No. 43043-6-II

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

RICHARD APPLEGATE and KAREN APPLEGATE, husband and wife,

Appellants/Cross-Respondents,

v.

WASHINGTON FEDERAL, INC. d/b/a WASHINGTON FEDERAL SAVINGS, a Washington Corporation and Federal Savings and Loan; KITSAP BANK, a Washington Financial Institution; HARBOR HOME DESIGN, INC., a Washington Corporation; CHARLES BUCHER and JANE DOE BUCHER, husband and wife, and the marital community comprised thereof; OHIO CASUALTY INSURANCE CO., Bond No. 3620699,

Respondents/Cross-Appellants.

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A. INTRODUCTION

Richard and Karen Applegate wanted to build their dream home, but it turned out to be a bad dream when they were the simultaneous victims of negligence and fraud. Employees at Washington Federal Savings ("WFS") who administered their progressive construction loan, assured them that their interests would be protected. They were not. As a result, their contractor Home Harbor Design, Inc. ("HHD"), owned by Charles Bucher, was able to overbill, commit forgery, and otherwise convert vast sums to which he was not entitled, while doing shoddy and incomplete work.

When a bank controls and administers the release of funds in a progressive construction loan, the fiduciary duty created when bank customers affirmatively rely upon the particular financial expertise of a bank, and the advice and expertise of its employees.

After improperly dismissing the Applegates' negligence and breach of fiduciary duty claims on summary judgment, the trial court compounded the injustice by improperly excluding key witnesses and presenting the jury with a verdict form that misled and clouded the issues before it. This Court should reverse and remand this case for retrial to include the negligence claims and allow the Applegates a full and fair opportunity to litigate their other claims.

B. ASSIGNMENTS OF ERROR

(1) Assignments of Error

1. The trial court erred when, on reconsideration, it granted summary judgment in favor of WFS on the Applegates' negligence claim.

2. The trial court erred when it granted summary judgment to WFS on the Applegates' claim for breach of fiduciary duty.

3. The trial court erred when it struck Diane Behrens as a witness for the Applegates.

4. The trial court erred when it excluded Robert Floberg as a witness.

5. The trial court erred when it submitted to the jury the special verdict form misstating the nature of the Applegates' claim against WFS.

6. The trial court erred when it entered judgment in favor of WFS.

7. The trial court erred when it entered judgment in favor of HHD/Bucher.

8. The trial court erred when it denied the Applegates' motion for reconsideration or to vacate the judgment in favor of WFS.

9. The trial court erred when it denied the Applegates' motion for reconsideration or to vacate the judgment in favor of HHD/Bucher.

(2) Issues Related to Assignment of Error

1. Does a bank releasing payments to a builder the progressive construction loan context have a fiduciary duty when a bank agent makes specific assurances to the customer that the bank will protect the customer's interests? (Assignments of Error 2, 6, 8)

2. Does a bank releasing payments to a builder the progressive construction loan context have a duty of reasonable care because the bank's control and authority over the release of funds constitutes special circumstances? (Assignments of Error 1, 6, 8)

3. Does a trial court err in submitting a special verdict form asking the jury to decide if a bank breached its contract "to provide a construction loan" when *provision* of the loan is not at issue, rather it is the *manner of administering* the loan that was in breach of contract? (Assignments of Error 5, 6, 8)

4. Does a trial court abuse its discretion when it strikes a witness under ER 404(b) as improper character evidence, when the defendant has argued that allegations of fraud were mere mistakes, and the witness can demonstrate lack of mistake? (Assignments of Error 3, 7, 9)

5. Does a trial court abuse its discretion when it strikes an expert witness who was timely listed and available for deposition, when the opposing party agrees to depose the witness past the discovery

deadline violates court rules regarding scheduling, particularly when the purported basis for striking the witness is his opinion was not disclosed before the discovery cutoff? (Assignments of Error 4, 7, 9)

C. STATEMENT OF THE CASE

In 2007, the Applegates wanted to build their dream retirement home in Gig Harbor. They deposited $171,000 into an account at WFS, and sought and obtained a progressive construction loan from WFS. CP 388. To build their home, they hired HHD and its owner, Bucher. *Id.*

Under the terms of the WFS loan, HHD/Bucher would complete various items of the house and then submit a "Certification of Job Progress" ("CJP") to the Applegates. CP 287. The contract specified that if the Applegates and Bucher signed the CJP, then WFS was authorized to issue a check made out to the Applegates and HHD/Bucher for the requested amount and send it to the Applegates, not to HHD/Bucher directly. *Id.* According to the contract, the Applegates would then endorse the check and send it to HHD/Bucher for signature and deposit. *Id.* WFS was not supposed to send draw checks to HHD/Bucher directly.

Although the loan documents purported to place primary responsibility for the site inspections on the Applegates, WFS' own policies and procedures specified that it would undertake inspections to ensure that work was being completed as represented by HHD/Bucher.

CP 397. For example, WFS' "Custom Construction Loan Policies and Procedures" stated that WFS would not issue payments for incomplete or unsatisfactory work, and that WFS could conduct on-site inspections, stop work and order replacement if need be:

> DRAWS: ...WFS will not advance any money for items not yet delivered and installed. WFS shall at all times have the right to enter upon the property during the period of construction work, and if the work is not satisfactory to Lender, it shall have the right to stop the work and order its replacement....

Id. WFS' Policies and Procedures also stated that "All changes to the contract, plans, specifications, and cost breakdown must be authorized by WFS *prior* to any alterations. A reduction in the quality of the project will not be allowed." *Id.* (emphasis in original).

