to acquire that person's rights. *E.g.*, *State v. Base*, 131 Wn. App. 207, 217, 126 P.3d 79 (2006). However, equitable subrogation is "not an absolute right, but one which depends upon the equities and attending facts and circumstances of each case." *Kim v. Lee*, 145 Wn.2d 79, 88, 31 P.3d 665 (2001). Fundamentally, subrogation is an equitable balancing designed "to impose ultimate responsibility for a wrong or loss on the party who, in equity and good conscience, ought to bear it." *Id.* at 88.

In the context of real estate loans, Washington has adopted a specific formulation of the equitable subrogation doctrine from *Restatement (Third) of Property: Mortgages* § 7.6 (1997) ("*Restatement*"). *See Prestance*, 160 Wn.2d at 582. Under the *Restatement*, equitable subrogation is available only to "[o]ne who fully performs an obligation of another," and even then only "to the extent necessary to prevent unjust enrichment":

> (a) One <u>who fully performs an obligation of another</u>, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage <u>to the extent necessary to prevent unjust enrichment</u>. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.

Restatement § 7.6 (emphases added).

Even before our courts adopted *Restatement* § 7.6 and its express requirements, it was widely accepted that equitable subrogation was available only to prevent unjust enrichment. *See Kim*, 145 Wn.2d at 89 ("[I]n the real estate context, equitable subrogation has been traditionally invoked only to prevent unjust enrichment[.]"); *see also Coy v. Raabe*, 69 Wn.2d 346, 350-51, 418 P.2d 728 (1966). Indeed, preventing unjust enrichment is the whole point of the doctrine. *Prestance*, 160 Wn.2d at 575-76 ("the overall purpose" of equitable subrogation is to prevent unjust enrichment). Thus, applying equitable subrogation where there is no danger of unjust enrichment would elevate form over substance—the very antithesis of equity.

Our courts have also been clear that enrichment alone is not enough to warrant subrogation; the enrichment must be unjust:

> Enrichment alone will not suffice to invoke the remedial powers of a court of equity. It is critical that the enrichment be unjust both under the circumstances and as between the two parties to the transaction.

Norcon Builders, LLC v. GMP Homes VG, LLC, 161 Wn. App. 474, 490, 254 P.3d 835 (2011). Unjust enrichment occurs when one retains money or benefits which in justice and equity belong to another. *Bailie Comm'cs, Ltd. v. Trend Bus. Sys., Inc.*, 61 Wn. App. 151, 810 P.2d 12 (1991).

B. Under *Coy v. Raabe*, Equitable Subrogation Was Unavailable as a Matter of Law Because There Was No Danger of Unjust Enrichment.

Applying these rules to this case, equitable subrogation cannot apply because, as a matter of law, no unjust enrichment results when a title company pays a claim caused by its own error. Nearly 50 years ago, in *Coy v. Raabe*, 69 Wn.2d 346, 418 P.2d 728 (1966), this Court held that equitable subrogation cannot be used to aid a title insurer who suffered a loss because of its own error:

> It would be a gross misapplication of the doctrine of subrogation were we to hold that its cloak settles automatically upon one who has simply made a mistake, when it is a commercial transaction involving a consideration. Intervenor's [i.e., the title company] relationship is governed by the law of contracts. Further, it is difficult to think of a situation in which a title insurance company could not claim unjust enrichment as to someone who might inadvertently benefit by their negligence. Either they insure or they don't. <u>It is not the province of the court to relieve a title insurance company of its contractual obligation.</u>

Id. at 351 (emphasis added).[3] As this quotation from *Coy* demonstrates, it simply is not unjust to require a title insurer to pay a claim on a bargained-for insurance contract for which it has accepted a premium, particularly when, as here, the claim results from the title insurer's own negligence.

In *Kim*, this Court reaffirmed *Coy*'s holding that title insurers cannot rely on equity to avoid paying legitimate claims. Examining *Coy* at length, the court in *Kim* said that "[t]he role of the title insurer is to insure title," and since "the title company was 'engaged in giving [ ] expert opinions for a consideration,'" subrogation is unavailable to them.

[3] A variety of other jurisdictions have since either adopted *Coy* or cited it with approval in reaching similar outcomes. *See, e.g., Wells Fargo Bank v. Ky. Dep't of Revenue*, 345 S.W.3d 800, 808 (Ky. 2011) (characterizing *Coy* as "persuasive," noting that title companies are in a "very profitable business" and holding that "[i]f the title insurer's examiners bungle the title search, no matter how innocent the mistake might be, then the title insurers must ultimately be held liable"); *Universal Title Ins. Co. v. U.S.*, 942 F.2d 1311, 1317 (8th Cir. 1991) (quoting *Coy* with approval); *USLife Title Ins. Co. v. Romero*, 98 N.M. 699, 703, 652 P.2d 249 (1982) (quoting *Coy* remark "either they insure or they don't" passage before holding a title company's negligence bars subrogation); *Lawyers Title Ins. Co. v. CAPP*, 174 Ind. App. 633, 636, 369 N.E.2d 672 (1977) (disagreeing that "no distinction exists between title insurance and other forms of indemnity agreements" and quoting *Coy* "with which we agree").

Kim, 145 Wn.2d at 91 (quoting *Coy*, 69 Wn.2d at 350). In balancing the equities to avoid unjust enrichment, *Kim* also recognized that courts are deciding whether to let the loss fall on a title company, or to use an equitable doctrine to shift the loss to an innocent third party such as Mountain West:

> In the instant case, legal remedies and equity suggest that the loss should fall on the title company rather than the innocent judgment creditor. As in *Coy*, this case was precipitated by the title company's negligence and failure to acknowledge the lien.

Kim, 145 Wn.2d at 91-92.

The same logic applies to Stewart in this case, and unless *Coy* and *Kim* are to be overruled, Stewart cannot rely on equitable subrogation to recoup its loss. First, Stewart has not denied that its loss was caused by its own error, nor could it given the highly critical analysis its own senior management wrote about the failure to conduct a site inspection and get an adequate indemnity agreement. (CP 1438.) There is simply nothing inequitable or unjust about requiring Stewart to clear Sterling's title given the obligation to pay was caused by Stewart's own mistakes. Title companies have expertise in identifying title defects and are paid a premium to contractually assume the risk that they are wrong. Nor was Mountain West unjustly enriched when it was paid the agreed price for work it actually performed.

