No. 90432-4

IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

WASHINGTON FEDERAL SAVINGS & LOAN ASSOCIATION, a federal association,

Respondent

v.

MARK A. McNAUGHTON and MARNA L. McNAUGHTON, husband and wife, and the marital community comprised thereof,

Petitioners

ON PETITION FOR REVIEW FROM
COURT OF APPEALS, DIVISION I
(Court of Appeals No. 681788-I)

ANSWER TO PETITION FOR REVIEW

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES, REGULATIONS AND COURT RULES

I. INTRODUCTION

The Petition for Review should be denied. The McNaughtons guaranteed a commercial loan made to a company they owned. They breached the guaranty when the company defaulted and they failed to pay the debt. They do not dispute that they are liable to Washington Federal for the deficiency on the debt following the non-judicial foreclosure of the property. The only dispute is the amount. The Deeds of Trust Act allows a guarantor to claim, as an affirmative defense, that the "fair value" of the property was greater than the sale price and, if proven, to receive a corresponding set-off in the deficiency amount. RCW 61.24.100(5). The trial court rejected the McNaughtons' "fair value" defense, and granted Washington Federal summary judgment in the full amount of the deficiency. The Court of Appeals affirmed. *Washington Federal Sav. & Loan Ass'n v. McNaughton*, --- Wn. App. ---, 325 P.3d 383 (2014).

The Petition does not raise an issue of substantial public interest. RAP 13.4(b)(4). The Court of Appeals properly applied traditional rules of statutory construction to conclude that the term "fair value" used in RCW 61.24.100(5) does not have the same meaning as the term "upset price" used in RCW 61.12.060 and, thus, a "fair value" determination does not allow a trial court to ascribe value to a foreclosed property based on market conditions that do not actually exist on the date of the trustee's

sale. The Court also properly concluded that the McNaughtons failed to satisfy their burden on summary judgment; despite receiving a CR 56(f) continuance, the McNaughtons failed to present any evidence regarding the property's value, much less evidence showing that the property's "fair value" was more than the $6 million paid for it at the trustee's sale.

II. COUNTERSTATEMENT OF THE ISSUES

Did the Court of Appeals properly construe the term "fair value" as used in RCW 61.24.100(5) and defined in RCW 61.24.005(6) according to its plain and unambiguous meaning? **Yes.** Was Washington Federal entitled to summary judgment based on the McNaughtons' failure to produce any evidence establishing the property's "fair value"? **Yes.**

III. COUNTERSTATEMENT OF THE CASE

A. The McNaughtons Guaranty A Commercial Loan Made To TMG; Horizon Bank Nonjudicially Forecloses On TMG's Property After TMG And The McNaughtons Default.

In March 2005, Horizon Bank loaned The McNaughton Group, LLC ("TMG") $11,700,000 pursuant to a business loan agreement and promissory note. CP 695-702; CP 704-07. To secure the loan, TMG granted Horizon Bank a deed of trust on two parcels of real property in Snohomish County, referred to as the Sommerwood Property and King's Corner Property. CP 690 (McKenzie Decl.), ¶ 4. In addition, Mark and Marna McNaughton, the owners of TMG, each executed a Commercial

Guaranty, in which they personally, absolutely and unconditionally guaranteed payment of TMG's indebtedness on the loan. CP 709-14.

TMG defaulted on the loan. CP 690 (McKenzie Decl.), ¶ 7. The McNaughtons also defaulted on the guaranties. *Id.*, ¶ 8. As of September 2009, the amount owing on the loan and guaranties was over $12 million. *Id.* Horizon Bank initiated a nonjudicial foreclosure of the Sommerwood and King's Corner Properties, and provided notice to the McNaughtons that they would be liable for a deficiency. *Id.*, ¶ 9; CP 716-19. Around the same time, in preparation for the sale, Horizon Bank obtained a third-party appraisal of the Sommerwood and King's Corner Properties, which identified a combined market value of $5,045,000. CP 367-68 (Bryan Decl.), ¶¶ 2-3; CP 371-478 (Sommerwood); CP 489-598 (King's Corner).