Joni Cross, WFS branch manager and lead contact for the Applegates on the project, also confirmed that she would physically inspect the property prior to approving any draw request. CP 298. Although Cross is "not a licensed builder or architect," she stated she could verify the work done as a "layman." *Id.* Cross said that these internal procedures "provid[ed] the Applegates with numerous protections from inappropriate disbursements." CP 299.

At first, the Applegates trusted Bucher and relied upon his assurances. CP 388. However. over time they began to discover that the

home was not being built as promised, and became suspicious that Bucher was not being honest with them. CP 390. The $52,000 the Applegates had deposited with Bucher, was supposed to be credited toward construction costs and deducted from the first WFS draw request. CP 624. It was not, and Bucher later admitted that fact. CP 626. Bucher was claiming to have completed certain items and requesting draws that were higher than the invoice submitted by the subcontractor, such as the foundation and framing. CP 649-50, 652-54. They also noticed that Bucher had billed higher for certain items, such as their deck, than the budgeted amount. CP 389.

In mid-2008, the Applegates discovered Bucher had forged Richard Applegate's signature on a draw check for $108,000. CP 390. Bucher did not deny forging the signature on the check. CP 2260. He claimed that Richard Applegate's signature on the CJP confirmed that Applegate had given Bucher permission to sign the check in his name. *Id.* However, Applegate also had not signed the CJP. CP 689.

When the Applegates began to raise concerns with WFS about Bucher and HHD's actions, Cross verbally assured the Applegates that WFS would represent the Applegates with respect to the project and ensure it was proceeding in accordance with their plans. CP 389. For example, in February 2008, Richard Applegate expressed concern to Cross

that the construction was not proceeding according to the plans and budget. He explained that he and Karen had "never built a house before" and had no idea what they were doing. *Id.* Cross assured them that they could rely on her "experience and expertise" and that WFS would be "looking out for their interests" and "representing [the Applegates] in the process." *Id.* Cross also stated that the project was going well and that Bucher was doing an "excellent job." *Id.*

Cross claimed that every CJP and draw Bucher took was signed by the Applegates. CP 301. However, the record shows that this is not the case. For example, one CJP had no signatures of any kind, yet WFS disbursed $37,000 to Bucher. CP 412-13. Another unsigned CJP authorizing a $17,000 payment to HHD had a note on top indicating that the check had already been mailed to Bucher, and to "please have all parties sign and return" the CJP. CP 416.

WFS' response to the Applegates' increasing concerns regarding Bucher's activities was to classify them as "difficult customers" and to deny any responsibility for oversight of the payments. CP 300.

The Applegates filed claims against WFS, HHD, and Bucher in January 2010.[1] CP 1. They asserted, *inter alia*, that WFS had breached its duty of care and its fiduciary duty to the Applegates. CP 7. They also

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[1] There were several other named defendants, but only the claims against Bucher, HHD, and WFS went to trial.

made a number of claims against HHD/Bucher, including claims of fraud, conversion, and unjust enrichment. CP 9-11.

WFS moved for summary judgment on the Applegates' negligence and breach of fiduciary duty claims. CP 211. The trial court granted the motion as to fiduciary duty, but ordered a trial on the negligence claim. CP 755. However, upon reconsideration, the trial court also dismissed the Applegates' claim for negligence. CP 865.

HHD/Bucher moved to exclude two of the Applegates' witnesses. CP 1358, 3568. One, Diana Behrens, had direct knowledge of other instances of HHD/Bucher's fraud and forgery in connection with construction draw requests. CP 787-89. Because HHD/Bucher's defense was to claim that any suspicious activity was simply the result of misunderstanding or mistake, CP 932, the Applegates sought to call Behrens to demonstrate an absence of mistake. VRP 10/06/11 at 60-61. HHD/Bucher claimed that Behrens' testimony was improper under ER 404(b), and the trial court excluded Behrens. VRP 10/06/11 at 63.

The other witness, Robert Floberg, was a document forensics expert who was prepared to testify that the signature on the $108,000 CJP was forged. CP 3525. Floberg was timely named as a witness in April 2011. *Id.* HHD asked for agreement to take his deposition past the August 16, 2011 discovery deadline, and the Applegates agreed. CP 3533,

3538. After a dispute about scheduling and giving Floberg access to original documents, CP 3533-38, HHD/Bucher cancelled Floberg's deposition and moved to exclude Floberg as a witness on the grounds that his opinion had not been disclosed before the discovery deadline. CP 3452. The trial court excluded Floberg as a witness. CP 3568-70.

Trial proceeded. The remaining claims against WFS focused on the Applegates' allegations of breach of contract. The jury instructions properly framed the issue as: "plaintiffs also claim that Washington Federal breached its construction agreement with the plaintiffs by failing to properly inspect the residence while it was under construction to make sure that the amounts requested by the builder for building the Project were proper." CP 2699.

However, the special verdict form that the trial court submitted to the jury, over objection (VRP 10/31/11 at 393) stated the claim this way: "Did Washington Federal Savings ("WFS") breach its contract *to provide a construction loan to the Applegates*?" CP 2739 (emphasis added).

The jury found in favor of the defendants on all claims. The Applegates' various motions for reconsideration or to vacate the verdicts were denied. CP 2733-41.