Thus, as the above quote from *Kim* recognizes, there is no unjust enrichment or other compelling injustice requiring a court of equity shift Stewart's contractual loss on the policy to an innocent contractor who is simply being paid for its work. *Id.* Since there has been no showing that *Coy* and *Kim* are incorrect or harmful, the rule established in those cases controls.

C. **Stewart's Arguments to the Contrary Are Unavailing.**

Stewart attempts to muddy the clear absence of any unjust enrichment with several spurious arguments. First, Stewart tries to recast the issue as whether Stewart's "constructive knowledge" of Mountain West's intervening lien precludes the use of subrogation. Stewart's Br. at 37-42. This is entirely beside the point. The reasoning of the *Coy* line of cases does not turn on knowledge, constructive or otherwise. Instead, these cases recognize that subrogation is an equitable doctrine designed to avoid unjust enrichment and thus requires an equitable balancing of where the loss should fall. *Coy*, 69 Wn.2d at 350-51. Regardless of who knew what, it is not unjust for a title insurer to pay the cost of clearing title where it faces liability because of its own negligence, and it would be a strange result if equity intervened to shift the loss to a contractor simply seeking to be paid for its work. Stewart's discussion of constructive knowledge adds nothing useful to the court's analysis.

Next, Stewart ignores precedent by arguing that the *Coy* line of cases does not apply because it would have been Sterling (a bank) asserting equitable subrogation not Stewart (a title insurer). Stewart's Br. at 41. The problem with this argument is that this Court explicitly rejected it in *Kim*, where Justice Sanders made the same argument in dissent. *See* 145 Wn.2d at 93-94. As this Court recognized in *Kim*, Stewart's (and

Justice Sanders') reasoning ignores the reality of the situation. *Id.* at 91-92. In balancing the equities to determine unjust enrichment, courts recognize that the loss will never fall on the insured: if subrogation is granted, Sterling is in first position and the loss will fall on Mountain West; if subrogation is not granted, Sterling has title insurance and the loss will fall on Stewart. Thus, it makes no difference whether the insured or the insurer asserts the defense because under *Kim*, courts must look through the insured to the real issue: should it shift the title company's loss to an innocent third party. *See id.* Thus, the Court of Appeals recently denied equitable subrogation to condominium owners in part based on the negligence of their title insurer notwithstanding that it was the owners, not the insurer, seeking subrogation. *Norcon Builders,* 161 Wn. App. at 490, 499-500.[4]

Finally, Stewart urges that making title insurers pay for their own mistakes will limit the availability of equitable subrogation and increase

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[4] Stewart is also wrong that *Kim* and *Coy* are no longer viable after *Prestance. Prestance* revisited the issue of whether a bank's actual knowledge of an intervening encumbrance would bar the bank's use of equitable subrogation. The court had to address *Kim*'s holding that actual knowledge of an encumbrance barred the use of equitable subrogation. However, rather than overrule *Kim*, the Supreme Court carefully distinguished *Kim*, holding that it turned on the equities applicable to title insurers who face a loss because of their own mistake. *Prestance*, 160 Wn.2d at 564. Thus, following *Prestance*, Washington courts have continued to hold that there is no unjust enrichment when a title company is required to make good on coverage as a result of the title company's own error:

> The UOs [condominium unit owners] fail to show why it is unjust for their title insurer, First American Title Insurance Company, to pay $1.3 million when the duty to defend the UOs under the First American title policy was triggered by a First American escrow officer's error or omission.

Norcon, 161 Wn. App. at 490.

the cost of title insurance. Stewart's Br. at 43. Again, however, equitable subrogation is available only to prevent unjust enrichment. Stewart never explains why lowering premiums and giving title companies broader protections should come at the cost of shifting losses to innocent parties like Mountain West that are simply being paid for work performed. Stewart declines to justify this cost shifting because making Mountain West pay the consequences of Stewart's internal mistake is obviously unfair and has nothing to do with preventing unjust enrichment.[5]

None of Stewart's arguments change the simple fact that equitable subrogation was not available to Sterling as a defense because there was no danger of unjust enrichment. There are no genuine issues as to any material fact, and *Coy* entitles Witherspoon to judgment as a matter of law that it was not malpractice to fail to argue that Stewart's loss should be shifted to Mountain West. This Court should affirm summary judgment, and it is sufficient to resolve this appeal on this basis alone.

D. Equitable Subrogation Was Not a Valid Defense in This Case Because Sterling Was Not Answering for the Debt of Another.

To the extent this Court wishes to indulge Stewart's creative theories about why Stewart's loss should have been shifted to Mountain West, it would be necessary not only to discard the requirement of unjust enrichment, but also to untether equitable subrogation from another basic

[5] In addition, applying equitable subrogation to protect Stewart from its own mistakes would undermine the policies behind Washington's mechanics' lien statute. The whole point of giving mechanics' liens priority through relation back is that it is unjust to not be paid for work performed. *Haselwood v. Bremerton Ice Arena, Inc.*, 137 Wn. App. 872, 887-88, 155 P.2d 952 (2007), *aff'd*, 166 Wn.2d 489 (2009).

requirement—that it is available only where you answer for the debt of another. Absent the abandonment of this longstanding requirement, Sterling's loan to JA to purchase the Cook Addition from DAD cannot provide a basis for subrogating Sterling to the positions of Brown and IFA. Sterling's loan to JA to purchase property from DAD is fundamentally different than a loan to discharge DAD's obligations to Brown and IFA.

1. **Subrogation Is Available Only to One Who Answers for the Debt of Another.**

Subrogation is available only to one who answers for a debt owed by another:

> Subrogation exists only as a three-party transaction, where the subrogee is answering for the debt of another.