The trustee's sale was held on September 18, 2009. CP 691 (McKenzie Decl.), ¶ 10. Horizon Bank purchased the properties with a credit bid of $6,000,000—nearly a million dollars more than the appraised value of the Sommerwood and King's Corner Properties. *Id.*; *also* CP 368 (Bryan Decl.), ¶ 4; CP 721-25 (trustee's deed). After applying a credit in the amount of the successful bid, over $6 million still remained owing on the loan and guaranties. *Id.* Shortly thereafter, the FDIC assigned all of Horizon Bank's interest in the loan documents and guaranties to Washington Federal. CP 690 (McKenzie Decl.), ¶ 6.

B. Washington Federal Sues The McNaughtons For A Deficiency Judgment; The McNaughtons Admit Liability But Assert A "Fair Value" Affirmative Defense.

In May 2010, Washington Federal sued the McNaughtons to enforce the guaranties in the amount of the deficiency. CP 1289-1314; *see* RCW 61.24.100(3)(c) (deficiency judgments allowed against guarantors of commercial loans). The McNaughtons answered and admitted that they defaulted on the guaranties, but asserted as an affirmative defense a claim "that the Court determine the fair value for the property sold at the trustee's sale, pursuant to RCW 61.24.100(5)." CP 1281-86. Under the Deed of Trust Act, if a guarantor proves that the "fair value" of the foreclosed property is greater than the price paid at the trustee's sale, the guarantor's liability for a deficiency judgment is limited to the difference between the indebtedness and that "fair value." RCW 61.24.100(5).

Washington Federal served discovery on the McNaughtons asking them to identify the alleged "fair value" of the properties. CP 738-39. The McNaughtons failed to produce any information regarding value, stating only that they were "in the process of identifying an expert witness" on the issue. *Id.* Washington Federal's counsel followed up with a letter, noting the McNaughtons' failure to identify the alleged value of the properties and insisting that it was critical that they supplement their discovery responses "given that the alleged value of the property is your

clients' primary defense." CP 754. The McNaughtons replied, but they still made no reference to valuation whatsoever. CP 726 (Fox Decl.), ¶ 3.

C. The Trial Court Continues Washington Federal's First Motion For Summary Judgment To Give The McNaughtons Time To Obtain An Expert Opinion Regarding "Fair Value."

Washington Federal moved for summary judgment. CP 1268-76. Washington Federal's motion established that the McNaughtons admitted default on the guaranties; that it purchased the Sommerwood and King's Corner Properties for nearly $1 million more than the properties' market value; and that the McNaughtons failed to produce any evidence of a greater "fair value" under RCW 61.24.100(5). CP 1268-76. Washington Federal also submitted a more recent appraisal, prepared in June 2010, that identified the then-current market value of the properties at $5.1 million—still $900,000 less than what Horizon Bank paid for the properties at the trustee's sale. CP 1030 (McMahon Decl.), ¶ 4; CP 1150-1238 (appraisal).

The McNaughtons asked for a continuance under CR 56(f) on the grounds that their recently retained expert, Anthony Gibbons, had not yet completed his analysis. CP 1020. Gibbons submitted a short "preliminary opinion" that the 2009 appraisal did "not accurately value the Property as of the date of the trustee's sale." CP 1011-12. He speculated that the sale price "may not represent the 'Fair Value' of the Property under 'normal' market conditions due to the extraordinary economic conditions beginning

in late 2008 and continuing into 2009." *Id.* Gibbons did not, however, provide an opinion on "fair value." *Id.* He said he needed more time "to conduct additional analysis ... in order to provide a final opinion." *Id.*

The trial court continued Washington Federal's motion until December 2011 to give Gibbons time to finish his "fair value" analysis. CP 1333-34. But that never happened. When Washington Federal asked the McNaughtons to produce Gibbons' expert report or appraisal, and to supplement their prior discovery responses, they did not respond. CP 727 (Fox Decl.), ¶ 5; CP 771-72. Washington Federal then noted the deposition of Gibbons, and asked the McNaughtons to produce his report in advance of the deposition. The McNaughtons' counsel responded that there was no report and, despite the December 2011 hearing date, the report "likely won't be completed before the 1st of the year." CP 776.