D. SUMMARY OF ARGUMENT

Washington case law is scant regarding the common law relationship between banks and their customers, and in what circumstances those banks can be held liable for negligence and/or breach of a fiduciary duty. Fundamental public policy issues surround consumer protection and the business practices of the banking industry, particularly the modern administration of progressive construction loans.

E. ARGUMENT

(1) The Applegates Have Produced Sufficient Evidence for Trial that WFS' Progressive Construction Loan and Affirmative Assurances Create a Fiduciary Relationship and Tort Duty to Properly Oversee the Disbursements

(a) Standard of Review

This Court reviews an order granting summary dismissal of a plaintiff's claims *de novo*. *Twelker v. Shannon & Wilson, Inc.*, 88 Wn.2d 473, 564 P.2d 1131 (1977). The defendants bear the burden of establishing there are no genuine issues of material fact, and they are held to a strict standard. *Scott v. Pac. W. Mountain Resort*, 119 Wn.2d 484, 502-03, 834 P.2d 6 (1992). Any doubt as to the existence of a genuine issue of material fact will be resolved against the movant, and all inferences from the evidence must be construed in the light most favorable to the nonmoving party. *Magula v. Benton Franklin Title Co.*, 131 Wn.2d

171, 930 P.2d 307 (1997). The moving party bears the burden of showing that the Plaintiffs may not recover, as a matter of law, as to any of the claims or causes of action brought and that there is no genuine issue for trial on any such claims. *Young v. Key Pharm., Inc.*, 112 Wn.2d 216, 225, 77 P.2d 182 (1989).

(b) Cases Addressing the a Fiduciary Duty Between a Bank and Its Customer Are Scant, Dated, and Do Not Address Progressive Construction Loans

The Washington Supreme Court has not directly confronted the issue of whether a particular bank has, through its actions, created a fiduciary duty to a customer.[2] The only Washington opinions squarely addressing this question are two cases from Division Three of this Court, *Tokarz v. Frontier Savings & Loan Ass'n*, 33 Wn. App. 456, 656 P.2d 1089 (1982), and *Hutson v. Wenatchee Federal Savings & Loan Ass'n*, 22 Wn. App. 91, 588 P.2d 1192 (1978), *review denied*, 92 Wn.2d 1002 (1979). *Tokarz*, the most recent decision on the subject, was filed nearly 30 years ago.

The passage of so much time is significant. Banking law since 1982 has not been static, nor have the economic realities of modern

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[2] The Supreme Court has recently ruled on the question of an individual bank employee's personal liability for such acts, but declined to speak to the issue of a bank's liability, concluding that the question was not before it. *Annechino v. Worthy*, __ Wn.2d __, __ P.3d __ (Supreme Court No. 86220-6, October 18, 2012). However, the Court did affirm that a bank can be held liable in tort if it makes assurances to a customer, or there are other special circumstances that apply. *Id.*

banking practice. Since that time, there have been a number of banking crises, beginning with the savings and loan crisis of the mid-1980's. *See* "The Banking Crises of the 1980s and Early 1990s: Summary and Implications," Federal Deposit Insurance Corporation, http://www.fdic.gov/bank/historical/history/vol1.html. Recently, the question of good banking practices has been of particular interest to individual and institutional customers alike. *See* David Erkens, Mingyi Hung, and Pedro Matos, "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide," August 2009.

Simply put, good banking practices are currently at the forefront of public policy decisions in legislative and judicial circles. Although some of these issues can be addressed at the federal level, banks are also highly regulated at the state level. State law is still the first line of defense for consumers of banking services.

In furtherance of this public policy of protecting consumers, it is important to uphold consumers' ability to bring common law negligence actions against banks and their officers when they assume, and then violate, a fiduciary duty to their customers.

Most jurisdictions do generally hold that the basic relationship between lenders and borrowers is usually an arm's-length transaction, as is

present between creditors and debtors. Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 Wake Forest L. Rev. 719, 736 (1994). However, jurisdictions sharply diverge regarding the extent to which a bank's relationship with a customer can, or should, ever give rise to fiduciary obligations by the bank.

Washington courts have concluded that under "special circumstances" or when there is a "special relationship" beyond an arm's length banking transaction, a bank may have a fiduciary duty. *Tokarz*, 33 Wn. App. at 458, and *Hutson*, 22 Wn. App. at 105; *Annechino*, Supreme Court No. 86220-6 at *7. The decisions are in keeping with this state's "fundamental public policy to protect consumers...." *McKee v. AT & T Corp.*, 164 Wn.2d 372, 385, 191 P.3d 845, 852 (2008), citing *Scott v. Cingular Wireless*, 160 Wn.2d 843, 854, 161 P.3d 1000 (2007); *see also*, *Dix v. ICT Group, Inc.*, 160 Wn.2d 826, 841, 161 P.3d 1016, 1024 (2007); RCW 19.86.920. Consumers of financial services are shielded under this public policy umbrella. *See, e.g., Dwyer v. J.I. Kislak Mortg. Corp.* 103 Wn. App. 542, 13 P.3d 240, *review denied*, 143 Wn.2d 1024, 29 P.3d 717 (2000) (mortgagee's practice of including miscellaneous service charges along with secured sums due on its mortgage payoff statement violated Consumer Protection Act).