Livingston v. Shelton, 85 Wn.2d 615, 618, 537 P.2d 774 (1975). The Washington Supreme Court cases holding that equitable subrogation is available only where one pays the debt owed by another span many decades. *E.g., Winters v. State Farm Mut. Auto. Ins. Co.*, 144 Wn.2d 869, 875 n.2, 31 P.3d 1164 (2001) ("The right to subrogation exists when a party, not a volunteer, pays another's obligation for which the subrogee has no primary liability in order to protect such subrogee's own rights and interests."); *Austin v. Wright*, 156 Wash. 24, 30, 286 P. 48 (1930) ("Subrogation is allowed only in favor of one who under some duty or compulsion, legal or moral, pays the debt of another."). In fact, the requirement that you answer for the debt of another is the rationale for allowing you to step into that person's shoes and acquire their rights:

> Subrogation is the substitution of one party for another whose debt the party pays. The substituted party is then entitled to all of the rights, remedies, or securities that otherwise would belong to the debtor.

State v. Base, 131 Wn. App. at 217.

Although the Washington Supreme Court has expanded the doctrine of equitable subrogation to apply where a bank refinances an earlier mortgage given by its borrower, it did not strip the doctrine of its basic character. Section 7.6 of the *Restatement*[6] expressly retains the fundamental character of subrogation by providing that equitable subrogation is available only where one answers for the debt of another:

> (a) One <u>who fully performs an obligation of another</u>, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. . . .

Restatement: Mortgages § 7.6 (emphasis added). The requirement that, under Section 7.6, a lender must pay a debt its borrower owes to another lender is further illustrated by the example the Washington Supreme Court gave of how equitable subrogation works in the case adopting Section 7.6 as Washington law:

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[6] The Washington Supreme Court adopted Section 7.3 of the *Restatement* in *Kim*, 145 Wn.2d at 89-90, and adopted Section 7.6 of the *Restatement* in *Bank of America N.A. v. Prestance*, 160 Wn.2d at 582. Section 7.3 provides for subrogation when a lender refinances its own previous loan to its borrower. Section 7.6 provides for subrogation when a lender refinances a previous loan its borrower had obtained from another lender. *Bank of Am. N.A. v. Wells Fargo Bank N.A.*, 126 Wn. App. 710, 716 n.4, 109 P.3d 863 (2005), *rev'd on other grounds*, 160 Wn.2d 560, 160 P.3d 17 (2007); *BNC Mortgage, Inc. v. Tax Pros, Inc.*, 111 Wn. App. 238, 257 n.59, 46 P.3d 812 (2002). Thus, if Sterling wanted to argue it was equitably subrogated to the rights of IFA and Brown by virtue of paying DAD's obligations to them, it would proceed under Section 7.6.

> For example, suppose *A*, a homeowner, has two mortgages: one recorded first by bank *B* and one recorded second by bank *C*. Our recording act says *B* has a higher priority because it recorded first, putting the world on notice as to its interest in *A*'s land. RCW 65.08.070. <u>If *D* fully discharges *B*'s debt</u>, then equitable subrogation substitutes *D* for *B*, so *D* has a higher priority than *C*, even though *D* recorded after.

Prestance, 160 Wn.2d at 564 (emphasis added).

2. <u>It Is Undisputed That Sterling Lent JA Money to Buy the Cook Addition, Not to Discharge DAD's Obligations to IFA and Brown.</u>

Under these longstanding legal principles, equitable subrogation was not available to Sterling because it did not lend money to JA to discharge DAD's obligations to Brown and IFA. Instead, Sterling made a purchase money loan to enable JA to purchase the Cook Addition from DAD. Lending money to purchase property and lending money to discharge someone else's obligations are fundamentally different transactions. The fact that DAD may have used the sale proceeds paid by JA to discharge its obligations to IFA and Brown does not transform DAD's payment into a payment made by Sterling or JA. As the escrow agent testified, once DAD traded the Cook Addition for the sale proceeds, those funds became DAD's own money which it then used to discharge its own obligations to IFA and Brown. (CP 1411-12; 1306.)

Indeed, because DAD and JA entered into a Real Estate Purchase and Sale Agreement governing the sale of the Cook Addition (CP 1498-502), what JA was actually doing in paying DAD the purchase price for the Cook Addition was performing its own contractual obligation to tender the purchase price. Under long-settled law, one who simply performs their own primary obligation under a contract is not answering for the debt of another and can "never" be equitably subrogated:

> Subrogation is allowed only in favor of one who under some duty or compulsion, legal or moral, pays the debt of another; and not in favor of him who pays a debt in performance of his own covenants, for the right of subrogation never follows an actual primary liability, and there can be no right of subrogation in one whose duty it is to pay . . . . In such cases payment is extinguishment.

Austin v. Wright, 156 Wash. at 30 (emphasis added) (quoting 37 Cyc. 374). *Accord Winters v. State Farm*, 144 Wn.2d at 875 n.2. Said differently, "a person cannot seek subrogation for paying one's own debt." *Livingston v. Shelton*, 85 Wn.2d at 620.

Finally, the problem with applying equitable subrogation to a purchase money transaction where no party has answered for another's debt is that it creates an undeserved double recovery. This case is a good example. Because Sterling and JA did not answer for DAD's obligations to its creditors, IFA and Brown, it would be inequitable if they were substituted into IFA's and Brown's positions. If this happened, Sterling and JA would get a double recovery, having a claim against DAD for the amount of its obligations to IFA and Brown by virtue of being subrogated into their shoes, while also having title to the Cook Addition by virtue of having purchased it from DAD. This is backwards: equitable subrogation should be used to avoid a duplicate recovery, not to create one. *See Mattson v. Stone*, 32 Wn. App. 630, 633, 648 P.2d 929 (1982). Thus, equitable subrogation was not available as a defense below and Witherspoon did not commit malpractice by not raising it.