Gibbons testified that he had been hired in June 2011 and asked to prepare an appraisal of the Sommerwood and King's Corner Properties, but had been "too busy" to do so. Indeed, he had not done ***any work*** on the case beyond his 3-page CR 56(f) declaration. CP 249-252, 279. He repeatedly conceded he had not undertaken any effort to appraise the properties, and had no idea what their value was on the date of the trustee's sale or any other time. CP 253, 271, 273, 283, 299-300, 310-311, 315, 317-18. Finally, and critically, Gibbons could not and would not

testify that Horizon Bank's $6 million credit bid was less than the properties' "fair value" on the date of the sale. CP 318-19.

D. The Trial Court Grants Washington Federal's Second Motion For Summary Judgment When The McNaughtons Fail To Submit Any Evidence On The Properties' Fair Value.

Washington Federal thereafter filed a second motion for summary judgment. Once again, the only issue was the McNaughtons' affirmative defense of "fair value" under RCW 61.24.100(5). Mustering both existing and additional evidence, Washington Federal demonstrated that:

- The properties were appraised shortly before the trustee's sale at a market value of $5,045,000—almost $1 million less than the sale price. CP 367-68 (Bryan Decl.), ¶¶ 2, 3; CP 371-598.
- The market value of the properties did not materially change between the date of the appraisals and the trustee's sale, and was less than the $6 million sale price. *Id.*, ¶ 4.
- The properties were appraised nine months after the trustee's sale at a market value of $5.1 million—still $900,000 less than the $6 million sale price. *Id.*, ¶ 5; CP 600-88.
- The "fair value" definition contained in RCW 61.24.005(6) is consistent with the market value definition in the two appraisals of the properties. CP 4 (Bryan Decl.), ¶ 2.
- Washington Federal received several third-party offers for the properties ranging from $3,858,260 to $5,250,000—all less than the $6 million sale price. CP 692 (McKenzie Decl.), ¶ 12.
- Washington Federal sold the Sommerwood Property for $4 million in 2011—less than its previously appraised value and the price paid for it at the trustee's sale. *Id.*, ¶ 13.
- The McNaughtons failed to produce any evidence regarding the "fair value" of the properties on the date of the trustee's

> sale, their expert had no opinion on "fair value," and could not state that the $6 million sale price was less than "fair value."

CP 786-805. Amazingly, the McNaughtons still did not offer any evidence on "fair value," even though they bore the burden of proof on the issue. CP 15-35. Gibbons still provided no declaration or appraisal on the issue. The best the McNaughtons could muster was a declaration from Mark McNaughton attaching appraisals of unrelated properties that he believed were comparable to the properties at issue. But even he did not offer any estimate or opinion on "fair value." CP 39-41. The trial court granted Washington Federal's motion and entered judgment. CP 1-3.

E. The Court of Appeals Affirms.

On appeal, the McNaughtons struggled to find a legal issue to overcome their two-time failure to present evidence on "fair value." First, they argued the trial court applied an incorrect legal standard when it refused to give the term "fair value" the same meaning as "upset price." Second, they argued there were genuine issues of fact on the fair value issue. The Court of Appeals rejected both arguments in its published opinion: "[b]ecause the McNaughtons' arguments ignore the plain language of the Deeds of Trusts Act and the well-established burden of proof on summary judgment, we affirm." *McNaughton*, 325 P.3d at 384.

IV. ARGUMENT WHY THE PETITION SHOULD BE DENIED

The Court of Appeals' opinion does not conflict with prior case law. Nor does it involve an issue of substantial public interest. It applies ordinary rules of statutory construction, and gives the definition of "fair value" its plain and unambiguous meaning. The opinion also reflects a straightforward application of the well-established summary judgment standard. Indeed, even if the term "fair value" had the same meaning as "upset price," as the McNaughtons claim, it would not result in a reversal; the McNaughtons failed to satisfy their burden of presenting evidence of the property's "fair value," under *any* definition of that term, when opposing Washington Federal's motion for summary judgment.

A. The Term "Fair Value" As Used In Deeds Of Trust Act Does Not Have The Same Meaning As "Upset Price."

The McNaughtons implausibly claim that the $6 million paid for the properties did not reflect "fair value," not because there was collusion or unfair bidding, but because it was based on actual market conditions existing at the time of the trustee's sale, rather than "normal conditions." Pet. at 7-10. They argue that the term "fair value," which is expressly defined in RCW 61.24.005(6) and applies exclusively in the context of nonjudicial foreclosures, should be given the same meaning (and judicial

gloss) as the term "upset price," which is used (but not undefined) in RCW 61.12.060 and applies exclusively in the context of judicial foreclosures.