(c) The "Special Circumstances" Test Allows for Negligence and Breach of Fiduciary Duty Claims Against Banks and Has Never Been Applied to a Lender-Borrower Relationship at Issue Here

In Washington, "special circumstances" can create a fiduciary or tort duty of care where otherwise a transaction would be considered at arm's-length. *Liebergesell v. Evans*, 93 Wn.2d 881, 613 P.2d 1170 (1980). In *Liebergesell*, our Supreme Court considered whether special circumstances established a fiduciary relationship between a borrower and a lender where a businessman induced a widowed school teacher to lend him money at a 20 percent interest rate, even though he knew that interest rates over 12 percent were illegal. *Id.* at 884–85. The lender, in contrast, had no business expertise, considered the borrower a friend, and relied on him for financial advice. *Id.* But when she attempted to collect the unpaid interest, the borrower raised usury as an affirmative defense. *Id.* at 885–86. In considering whether the lender could estop the borrower from raising the usury defense, based on a fiduciary relationship between the parties, the *Liebergesell* court reviewed the relevant case law and listed several factors that may establish a fiduciary relationship in fact where one would not normally arise in law:

> For instance, in *Salter v. Heiser*, [36 Wn.2d 536, 550–55, 219 P.2d 574 (1950)], lack of business expertise on the part of one party and a friendship between the contracting parties were important in establishing the right to rely.

> *Graff v. Geisel,* 39 Wn.2d 131, 141–42, 234 P.2d 884 (1951). Superior knowledge and assumption of the role of adviser may contribute to the establishment of a fiduciary relationship. Friendship seemed a determinative element under the facts of *Gray v. Reeves,* 69 Wash. 374, 376–77, 125 P. 162, 163 (1912).

Id. at 891. The *Liebergesell* court then concluded that the lender had submitted sufficient evidence to establish a fiduciary relationship and overcome summary judgment. *Id.*

As in other consumer transactions, these "special circumstances" can give rise to a fiduciary or tort duty between a bank and a customer. *Hutson,* 22 Wn. App. at 105; *Annechino,* Supreme Court No. 86220-6 at *7. When the bank makes assurances to a borrower upon which a customer reasonably relies, it can create for itself both tort and fiduciary duties. *Id.*

Here, the trial court dismissed the Applegates' breach of fiduciary duty and negligence claims on summary judgment, concluding that even taken in the light most favorable to the plaintiffs, no evidence supported those claims. CP 755, 865. In so doing, the trial court implicitly concluded that the transaction between the Applegates and WFS was merely at arm's length, and that there was no evidence of special circumstances.

(d) <u>Applying the "Special Circumstances" Test to These Facts, Trial on the Applegates' Negligence and Breach of Fiduciary Duty Claims Is Warranted</u>

The Applegates met their evidentiary burden to create a fact issue on whether WFS's actions created a fiduciary or tort duty to them. Regarding their negligence claim, the Applegates reasonably relied on WFS's assurances that it would look out for their interests and conduct inspections. Regarding their fiduciary duty claims, WFS's assumption of extensive oversight responsibilities in administering the loan raises a factual issue regarding the lenders duties to the Applegates. In fact, the very nature of a progressive construction loan constitutes a special relationship that at least merits a trial on negligence and breach of fiduciary duty.

(i) <u>There Is an Issue of Material Fact Regarding WFS's Assurance and the Applegates' Reasonable Reliance Thereon</u>

Hutson holds that the particular assurances of a bank can create an issue of fact regarding negligence. In *Hutson*, Division Three of this Court considered whether a savings and loan association had a duty to define the phrase "mortgage insurance" for a borrower where the borrower alleged that she had asked the lender to procure credit life insurance (which pays the balance of the mortgage if the mortgagor dies), but the lender procured only mortgage insurance (which insures the lender if the

borrower defaults on the mortgage). *Hutson*, 22 Wn. App. at 92. The lender never explained the difference between the two and, when the borrower saw that she was paying for mortgage insurance, she believed it was credit life insurance. *Id.* at 93. Division Three of this Court recognized that a "lender is not a fiduciary in the common sense of the term" because it profits from the business transaction. *Id.* at 102. But the court observed that the lender in this case had (1) advised the borrower about the availability of a federal subsidy and reviewed and submitted the application to the federal government on her behalf; (2) persuaded the borrower to obtain a home construction loan, rather than a home improvement loan, because the former would be easier to finance; and (3) offered to provide an "extra service" by arranging credit life insurance for the borrower. *Id.* at 92. The *Hutson* court held:

> While the lender's duty is not that of a fiduciary, we hold that, under the circumstances of this case, it was a jury question whether the lender had a duty to define any ambiguous or specialized terms which might mislead unknowledgeable and uncounseled customers, members of the lay public who rely on the lender's advice. The relationship between such parties involves more trust and confidence than is true of ordinary arm's-length dealing, even though the lender legitimately profits from the transaction.

Id. at 105. Although the *Hutson* court found no fiduciary duty, it did conclude that the borrower should have been allowed to present evidence

in support of his negligence claim that he had reasonably relied on the lender's advice. *Id.* at 105.

The *Hutson* court relied on a well-established Washington policy of consumer protection, most notably articulated by our Supreme Court in *Boonstra v. Stevens-Norton, Inc.*, 64 Wn.2d 621, 626, 393 P.2d 287, 290 (1964). Although *Boonstra* was a fraud case involving bad investment advice, the *Hutson* Court noted *Boonstra's* admonition that a "party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated such matters as the other is entitled to know because of a relation of trust and confidence between them." *Boonstra*, 64 Wn.2d at 621.