E. <u>Stewart's Request to Expand Equitable Subrogation to Purchase Money Transactions and Ignores the *Restatement*.</u>

Undeterred, Stewart argues that the Court should expand equitable subrogation to purchase money transactions, *i.e.*, to mortgages given to secure loans to purchase real estate. Stewart's Br. at 23-28. However, it is clear that the drafters of the *Restatement* did not intend that purchase money mortgages be characterized as a "refinance" under Sections 7.3 and 7.6 because the drafters of the *Restatement* provided an entirely separate section, 7.2, to deal with purchase money transactions. Section 7.2 of the *Restatement*, entitled Purchase Money Priority Mortgage, gives a lender who finances the purchase of real estate priority over certain prior encumbrances:

> (a) A "purchase money mortgage" is a mortgage given to a vendor of the real estate or to a third party lender to the extent that the proceeds of the loan are used to:
>
> (1) acquire title to the real estate; or
>
> (2) construct improvements on the real estate if the mortgage is given as part of the same transaction in which title is acquired.
>
> (b) A purchase money mortgage, whether or not recorded, has priority over any mortgage, lien, or other claim that attaches to the real estate but is created by or arises against the purchaser-mortgagor prior to the purchaser-mortgagor's acquisition of title to the real estate

Restatement (Third) of Property § 7.2(a)-(b). As can be seen, in contrast to Sections 7.3 and 7.6, Section 7.2 does not utilize subrogation. It simply gives purchase money mortgages priority over certain prior encumbrances.

That the drafters of the *Restatement* provided a separate section to govern loans to purchase real property, which does not utilize subrogation principles, strongly implies that they did not intend such loans to be shoehorned into Sections 7.3 or 7.6 as *de facto* "refinances" giving rise to subrogation. In addition, despite raising the issue, Washington's appellate courts have yet to adopt Section 7.2. *See Norcon Builders*, 161 Wn. App. at 500 n.19. Again, this implies that Washington does not view a loan to purchase real property as a "refinance" of the seller's mortgage giving rise to the subrogation. Otherwise, there would be no need to consider adoption of Section 7.2.

F. ***Kim v. Lee* Does Not Support Stewart's Attempt to Recast the Underlying Transaction.**

Stewart also argues that Sterling's loan to JA can be deemed a refinance of DAD's obligations to Brown and IFA under *Kim v. Lee*, 145 Wn.2d 79, 31 P.3d 665 (2001). Stewart's Br. at 28-33. However, *Kim* involved parents gifting a home to their children who then paid off their parents' mortgage by taking a new loan. In the context of this family transaction structured as a gift, the *Kim* court agreed that a second loan could be considered a "refinance" because "[a]lthough the borrowers are different parties, since they are a family and the transfer of title . . . was a gift, that fact should not preclude treatment of the new deed of trust as a refinance." 145 Wn.2d at 87.

Kim's holding, that family members acting out of affection to promote their mutual welfare can be treated as a coherent economic unit effecting a "refinance," does not help Stewart in this case. First, there is no evidence that DAD and JA acted as a family or coherent economic unit in the sale of the Cook Addition. To the contrary, the whole point of the sale was that JA and DAD did not have consistent economic interests. James had an ownership interest in JA whereas he had no interest in DAD. (CP 930; 966-67.) Thus, to compensate James for going to work at the job site "pretty much every day" (CP 927-28; 943), the project was sold to a different entity, JA, where James had an economic interest. That Milne guaranteed both the debt of DAD to Brown and IFA, and the debt of JA to Sterling, does not mean that JA and DAD are the same entity as Stewart argues. It simply means that Milne had an ownership interest in each, albeit in different percentages.

Moreover, because the children in *Kim* paid their parents' loan as part of a transaction where they received their home as a "gift," the children's payment of their parents' obligation cannot be characterized as a purchase of the property. Accordingly, the children's discharge of their parent's debt satisfies the rule that subrogation is available where you answer for the debt of another. The same cannot be said of DAD's sale of the Cook Addition to JA in a commercial transaction for $4.5 million. In short, *Kim* does nothing to support Stewart's subrogation argument here.

G. In Desperation, Stewart Argues That JA and DAD Are Actually One Entity.

Desperate times call for desperate measures. When Stewart finally realized that purchase money loans do not satisfy the basic elements of subrogation, it began to vigorously recharacterize the facts, arguing in the Superior Court that JA and DAD are really a single entity:

> Here, JA can only be viewed as DAD's successor, or at the very least, the two entities are so intertwined, and were treated as the same entity, such that any distinction between them is meaningless.

(CP 543:8-14.) Under Stewart's reworking of the facts, Sterling's loan to this unitary entity, which Stewart called "Milne/DAD/JA" in the Superior Court briefing, could satisfy the requirements of subrogation because it would both receive the proceeds of the loan to JA, and also repay DAD's obligations to IFA and Brown. In that fashion, Sterling's purchase money loan to JA could be transformed into a "refinance" of "Milne/DAD/JA's" obligations to IFA and Brown:

> Here, Sterling's loan proceeds paid and replaced, and therefore refinanced, the IFA loan and the Brown loan. The obligations of Milne/DAD to IFA and Brown were replaced by the obligations of Milne/DAD/JA to Sterling.

(CP 541:18-21.)

Stewart continues to urge its unitary entity recharacterization on appeal. At various points in the brief, Stewart asserts that: JA borrowed money from Sterling "for the express purpose of refinancing the Brown loan and the IFA loan" (Stewart Br. at 6); "the borrower was essentially the same both on the IFA and Brown loans, and the Sterling loan" (*id.* at

7); "Milne and James also treated DAD and JA as one and the same" (*id.* at 8); "third-parties treated Milne and the two entities interchangeably (*id.* at 9); and "[a]ll of the parties involved knew and expected that Sterling intended to discharge the IFA and Brown loans" (*id.* at 10).

H. <u>**Stewart's Unitary Entity Theory Was Not Endorsed by a Single Witness.**</u>

Whatever internal logic this recharacterization may have, it is factually wrong. The record establishes that JA and DAD are not and have never been a unitary entity. In this regard, Stewart was granted additional CR 56(f) discovery to explore its unitary entity theory, but all of the discovery demonstrated that it is without basis in fact.