The Court of Appeals properly rejected the McNaughtons' effort to equate "fair value" to "upset price" because it defies the plain meaning of both statutes. *McNaughton*, 325 P.3d at 387-90. The concept of "upset price" is exclusive to *judicial* foreclosures governed by the Foreclosure of Real Estate Mortgages Act ("Judicial Foreclosure Act"). *See* RCW 61.12.060. The concept of "fair value" is exclusive to *nonjudicial* foreclosures governed by the Deeds of Trust Act. *See* RCW 61.24.005(6); RCW 61.24.100(5). Critically, the legislature manifested its clear intent ***not*** to incorporate the concept of "upset price" into the Deeds of Trust Act: "This section is ***in lieu of any right*** any guarantor would otherwise have ***to establish an upset price*** pursuant to RCW 61.12.060 prior to a trustee's sale." RCW 61.24.100(5) (emphasis added). The McNaughtons' argument is baseless for this reason alone.

The legislature also used different language when describing "upset price" and "fair value," and only the text of the former supports an interpretation that would permit a court to consider hypothetical market conditions when valuing the foreclosed property. *McNaughton*, 325 P.3d at 390. Specifically, the Judicial Foreclosure Act states that, when setting an "upset price," the court may "take judicial notice of economic

conditions ...." RCW 61.12.060. This unique statutory language has been interpreted as giving courts discretion, under certain circumstances, to consider "the state of the economy and local economic conditions," and to fix an "upset price" based on "normal" economic conditions. *Nat'l Bank of Wash. v. Equity Investors*, 81 Wn.2d 886, 926, 506 P.2d 20 (1973).

The Deeds of Trust Act, unlike RCW 61.12.060, does not permit judicial notice of "economic conditions." Nor is there any language in either RCW 61.24.005(6) or RCW 61.24.100(5) that could be construed to artificially increase a property's "fair value" to reflect ideal economic conditions that do not currently exist. On the contrary, the definition of "fair value" unambiguously requires a court to determine value based on actual market conditions that exist "as of the date of the trustee's sale":

> This value shall be determined by the court or other appropriate adjudicator by reference to the most probable price, ***as of the date of the trustee's sale***, which would be paid in cash or other immediately available funds, after deduction of prior liens and encumbrances with interest to the date of the trustee's sale, ***for which the property would sell on such date*** after reasonable exposure in the market under conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under duress.

RCW 61.24.005(6) (emphasis added). The point of the statute is to protect against the possibility that the property was sold at an artificially low price by virtue of the context in which it was sold, *i.e.*, foreclosure. The statute

therefore requires the court to determine value based on a hypothetical price for the property in an arms-length transaction between self-interested parties. The statute expressly pegs the relevant date for this probable price "as of the date of the trustee's sale"—not some date in the past or future when "normal" economic conditions may exist. *Id.*

The Court of Appeals also properly rejected the McNaughtons' argument that RCW 61.24.005(6)'s reference to "duress" permits a court to consider a "distressed market" when determining "fair value." Pet. at 9. As the Court correctly noted, the term has nothing to do with market conditions. "[T]he phrase 'assuming neither is under duress' clearly refers to the buyer and seller 'acting prudently, knowledgeably, and for self-interest.'" *McNaughton*, 325 P.3d at 390. Here, too, the statute is intended to protect guarantors by ensuring that "fair value" is measured by the "probable price" a reasonable buyer would pay for the property on the open market, outside of foreclosure, *i.e.*, the seller is not "under duress." To be sure, no prudent, knowledgeable and self-interested buyer—the hypothetical buyer described in RCW 61.24.005(6)—would pay more on "the date of the trustee's sale" than current market conditions dictate.