There is evidence that the Applegates reasonably relied on WFS assurances to their detriment. On the one hand, WFS presented a contract that it claims shifted the duty of care entirely to the Applegates. On the other hand, WFS made verbal and written representations that it would look out for their interests, and take special care to make sure that their funds were not misused. CP 297-99, 397. WFS's "Policies and Procedures" afforded WFS significant control over the disbursement of funds, stated that WFS would "not advance money" for items not installed, and said WFS would have the right to stop work if it was unsatisfactory. CP 397. The Applegates justifiably believed that WFS

policies meant that at least, when they complained about potential problems with HHD/Bucher, WFS would investigate. CP 251. When Richard Applegate explained that he and Karen had "never built a house before" and had no idea what they were doing, CP 389, Cross assured them that they could rely on her "experience and expertise" and that WFS would be "looking out for their interests" and "representing [the Applegates] in the process." *Id.*

WFS's written policies, combined with the express representations and assurances of its employee, create an issue of material fact as to whether WFS took reasonable care to inform the Applegates and/or take action with respect to critical matters involving the administration of their progressive construction loan, and whether the Applegates reasonably relied upon those policies and assurances.

(ii) The Extensive Oversight and Control WFS Had Over the Progressive Construction Loan Were "Special Circumstances" and Created a Fiduciary Duty

The "special relationship" exception also applies here to create an issue of fact about breach of fiduciary duty. In *Tokarz*, this issue was whether a lender in a one-time financial transaction had a duty to disclose to a borrower that his builder was having financial problems and was unable to perform other contracts of which the lender had knowledge.

Tokarz, 33 Wn. App. at 458. The *Tokarz* court first observed that a bank generally does not enter into a fiduciary relationship with a depositor or customer, but it acknowledged that modern banking practices involve complexities that "often thrust a bank into the role of an adviser, thereby creating a relationship of trust and confidence which may result in a fiduciary duty upon the bank to disclose facts when dealing with the customer." *Tokarz,* 33 Wn. App. at 458–59 (citing *Stewart v. Phoenix Nat'l Bank,* 49 Ariz. 34, 64 P.2d 101, 106 (1937)). However, in *Tokarz* the lender simply loaned funds in a lump sum to the borrower, the funds were not released periodically based upon inspections or progress reports. Division Three of this Court concluded that no special circumstances established a fiduciary duty in that case, because the lender simply made a loan to the borrower with no additional responsibilities or expectations. *Tokarz,* 33 Wn. App. at 462–63.

Below, WFS relied upon *Tokarz* to support its summary judgment motion, arguing that WFS was in a similar relationship to the Applegates as the lender was to the borrower in that case. CP 226-28.

However, many facts that were absent in *Tokarz* are present here. First, WFS took on extra services beyond merely lending money. WFS' own policy manual established that WFS assumed extensive control and responsibility over the disbursement process, including on-site progress

inspections. CP 397. Second, nothing in the loan in *Tokarz* was simply a one-time payment, not a progressive construction loan where funds were to be disbursed only on completion of work. *Tokarz*, 33 Wn. App. at 458. The issue in *Tokarz* was not the bank's duty to properly administer an ongoing loan, but its purported duty to reveal to the plaintiffs that their builder was experiencing financial problems. *Id.* Also, the lender in *Tokarz* made no assurances to the plaintiffs that it would be monitoring the builder's financial situation and reporting that information to the plaintiffs. *Id.*

No Washington case has directly addressed the lender-borrower relationship at issue here, where construction loan funds are disbursed progressively over the course of a project by the lender. Other jurisdictions looking at the issue have concluded that a duty of reasonable care applies to lenders of progressive construction loans. In Mississippi, a bank made a construction loan and paid out $8,500 directly to the general contractor without taking any precautions to see that he applied the money to discharge liens for labor and materials. *Cook v. Citizens Sav. & Loan Ass'n*, 346 So.2d 370, 371-72 (Miss. 1977). The Mississippi Supreme Court concluded that the bank "should have used reasonable diligence to see that the funds were actually used in payment of materials or other costs of construction," and that it "totally failed to discharge its duty in

disbursing the loan proceeds." *Id.* Florida courts have reached similar conclusions based upon the unique nature of the construction loan disbursement process. *Sec. & Inv. Corp. of the Palm Beaches v. Droege*, 529 So. 2d 799, 802 (Fla. Dist. Ct. App. 1988) ("A construction mortgage is essentially a mortgage to secure future advances, and the mortgagee assumes the duty to use reasonable care to see that the funds advanced are used to pay for the materials and supplies and work done on the job."); *see also*, 55 Am.Jur.2d *Mortgages* § 14 (1971); *Kalbes v. California Federal Savings & Loan,* 497 So.2d 1256 (Fla. 2d DCA 1986). California courts have adopted the same duty of care with respect to progressive construction loans. *Commercial Standard Ins. Co. v. Bank of America*, 57 Cal. App. 3d 241, 247-48 (1976).

Here, the very nature of the lending arrangement – a progressive construction loan – constituted a "special relationship" between WFS and the Applegates, just as similar loans have in other jurisdictions. It is unlike the simple one-time transaction in *Tokarz.* WFS was in direct control of the disbursements, and had the duty to look out for the Applegates, who relied on the bank's expertise. Summary judgment on the Applegates' negligence and breach of fiduciary duty claims should be reversed.