First, JA and DAD were founded at different times, kept separate records, had independent business activities, and observed corporate formalities:

- DAD was incorporated as an Arizona LLC in 2001 (CP 1567-91);
- JA was incorporated as a Washington LLC in 2005 (CP 1440-56);
- JA had separate financial statements (CP 1536-51);
- JA generated separate tax documentation (CP 1553);
- They had different ownership structures with JA being owned 51 percent by David Milne and 49 percent by James Corporation, whereas DAD was wholly owned by David Milne (CP 1324-25); and
- They had a long history of working on different real estate development projects (CP 1557; 1332-34).

More generally, there was nothing about the background or operations of JA that suggested it was the same entity as DAD, or that JA lacked an existence apart from Milne or the Cook Addition project. To the contrary, Jim James and David Milne originally formed JA in 2005 to pursue an unrelated real estate development project in Gig Harbor called Horstman Heights. (CP 919.) In addition to the original project at Horstman Heights, JA also eventually undertook another unrelated development project at Steel Creek in Bremerton. (CP 920-21.)

Nor was there any evidence that James lacked a real role in the Cook Addition project as Stewart suggests. Milne asked James to get involved in the Cook Addition development in early 2007. (CP 922:2-10.) As James understood it, Milne wanted James involved because Milne was too busy to manage the actual development of Cook Addition. (CP 923; 941-42.) As with other JA projects, James' role was "to get it done on time." (CP 922; 927; 942.) In fact, James was at the Cook Addition job site "pretty much every day." (CP 927-28; 943.) As with other JA projects, Milne's role on Cook Addition was to handle financing and be the "managing partner." (CP 922; 932-33.) Accordingly, James had little to do with arranging financing with Sterling, but he provided some personal financial information and got a HUD statement from the bank showing the $7.5 million loan. (CP 930; 944-47; 1242-46.) As for guaranteeing JA's loan, Sterling's policy was that every owner of a borrower who had a 20 percent or greater interest had to personally guarantee the loan. (CP 892.) Although he was a 49 percent owner of JA, James was not eligible to give a guarantee under Sterling's policies because he had a recent bankruptcy. *Id.*

Given James' significant role in JA and the Cook Addition project, it is not surprising that Milne disagreed with Stewart's assertion that JA and DAD are really the same entity. Milne said flatly that they were separate entities. (CP 1334.) Milne likewise did not think much of Stewart's alternate theory, that JA was the corporate "successor" to DAD. Milne was unequivocal in testifying that is wrong. (CP 1333.) Finally, Milne contradicted Stewart's assertion that Sterling's loan was used to pay DAD's obligations to Brown and IFA:

> Q. After David Alan Development gave up the Cook Addition and took the purchase price, was the purchase price David Alan's or James Alan's?
>
> A. David Alan.
>
> Q. Is what Exhibit 33 [the Settlement Statement] shows, then, that it was David Alan, out of the sale proceeds that it received, which paid off IFA and Brown?
>
> [Objection omitted]
>
> A. Yes.

(CP 1336:11-20.)

Nevertheless, Stewart persisted, pointing to a Real Estate Excise Tax Affidavit, filled out by Milne, that claimed no excise tax was due when JA bought the Cook Addition from DAD because the sale was a "change of identity only." (CP 1417.) However, when Stewart took Milne's deposition, he explained that the claim was "not exactly accurate" because you are only supposed to claim a change in identity if the purchasing entity has an identical ownership structure as the selling entity. (CP 1331; 1338.) Milne then readily acknowledged that JA and DAD did not have the same ownership structures such that the change in identity exception did not apply. (CP 1337:17-21.) When asked why he had then claimed that the sale from DAD to JA was a change in identity only, Milne candidly acknowledged the obvious: "To eliminate $4,500 in cost." (CP 1338:9.)

Stewart also emphasized a declaration from Sterling's loan officer, Lisa Irwin, filed in the Lien Foreclosure Action by the attorney who took over after Stewart fired Witherspoon. The declaration said that Sterling's loan paid DAD's obligations to IFA and Brown and Sterling thus expected to "stand in the shoes of prior lienholders whose obligations it satisfied." (CP 1421 ¶ 9.) However, when Stewart deposed Ms. Irwin, she acknowledged what is otherwise obvious from all of Sterling's loan documentation, that Sterling did not lend money to discharge DAD's obligations to IFA and Brown; rather, Sterling lent money to allow its borrower, JA, to buy title to the Cook Addition property:

> Q. Would you just review paragraph nine [of your Declaration].
>
> A. (Witness peruses document.) Okay.
>
> Q. Is that a true statement?
>
> A. No.
>
> Q. So you lied in your declaration?
>
> [Objections omitted.]
>
> A. Sterling did not pay the prior deeds of trust. We used our loan fund and funded to escrow to pay David Alan Development for the purchase of the site.

(CP 1314:24-1315:11.)

I. **Stewart Cannot Avoid Summary Judgment by Arguing JA and DAD Are the Same Entity.**

In short, Stewart could not find a single witness who would say that JA and DAD are really one entity. Stewart cannot avoid summary judgment by continuing to argue that JA and DAD are the same entity on appeal. Summary judgment cannot be avoided simply by presenting a different version of facts that is unsubstantiated by the record. *Kirk v. Moe*, 114 Wn.2d 550, 556-57, 789 P.2d 84 (1990).

Moreover, this was a commercial transaction structured on carefully drafted contracts. Thus, whether Sterling loaned money to JA so that it could purchase the Cook Addition, or whether Sterling "refinanced" a loan to "JA/DAD/Milne" to pay off IFA and Brown, depends on the legal effect of the underlying contracts and deeds of trust. Washington follows the objective manifestation theory of contracts, under which the legal effect of contractual documentation is determined according to the objective meaning of the words used. *Wilson Court Ltd. v. Tony Maroni's, Inc.*, 134 Wn.2d 692, 699, 952 P.2d 590 (1998). Inconsistent subjective beliefs or understandings of the participants are irrelevant. *Id.* Thus, the legal effect of the underlying documentation depends on the objective meaning of the language used rather than Stewart's arguments about how various participants subjectively "treated" JA and DAD or what Lisa Irwin subjectively believed was "intended." On this key point, everyone involved meticulously documented the transaction as a sale of the Cook Addition by DAD to JA with JA taking a purchase money loan from Sterling. (CP 1202; 1215; 1523; 1330.)