Finally, the McNaughtons suggest that it would be "absurd" to conclude that the legislature intended different valuation standards in judicial and nonjudicial foreclosures. Pet. at 8-11. Not so. The Judicial

Foreclosure Act's "upset price" provision was enacted in 1935, during the Depression and prior to the development of modern appraisal standards, whereas the Deeds of Trust Act's "fair value" provision was enacted in 1998, and comports with those standards. *Compare* RCW 61.25.005(6) *with* 12 CFR § 34.42. Further, the Judicial Foreclosure Act allows lenders to obtain deficiency judgments against borrowers and gives courts wide discretion to determine upset price, whereas the Deeds of Trust Act bars lenders from obtaining deficiency judgments against borrowers (absent waste or other bad acts), and requires the court to determine "fair value" only with respect to guarantors. *Compare* RCW 61.12.070 *with* RCW 61.24.100(3), (5). In short, the different approaches to valuation reflect the time periods in which the statutes were enacted and the vast differences in deficiency rights and remedies in the two statutory schemes.

For similar reasons, the fact that the legislature chose different standards for valuation will not, as the McNaughtons suggest, result in "unfair" or "grossly inadequate bids" in nonjudicial foreclosures. Pet. at 5, 7, 10-11. If the price paid at a trustee's sale is lower than what would have been paid for the property in an arms-length transaction, RCW 61.24.100(5) reduces the deficiency to reflect "fair value." A lender making a credit bid has no incentive to underbid the property and, in all events, guarantors owe no more than what they would owe outside the

context of foreclosure. By contrast, the McNaughtons' interpretation would give guarantors a windfall they never bargained for: they would owe ***less*** than the actual indebtedness remaining on the commercial loan—even where, as here, the foreclosed property sold for more than its current market value. It was inherently reasonable for the legislature to define "fair value" differently than "upset price" to avoid that result.

B. The McNaughtons Did Not Satisfy Their Burden On Summary Judgment Of Presenting Evidence To Show That The Price Paid For The Properties Was Less Than Their "Fair Value."

The Petition does not and cannot offer any reason why the Court of Appeals' routine application of the well-established burdens on summary judgment merits review. It doesn't. The McNaughtons failed to present *any* contrary evidence on the "fair value" of the foreclosed properties—an issue for which they bore the burden of proof. Ironically, even though the McNaughtons argued that courts may consider "upset price" factors when determining "fair value," they made no effort whatsoever to establish the properties' supposed value under "normal" market conditions either. The Petition is particularly inappropriate for review for this reason as well.

1. Washington Federal Met Its Burden On Summary Judgment; The $6 Million Paid For The Properties At The Trustee's Sale Was More Than "Fair Value."

A "fair value" claim under RCW 61.24.100(5) is an affirmative defense for which the guarantor bears the burden of proof. *McNaughton*,

325 P.3d at 390; *see* RCW 61.24.042 ("the guarantor will have the right to establish the fair value of the property ..., and to limit its liability for a deficiency). Washington Federal therefore had only an initial burden to show that there was no genuine dispute of material fact on that issue. *Young v. Key Pharm., Inc.*, 112 Wn.2d 216, 225, 770 P.2d 182 (1982). The Court of Appeals correctly concluded that Washington Federal easily satisfied that initial limited burden and, indeed, the undisputed evidence proffered by Washington Federal showed that the $6 million paid for the properties at the trustee's sale far exceeded their "fair value."

The properties were appraised shortly before foreclosure at $5,045,000. CP 367-68 (Bryan Decl.), ¶¶ 2-3. The definition of "market value" used in the appraisals (CP 390-91) practically mirrors, and is consistent with, the definition of "fair value" used in RCW 61.24.005(6). CP 4 (Bryan Decl.), ¶ 2. The properties' value did not increase between the date of the appraisals and the date of trustee's sale and, thus, the "fair value" of the properties on that date was less than $6 million. CP 368 (Bryan Decl.), ¶ 4. Further, the post-foreclosure appraisal of the properties ($5,100,000), subsequent purchase offers (between $3,858,260 and $5,250,000) and re-sale price of Sommerwood ($4,000,000) all confirmed that the "fair value" of the properties on the date of the trustee's sale was far less than $6 million. *Id.*, ¶ 5; CP 692 (McKenzie Decl.), ¶¶ 12, 13.