(e) The Independent Duty Doctrine Does Not Preclude the Applegates' Claims Because the Special Circumstances Test Applies, and Because Public Policy Favors a Duty of Care

In addition to asserting that there was no evidence of a tort duty, WFS argued that the Applegates' claims were precluded by the "independent duty doctrine," formerly known as the economic loss rule. CP 225. It argued that any duty to the Applegates was based solely on the contract between them, and that no independent tort duty existed. *Id.*

As a threshold matter, if this Court concludes that the special circumstances test applies to create a duty, then the independent duty doctrine is irrelevant. The independent duty doctrine is a judicial method of examining and determining whether a duty *should* exist independent of a contract. *Elcon Const., Inc. v. E. Washington Univ.*, 174 Wn.2d 157, 165, 273 P.3d 965, 969 (2012); *Affiliated FM Ins. Co. v. LTK Consulting Services, Inc.*, 170 Wn.2d 442, 448-49, 243 P.3d 521, 525 (2010). If the special circumstances test applies here, then the independent duty already exists in law, and this Court need not employ the independent duty doctrine to find that duty elsewhere.

Assuming *arguendo* that the independent duty doctrine must be employed here, it is important to understand its boundaries. It is "a doctrine that has attempted to describe the dividing line between the law

of torts and the law of contracts." *Eastwood v. Horse Harbor Found.*, 170 Wn.2d 380, 385, 241 P.3d 1256 (2010). The rule used to be called the "economic loss rule, however, in the years leading up to *Eastwood*, courts tended to afford the rule a "broad reading" of the rule that was "not correct." *Id.* at 387. In *Eastwood*, our Supreme Court recognized the problem of treating the doctrine as a bright-line "rule of general application" that holds "any time there is an economic loss, there can never be recovery in tort." *Id.* at 387–88. "First, it pulls too many types of injuries into its orbit" because the definitions of economic injuries are broad and malleable. *Id.* Second, "[e]conomic losses are sometimes recoverable in tort, even if they arise from contractual relationships." *Id.* For these reasons, the Supreme Court concluded that "[t]he term 'economic loss rule' has proven to be a misnomer." *Id.*

Instead of looking at the type of loss incurred, courts must now focus on whether it is reasonable to impose an independent tort duty, even if the parties' relationship arose out of a contract. *Affiliated FM*, 170 Wn.2d at 448-49. To decide if the law imposes a duty of care, and to determine the duty's measure and scope, courts weigh considerations of "logic, common sense, justice, policy, and precedent." *Snyder v. Med. Serv. Corp. of E. Wash.*, 145 Wn.2d 233, 243, 35 P.3d 1158 (2001). The concept of duty is a reflection of all those considerations of public policy

which lead the law to conclude that a plaintiff's interests are entitled to legal protection against the defendant's conduct. *Taylor v. Stevens County,* 111 Wn.2d 159, 168, 759 P.2d 447 (1988) (citing W. Page Keeton, et al., Prosser and Keeton on Torts § 53 at 357 (5th ed.1984)). Using judgment, courts balance the interests at stake. *Affiliated FM,* 170 Wn.2d at 450; *see also, Hunsley v. Giard,* 87 Wn.2d 424, 435, 553 P.2d 1096 (1976) (balancing the interests and holding that the defendant owed the plaintiff "a duty to avoid the negligent infliction of mental distress").

The best example of the proper application of the independent duty doctrine is the Supreme Court's analysis in *Affiliated FM.* In that case, an engineer allegedly negligently recommended an electrical grounding system that ultimately led to a fire that damaged a train. *Affiliated FM,* 170 Wn.2d at 446. The engineer argued that the losses were purely economic, and thus the only available remedies were in contract, not tort. *Id.* at 447. However, the Supreme Court concluded that policy, common sense, and precedent dictated that engineers who provide services must do so with reasonable care. The Court focused not only on issues of safety, but also on the service engineers provide to the public, and their superior knowledge and expertise in executing their duties. *Id.* The Court found a duty *despite the fact that only economic losses occurred* in the case, based on a larger notion that professionals in a position of control have a

responsibility to internalize losses for their own negligence. *Id.* The

The industry of progressive construction loans is one that merits application of a duty of reasonable care in its administration. It is a high stakes, high risk venture for many borrowers. Borrowers are essentially entrusting lenders to oversee the disbursal of an amount of money that is, for most people, the largest financial obligation of their lives. Borrowers cede control of the payment of their funds to a professional, who in turn should have a duty to avoid disbursing those funds in a negligent manner.

The independent duty doctrine is of no relevance here, because the law already imposes a tort duty in these special circumstances. Even if the doctrine applies, this Court should find that financial institutions who administer loans in this manner have a duty to do so with reasonable care.

(2) The Special Jury Instruction Form Gave the False Impression that the Applegates' Breach of Claim Against WFS Was for Failure to Provide a Loan

The special verdict form misled jurors and likely prejudiced the outcome of the Applegates' breach of contract claim against WFS. At the very least, the form denied the Applegates the opportunity to argue their theory of the case.

(a) Standard of Review

This Court reviews *de novo* a trial court's decision on the wording of a verdict form, the same standard applied to a review of jury

instructions. *Hue v. Farmboy Spray Co.*, 127 Wn.2d 67, 92, 896 P.2d 682 (1995); *State v. Woods*, 143 Wn.2d 561, 593, 23 P.3d 1046 (2001). Instructions are sufficient if they correctly state the law, are not misleading and they permit the parties to argue their respective theories of the case. *Codd v. Stevens Pass, Inc.*, 45 Wn. App. 393, 396, 725 P.2d 1008 (1986), *review denied*, 107 Wn.2d 1020 (1987).