Alternatively, Stewart's argument that JA and DAD are really one entity cannot create a triable issue of fact because it constitutes an attempt to disregard that JA and DAD were formed as different entities with different ownership structures. RCW 25.15.060 authorizes piercing the veil of an LLC "to the extent that shareholders of a Washington business corporation would be liable in analogous circumstances." To pierce the corporate veil, the plaintiff must show that (1) the corporate form was used to violate or evade a duty, and (2) the corporate veil must be disregarded in order to prevent loss to an innocent party. *Wash. Water Jet Workers Ass'n v. Yarbrough*, 151 Wn.2d 470, 503, 90 P.3d 42 (2004). With regard to the first element—corporate form used to violate a duty—the trial court must find an abuse of the corporate form. *Meisel v. M & N Modern Hydraulic Press Co.*, 97 Wn.2d 403, 410, 645 P.2d 689 (1982). Here, Stewart does not even argue that it has facts sufficient to meet this exacting standard.

In short, absent a wholesale restructuring of longstanding law, or a rewrite of the facts bordering on fantasy, equitable subrogation does not apply here and it was not malpractice for Witherspoon to so conclude.

J. As a Separate Basis for Affirming Summary Judgment, Stewart Did Not Have Standing to Sue Witherspoon for Legal Malpractice.

Finally, summary judgment can and should be affirmed on an entirely separate ground: Stewart had no standing to sue Witherspoon for legal malpractice. A required element of a claim for legal malpractice is the existence of a duty on the part of the lawyer to the plaintiff. *Trask v. Butler*, 123 Wn.2d 835, 872 P.2d 1080 (1994). Traditionally, attorneys owed a duty only to their own clients and, thus, "the only person who could bring a lawsuit for attorney malpractice was the attorney's client." *Trask*, 123 Wn.2d at 840. Here, no one disputes that Stewart was not Witherspoon's client. Rather, Stewart claimed that it had standing as a "nonclient" to sue Witherspoon.

The trial court agreed with Stewart, in part, finding that, to the extent it made "specific recommendations," Witherspoon owed Stewart a duty of care as a nonclient under the multi-factor balancing test adopted in *Trask*. (CP 2981-83; 522-27.)[7] As an alternative means of affirming the grant of summary judgment, this Court should reverse this portion of the Superior Court's ruling and hold that Witherspoon owed Stewart no duty of care under *Trask*.[8]

1. **Witherspoon Owed No Duty to Stewart as an "Intended Beneficiary."**

Trask does not support the creation of a duty from Witherspoon to Stewart. Under *Trask*, the following factors must be considered:

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[7] Stewart also claimed standing to sue Witherspoon directly under the *Restatement (Third) of the Law Governing Lawyers* § 51 (2000) and standing to sue Witherspoon indirectly under a theory of subrogation. (CP 2629; 2642.) However, the trial court correctly rejected Stewart's two other theories, which failed for all of the reasons addressed in Witherspoon's briefing on standing. (CP 2687-2718; 2506-2529; 2851-56.)

[8] There is no need to file a notice of cross-appeal to raise an additional ground for affirmance, even though rejected by the trial court. *See Amalgamated Transit Union Local 587 v. State*, 142 Wn.2d 183, at 202, 11 P.3d 762 (2000). Accordingly, along with this brief, Witherspoon has filed a motion to dismiss its cross-appeal without prejudice.

1) the extent to which the transaction was intended to benefit the plaintiff;

2) the foreseeability of harm to the plaintiff;

3) the degree of certainty that the plaintiff suffered injury;

4) the closeness of the connection between the defendant's conduct and the injury;

5) the policy of preventing future harm; and

6) the extent to which the profession would be unduly burdened by a finding of liability.

Trask, 123 Wn.2d at 842-43.

In applying these factors, the threshold question is whether the nonclient "is an intended beneficiary of the transaction to which the advice pertained." *See Trask*, 123 Wn.2d at 843. Absent such an intent, there is no duty and no other *Trask* factor need be considered. *Id.* That the nonclient is an incidental beneficiary is not enough. *Id.* at 845. Moreover, the determinative inquiry regarding whether the nonclient was an "intended beneficiary" is what the client, Sterling, intended to accomplish through the representation. *See Strait v. Kennedy*, 103 Wn. App. 626, 633-34, 13 P.3d 671 (2000) (relevant inquiry is what client intended to accomplish in litigation, not what nonclient plaintiff hoped to gain by it); *see also* 1 Ronald E. Mallen & Jeffrey M. Smith *Legal Malpractice* § 7:8 (2012 ed.) ("[T]he determinative inquiry is whether the expressed intent of the client to benefit the plaintiff was the direct and agreed purpose of the transaction or relationship."). Thus, what the nonclient, Stewart, hoped to accomplish or receive by the representation is simply irrelevant. *Id.* Were it otherwise, a nonclient could unilaterally create conflicting duties on the part of counsel for another party.

Here, critically, Stewart put no evidence in the record that Sterling established its attorney-client relationship with Witherspoon with the express purpose of generating a benefit for Stewart. Witherspoon was not an "insurance defense" firm assigned by Stewart after tender and had no prior relationship with Stewart. (CP 55:10-23; 1986:16-1987:2.) Rather, Witherspoon was Sterling's long-time counsel. *Id.* Sterling retained Witherspoon to defend it in the Lien Foreclosure Action before Stewart was even contacted and answered before Stewart got around to accepting the tender. (CP 1140; 2150; 210.)

Nor did Stewart offer any evidence that Sterling's intent somehow changed when it agreed that Stewart could begin paying Witherspoon's legal bills. An insured such as Sterling buys an insurance policy and pays a premium to protect its own interests, not those of the insurer. Taking advantage of the defense offered under such a policy does not transform the insured's intent to protect its own interests into an intent to protect those of the insurer. Moreover, if there was any doubt about whose interests Witherspoon was supposed to protect, Stewart's retention letter resolved it by expressly instructing Witherspoon to limit its representation to the protection of Sterling:[9]

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[9] The terms of an engagement letter are contractual in nature. *Avocent Redmond Corp. v. Rose Elecs.*, 491 F. Supp. 2d 1000, 1002-04 (W.D. Wash. 2007). The interpretation of an (Footnote continued on next page.)