2. The McNaughtons Failed To Present Any Evidence Regarding The "Fair Value" Of The Property.

In the face of Washington Federal's showing, to survive summary judgment, the McNaughtons had to produce some evidence to show that "fair value" was more than the $6 million sale price. *Young*, 112 Wn.2d at 225. The Court of Appeals correctly concluded that they failed to do so. *McNaughton*, 325 P.3d at 390. Despite receiving a CR 56(f) continuance, the McNaughtons never once identified the alleged "fair value" of the properties in any discovery response, appraisal or expert report. CP 726-27 (Fox Decl.), ¶¶ 3, 5; CP 738-39; CP 754; CP 771-72; CP 776. Indeed, the McNaughtons' own expert made no effort to appraise the properties, did not know their value, and had no opinion on whether the $6 million sale price was lower than the properties' "fair value." CP 249-253, 299, 310-311, 315-319. Notably, this failure of proof exists regardless of how "fair value" is defined—even if it means the same thing as "upset price."

The Court of Appeals also properly rejected the McNaughtons' efforts to contrive an issue of fact, short of actually presenting evidence of "fair value," all of which they blithely repeat in the Petition. They suggest that fair value was more than $6 million because the pre-foreclosure appraisals did not include a $3 million lift station. Pet. at 12. But as the Court of Appeals held, and the McNaughtons simply ignore, the lift

station was conveyed to the Silver Lake Water & Sewer District more than six months *before* the trustee's sale. *McNaughton*, 325 P.3d at 391; CP 42 (McNaughton Decl.), ¶ 15.[1] Thus, not only was it appropriate to exclude the station from value of the properties, it is irrelevant to a "fair value" determination "as of the date of the trustee's sale." RCW 61.24.005(6).

The McNaughtons next argue that the sale of unrelated property in 2008 casts doubt on the "fair value" of the properties in 2009. Pet. at 13-14. The Court of Appeals likewise properly rejected this claim because the McNaughtons presented no evidence to show the sale was comparable. *McNaughton*, 325 P.3d at 391. Mark McNaughton merely recited the sales price in his declaration, and the McNaughtons' expert had no idea if the sale was comparable. CP 39-40 (McNaughton Decl.), ¶ 9; CP 281-82. In fact, the only evidence on the issue was submitted by Washington Federal, whose expert testified that the sale ***was not*** a valid comparable. CP 5 (Bryan Decl.), ¶ 5. As the Court noted, the McNaughtons failed to rebut that testimony as well. *McNaughton*, 325 P.3d at 391-92.

[1] In a related case, the Court of Appeals also recognized that the lift station had been conveyed in February 2009, well before the September 2009 nonjudicial foreclosure. *Wash. Federal Sav. & Loan Ass'n v. The McNaughton Group*, 179 Wn. App. 319, 324, 319 P.3d 805 (2014) ("After the Sewer Facilities were built, TMG conveyed and transferred them to the District under a February 26, 2009 Bill of Sale.").

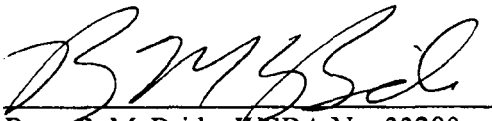
For all the same reasons, the Court properly held that the various appraisals cited by the McNaughtons, *see* Pet. at 14, failed to create an issue of fact on "fair value." *McNaughton*, 325 P.3d at 391. Here, too, the McNaughtons offered no evidence to show how these random appraisals —done on different property, on different dates, by different appraisers, working for a different bank—were relevant to the value of the properties; Mark McNaughton simply attached the unauthenticated appraisals to his declaration. CP 40-41 (McNaughton Decl.), ¶¶ 10-11; CP 45-156. The McNaughtons' expert had no opinion on the issue, nor did McNaughton.

V. CONCLUSION

The Court of Appeals applied the correct legal and procedural standards to affirm the summary judgment dismissal of the McNaughtons' "fair value" affirmative defense. There are no grounds for review. The Petition for Review should be denied.

RESPECTFULLY SUBMITTED this 2nd day of July, 2014.

LANE POWELL PC

By 

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CERTIFICATE OF SERVICE

I hereby certify that on July 2, 2014, I caused to be served a copy of the foregoing **Answer to Petition for Review** on the following person(s) in the manner indicated below at the following address(es):

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Kathryn Savaria

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Dear Clerk: Attached for filing is the following document:

Case Name: Washington Federal Savings & Loan Association v. Mark A. McNaughton and Marna L. McNaughton
Case No.: 90432-4
Document Name: Answer to Petition for Review
Filing Attorney: Ryan P. McBride, WSBA No. 33280

A hard copy will follow via U.S. mail to counsel of record. Thank you.

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