Even if a special verdict form is legally sufficient, reversal is warranted if form clouds the jury's vantage point of the contested issues. *Capers v. Bon Marche, Div. of Allied Stores*, 91 Wn. App. 138, 143, 955 P.2d 822, 825 (1998), *review denied*, 137 Wn.2d 1002 (1999); *Lahmann v. Sisters of St. Francis*, 55 Wn. App. 716, 723, 780 P.2d 868 (1989). Although a special verdict form need not recite each and every legal element necessary to a particular cause of action where there is an accurate accompanying instruction, it may not contain language that is inconsistent with or contradicts that instruction. *See, e.g., Koker v. Armstrong Cork, Inc.*, 60 Wn. App. 466, 483, 804 P.2d 659, *review denied*, 117 Wn.2d 1006 (1991) (citing *Hall v. Corporation of Catholic Archbishop*, 80 Wn.2d 797, 804, 498 P.2d 844 (1972)) (prejudicial error to give instructions that are inconsistent or contradictory on a given material point).

(b) The Jury Was Not Allowed to Consider the Applegates' Theory of the Case Because the Verdict Form Incorrectly Stated that They Sought to Prove WFS Failed to Provide a Loan

The Applegates' theory of the case against WFS, as stated in the jury instructions, is that it breached its contract with them in disbursing funds without investigating questionable draws. CP 2739. However, the sole question put to the jury on this issue in the special verdict form was "Did Washington Federal Savings ("WFS") breach its contract *to provide a construction loan to the Applegates*?" CP 2739 (emphasis added). This wording was adopted by the trial court over objection. VRP 10/31/11 at 393.

A misleading or confusing special verdict form case be grounds for reversal. In *Capers*, a terminated employee brought a racial discrimination claim against her employer. 91 Wn. App. at 139. The jury instructions had correctly stated the legal standard that race must have been a "substantial factor" in the termination decision. *Id.* However, Division One of this Court held that the special verdict form prejudicially misled and confused the jury by asking the jury to decide whether the employer terminated the plaintiff "because of" her race, without including the "substantial factor" language. *Id.* The Court concluded that the verdict form was inconsistent with the jury instructions, and reversed. *Id.*

The phrasing of the verdict form here incorrectly told the jury that the issue was whether WFS *provided* a construction loan, rather than breached its agreement regarding the manner in which the loan was administered. The Applegates never claimed that WFS failed to provide a loan, but that it breached its contract *in the course of providing* the loan.

In contrast, the jury instructions read: "plaintiffs also claim that Washington Federal breached its construction agreement with the plaintiffs by failing to properly inspect the residence while it was under construction to make sure that the amounts requested by the builder for the building the Project were proper." CP 2739.

However, these more specific jury instructions do not cure the fatal defect in the special verdict form, in fact, they are evidence of the prohibited inconsistency that necessitates reversal. *Capers*, 91 Wn. App. at 140; *Hall*, 80 Wn.2d at 804. Reversal of the jury's verdict on the Applegates' claims against WFS is warranted.

(3) The Trial Court Erred in Striking Key Witnesses in Support of the Applegates' Fraud Claims

The Applegates sought at trial to prove that Bucher and HHD committed fraud and conversion regarding the disbursal of construction funds. Two crucial witnesses were excluded that likely prejudiced the jury's view of the Applegates' claims and HHD's defense.

(a) Standard of Review

Rulings excluding witnesses are reviewed for an abuse of discretion. *Weyerhaeuser Co. v. Commercial Union Ins. Co.*, 142 Wn.2d 654, 683, 15 P.3d 115 (2000). However, this Court's overriding responsibility is to interpret the rules in a way that advances the underlying purpose of the rules, which is to reach a just determination in every action." *Burnet v. Spokane Ambulance*, 131 Wn.2d 484, 498, 933 P.2d 1036, 1042 (1997). When excluding a witness results in a party's inability to try an otherwise valid claim, that decision should be reserved for only the most willful and egregious conduct. *Id.*

(b) The Trial Court Improperly Excluded the Applegates' Forgery Expert, Who Would Have Proven that HHD/Bucher Forged a $108,000 CJP

One of the key instances of fraud and conversion involved Bucher forging Richard Applegate's "endorsement" on a $108,000 check and a "Certification of Job Progress" ("CJP"). CP 390. Bucher admitted that Bucher signed Applegate's name on the check, but claimed that Richard Applegate's signature on the CJP was proof that he had permission to sign the check. CP 2260. However, the Applegates retained an expert witness on document forensics, who concluded that the signature on the CJP was also a forgery. CP 3525.

In April 2011, the Applegates timely named their expert witness, Robert Floberg, whom they intended to call to dispute the authenticity of the signatures on both the check and the CJP. CP 3525. The disclosure stated that Floberg "was expected to testify regarding authenticity of signatures and documents submitted by Charles Bucher." *Id.* The Applegates subsequently clarified that Floberg was to address the authenticity of Richard Applegate's signature on the $108,000 CJP, a hotly contested issue. CP 3492.

The close of discovery was August 16, 2011, but as HHD/Bucher had not yet deposed Floberg, the parties agreed to hold the deposition on September 8. CP 3495. A week before the deposition was scheduled, the Appelgates disclosed Floberg's one-page opinion letter, stating that he believed the signature on the CJP to be inauthentic. CP 3492.

HHD then cancelled Floberg's deposition and moved exclude Floberg on the grounds that his one-page opinion was not received prior to the August 16 discovery cut-off, even though his deposition was scheduled after that date. CP 3542. The trial court struck Floberg as a witness, stating that his written opinions were not timely disclosed, and prejudiced HHD. CP 3568-70.