- [Sterling] shall at all times be entitled to your full and undivided professional loyalty through exercise of competence and preservation of confidences (CP 210);
- [C]onfine your representation solely to the interests of [Sterling] (CP 210);
- The payment of your fees shall in no way be interpreted as representation of Stewart (CP 211);
- Your retention is solely for the representation and protection of [Sterling] (CP 212).

Indeed, in providing a defense to an insured, an insurer's obligation of good faith prohibits it from placing its own interests—financial or otherwise—ahead of the interests of its insured. *See, e.g., Tank v. State Farm Fire & Cas. Co.*, 105 Wn.2d 381, 387-88, 715 P.2d 1133 (1986). Thus, as a matter of law, any benefit to Stewart from Witherspoon's representation of Sterling had to be *incidental* to the purpose of Witherspoon's representation, which was to provide independent and unconflicted legal advice to Sterling.

In short, there was no evidence that Stewart was an "intended beneficiary" of Witherspoon's representation of Sterling under *Trask*, 123 Wn.2d at 845. On this basis alone, and without reference to any of the other *Trask* factors, Witherspoon owed Stewart no duty of care that would give rise to a claim for malpractice.

2. Application of the Other Factors Does Not Support the Creation of a Duty.

However, even if one wanted to look beyond intent to the other *Trask* factors, they offer no basis for the creation of a duty from Witherspoon to

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unambiguous contract is for the court to determine as a matter of law. *See, e.g., State Farm Mut. Auto. Ins. Co. v. Avery*, 114 Wn. App. 299, 311, 57 P.3d 300 (2002).

Stewart. In this regard, the opinion in *Trask* focused on three primary considerations in applying the various factors: (1) whether the absence of a duty would mean no one could sue the attorney for an error; (2) whether the nonclient had some effective way to protect its own interests aside from a malpractice claim; and (3) whether imposing a duty on the lawyer to the nonclient would create potential conflicts risking divided loyalty to the client. *See* 123 Wn.2d at 843-45. Here, all three considerations weigh heavily against imposing a duty on Witherspoon to protect Stewart's interests.

a) Sterling Could Sue Witherspoon.

First, the absence of a duty under *Trask* will not create a situation where no one could sue Witherspoon for malpractice. Stewart acknowledged that Sterling could bring such a suit when it tried to assert Sterling's claims by means of subrogation.

b) Stewart Had Numerous Way to Protect Itself.

Second, Stewart was in a particularly strong position to protect its own interests and had no need for a malpractice claim. Stewart had a host of its own, independent lawyers looking out for its interests. Thus, Stewart instructed Witherspoon to report to one of its numerous in-house attorneys, Ms. Rickenbach, who had investigated the underlying lien dispute before accepting tender. (CP 211.) Stewart also availed itself of the advice of independent coverage counsel, Mr. Sirianni (CP 2158), and also hired yet another independent lawyer, Laurin Schweet, to represent it in the Lien Foreclosure Action. (CP 2769.) Under this scenario, if Witherspoon does not owe its allegiance exclusively to Sterling, then Sterling is the only participant involved without counsel devoted exclusively to its interests. In addition, Stewart could protect its own interests because it retained the right to control Sterling's defense of the Lien Foreclosure Action. In fact, Ms. Rickenbach approved in writing the disputed decision to stipulate to Mountain West's priority. (CP 1151.) Stewart also exercised this right when it fired Witherspoon for being too loyal to its client Sterling.

In addition, Stewart was able to protect itself because any likelihood of injury was ameliorated by other available remedies. *See* 123 Wn.2d at 844. Here, for example, the developer, JA, failed to pay Mountain West, and Stewart sued JA for indemnification. (CP 2769-73.) Stewart also blamed and extracted a settlement from its agent, Stewart of Kitsap, which failed to inspect the property before closing. (CP 1435-38; 2809-12.) There is no need to add a malpractice claim to these many other avenues of protection and redress that were available to Stewart.

c) **Public Policy Prohibits Imposing a Duty to Stewart on Witherspoon.**

Finally, imposing a duty on Witherspoon to protect Stewart's interests would create a risk of divided loyalties and subject attorneys to second guessing by the insurance company where, as here, the insurer does not like the outcome. In contrast, the Washington Supreme Court has time and again declined to impose any duty on attorneys that would create such a risk of undermining the attorney's undivided loyalty to the client.

In this regard, the Court in *Trask* reviewed its earlier decision in *Stangland v. Brock*, 109 Wn.2d 675, 747 P.2d 464 (1987), where it found that the interests of a personal representative are not necessarily aligned with those of an estate beneficiary and, despite the existence of a fiduciary relationship, that imposing a duty running from the personal representative's attorney to the estate beneficiaries would create a risk of divided loyalties on the part of the attorney. 123 Wn.2d at 843. Accordingly, in *Trask*, the Court again refused to recognize a duty from the attorney for a personal representative to the heirs because of the possibility that "estate proceedings may be adversarial":

> A conflict of interest arises in estate matters whenever the interest of the personal representative is not harmonious with the interest of an heir. Because estate proceedings may be adversarial, we conclude that policy considerations also disfavor the finding of a duty to estate beneficiaries.

123 Wn.2d at 844. Thus, in *Trask*, the simple possibility that the client's interests "may be" adverse to those of a nonclient precludes the recognition of a duty.

Significantly, Washington also has other well-developed case law establishing that public policy in Washington will not allow a lawyer to owe a collateral duty to anyone other than the client where that duty creates a risk of divided loyalty. This prohibition applies with particular force, where, as here, the "nonclient" is an insurance company paying for the defense. Under *Tank v. State Farm*, 105 Wn.2d at 388, because of the "potential conflicts of interest" inherent in a reservation of rights defense, the insurer owes its insured "enhanced obligations," which, among other things, requires that "[b]oth retained defense counsel and the insurer must understand that only the *insured* is the client." 105 Wn.2d at 388. Stewart argued that *Tank* did not bar the creation of a duty here because it had accepted Sterling's tender without an immediate reservation of rights such that Stewart's interests and Sterling's interests instead were "completely aligned" until Stewart fired Witherspoon. (CP 2837.) However, Stewart's retention letter pointedly refused to tell Witherspoon whether it had reserved its rights leaving Witherspoon little choice other than to assume there was or would be such a reservation. Moreover, Stewart was actively looking for a way to shift its loss to Sterling long before it fired Witherspoon. In addition, there were other potential conflicts such as Stewart wanting to assert equitable subrogation as a means of causing delay whereas Sterling's interest was to proceed promptly given the falling real estate market. (CP 1472; 2728:7-2729:17.) Thus, to say that Stewart's interests were "completely aligned" with those of Sterling is simply not supported by the record.

Moreover, that *Tank* should be read to prohibit an attorney from having obligations to both the insured and the insurer whenever there is a <u>risk</u> of conflicting interests was emphasized in *Mazon v. Krafchick*, 158 Wn.2d 440, 144 P.3d 1168 (2006).[10] *Mazon* addressed whether co-

[10] *Tank* does not expressly limit an insurer's "enhanced duties" to instances of "actual" conflicts or to instances where an insurer defends under a reservation of rights, as Stewart argued below. (CP 2635.) Instead, *Tank* found that the potential conflicts of interest inherent in a defense provided under a reservation of rights imposed an enhanced obligation of good faith as the insurer. 105 Wn.2d at 387. There is no reason why an insurer's obligation of good faith to the insured would not require it to resolve potential conflicts which arise when defending the insured in the absence of a reservation of rights in a fashion consistent with *Tank*.

counsel owed duties to one another allowing suit for loss of prospective fees. *Id.* at 446. However, *Mazon* cited *Tank* for the rule that public policy "prohibits an attorney from owing a duty to anyone other than the client when the collateral duty creates a risk of divided loyalty due to conflicts of interest." *Id.* at 448 (emphasis added). *Mazon* then went on to recognize that whether a nonclient's interest conflicts with those of the client "may be difficult to answer," particularly in litigation-related matters where tactical decisions could be characterized after the fact as adverse to the interests of the nonclient and a breach of duty. *Id.* at 449. Accordingly, *Mazon* observes that whether a potential conflict exists is often more easily answered in hindsight than during the conduct of the defense. 158 Wn.2d at 449.[11] To avoid any such issue, *Mazon* adopted "a bright-line rule" that no duties exist between co-counsel allowing recovery for lost prospective fees because such a rule "prevents conflicts from arising at any point during the representation, assures the client's interest is paramount regardless of the issue, and is easy to administer." 158 Wn.2d at 447.

The record here illustrates why imposing dual obligations on Witherspoon would create the risk of divided loyalties that the Washington

[11] Also, as recognized by other states that have rejected imposition of a dual duty to insurer and insured, "there clearly exists the potential for conflicts of interest to arise" before the final resolution of "any claim" against an insured. *In re Rules of Prof'l Conduct in Insurer Imposed Billing Rules & Procedures*, 299 Mont. 321, 333-34, 2 P.3d 806 (2000); *Finley v. Home Ins. Co.*, 90 Haw. 25, 33, 975 P.2d 1145 (1998) (potential for conflicts is "inherent" where counsel owes duty to insured and insurer). In this regard, whether interests of the insured and the insurer are aligned "can best be determined with the perfect clarity of hindsight." 229 Mont. at 333.

Supreme Court sought to prohibit in *Trask*, *Tank*, and *Mazon.* First, there were clear differences in the goals Sterling and Stewart pursued in the Lien Foreclosure Action. Sterling's interest was a prompt resolution of Mountain West's $800,000 mechanics' lien so it could foreclose on its collateral, the value of which was falling. In contrast, Stewart's interest was to avoid its contractually-assumed losses that were caused by its own negligence. Stewart sought to avoid these losses, in part, by shifting them to others or by otherwise dragging out any duty to perform under its policy.

The danger of creating a duty for Witherspoon to advise Stewart in this situation is illustrated by what happened when Swinton candidly explained his conclusion that equitable subrogation was not available as a defense. Witherspoon got fired for being too loyal to its client. If lawyers are told that they have a duty both to their client, the insured, and also to the insurer, then in evaluating defenses and recommending a course of conduct, they will naturally seek to consider not only the interests of their client, but also to accommodate those of the insured. Thus, any such duty would place the attorney in a difficult situation, where, throughout the litigation, and even when the insurer and the insured's interests might seem aligned, the attorney constantly would have to second guess whether its recommendations and its decisions might adversely impact or upset the nonclient insurer. This case illustrates that such concerns would not be unfounded. Stewart is claiming that Witherspoon's recommendation, whether or not it was in the best interests of Sterling, was not in the best interests of Stewart and breached Witherspoon's alleged duty of care to Stewart.

Thus, in addition to being unnecessary and redundant of other protections available to Stewart, no duty can be recognized under *Trask* for the additional reason that it would create the risk of divided loyalties which the Washington Supreme Court has repeatedly refused to allow. For this additional reason, the dismissal by summary judgment of Stewart's malpractice claims against Witherspoon was proper and should be affirmed.[12]

VI. CONCLUSION

This Court should affirm.

RESPECTFULLY SUBMITTED this 7th day of September, 2012.

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[12] Stewart claims in its brief at page 37, note 4, that the trial court erred by "failing to rule" on its "properly-noted" motion to strike Witherspoon's two expert declarations. However, as Stewart conceded on reply below, its motion to "strike" was not properly noted but instead was filed in direct violation of KCLR 56(e), which requires such objections to be noted in responsive pleadings. (CP 1749.) Moreover, there simply was no basis on which to strike either declaration. (CP 1741-46.) Instead, both declarations confirm that summary judgment was proper. (CP 1597-1605; 1606-1610.)

CERTIFICATE OF SERVICE

The undersigned attorney certifies that a true copy of the foregoing pleading was served upon the following individuals:

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

DATED in Seattle, Washington, this 7th day of September, 2012.

Roger E. Gramaso Jr.