Although a trial court has discretion in choosing how to sanction a discovery violation, excluding an expert witness is a severe sanction that

should not be imposed if a less stringent sanction will suffice. *Burnet*, 131 Wn.2d at 498; *Washington State Physicians Ins. Exch. & Ass'n v. Fisons Corp.*, 122 Wn.2d 299, 858 P.2d 1054 (1993). The court should impose the least severe sanction that will be adequate to serve the purpose of the particular sanction, but not be so minimal that it undermines the purpose of discovery; the purpose of sanctions generally are to deter, to punish, to compensate, to educate, and to ensure that the wrongdoer does not profit from the wrong. *Fisons*, 122 Wn.2d at 355-56.

An expert witness is not required to submit any written materials in discovery, unless the party plans to submit those materials as evidence at trial. CR 26(5)(A)(i). Under local rules at issue here, an party is required to disclose a "summary of an expert's anticipated opinions." PCLR 26(d)(3). Discovery of expert opinions is allowed through interrogatories or depositions, but is limited to the subject matter of the testimony, the substance of the facts and opinions, a summary of grounds for each opinion, and other discoverable information. *Id.*

Here, Floberg was timely disclosed as a witness, and made available for deposition in accordance with the court rules. CP 3315. Conflicts in scheduling *on both sides* and other disagreements led to repeated scheduling and cancelling of the deposition. CP 3422-23, 3530,

3533, 3538. The objection was *not* to the timely disclosure of Floberg, the one-page opinion issued by Floberg in advance of his deposition.

Floberg's opinion was disclosed in advance of his deposition, which HHD/Bucher agreed to schedule after the discovery cutoff. It was a one page opinion that did not take Herculean efforts to analyze. There was no prejudice to HHD/Bucher in allowing Floberg to testify, and instead simply excluding any written materials he relied upon. HHD/Bucher were aware since the filing of the second amended complaint in January 2010 that the signatures on the $108,000 check and the supporting CJP were in question. HHD/Bucher had notice in April 2011 that Floberg would be testifying as to the authenticity of the signatures on documents submitted by HHD/Bucher. That there is no prejudice is also evidenced by the fact that HHD/Bucher *agreed to depose* Floberg *after* the same discovery deadline of which they later complained in their motion.

The Bucher forgeries on a $108,000 check were critical evidence of Bucher's fraud and conversion. Excluding Floberg as a witness, when he was timely disclosed under the discovery rules and could testify as to the signatures' inauthenticity live on the stand, was an extreme and unnecessary sanction that severely prejudiced the Applegates. The trial court abused its discretion, and reversal is warranted.

(c) Another HHD/Bucher Customer Had Direct Knowledge of Fraud and Conversion, Which Would Have Demonstrated an Absence of Mistake

HHD and Bucher argued that any misdeeds with respect to how they obtained funds improperly were merely mistakes and omissions, rather than fraud or conversion. CP 932. A key witness the Applegates sought to produce, Diana Behrens, had direct knowledge that controverted the notion that the fraud and conversion were mere mistakes or misunderstanding. CP 787-89. The trial court excluded Behrens as a witness under ER 404(b). VRP 10/06/11 at 63.

"Evidence of other crimes, wrongs, or acts is not admissible to prove the character of a person in order to show action in conformity therewith." ER 404(b). Such evidence is admissible for other purposes, including absence of mistake or accident. *Id.* When a trial court admits bad acts evidence, it must first identify the purpose for which the evidence is to be admitted. *Brundridge v. Fluor Fed. Services, Inc.*, 164 Wn.2d 432, 444-45, 191 P.3d 879, 887-88 (2008). The court must then, on the record, balance the probative value of the evidence against its potential for prejudice. *Id.*

Whether other wrongs evidence is offered to show lack of mistake or accident is determined based upon the *defense raised*, not by trying to divine the motives of the plaintiff in offering the evidence. *State v.*

Brown, 113 Wn.2d 520, 527, 782 P.2d 1013, 1019 (1989) *opinion corrected*, 787 P.2d 906 (1990). In *Brown*, our Supreme Court instructed trial courts on how to analyze whether such evidence is admissible:

> We believe ER 404(b) contemplates admission of prior convictions for the purpose of showing lack of accident or mistake in cases where the prior convictions tend to disprove a defendant's claim that the conduct underlying the charged crime occurred as the result of accident or mistake.

Id. In other words, if a plaintiff claims fraud and the defendant responds by claiming a mere mistake, then prior instances of fraud are appropriate evidence for the jury to consider, with proper limiting instructions. *Id.*

Here the trial court concluded that the evidence was "obviously being attempted to use as to the character of the defendant and/or his business in that if he…was doing the same thing in her home project, then it's more likely than not he was doing the same things in the case at hand." VRP 10/6/11 at 62. The trial court then simply excluded the evidence, without conducting the balancing test. *Id.* at 63.

The trial court improperly applied ER 404(b) in rejecting Behrens as a witness based upon the perceived motives of the Applegates, rather than based on the defense raised by HHD/Bucher. As a result, a key witness was excluded that would have called into question HHD/Bucher's defense of mistake. That error was prejudicial, and should be reversed.

(4) In the Event that This Court Concludes a Basis for Attorney Fees Exists, the Applegates Are Entitled to Those Fees at Trial and On Appeal

RAP 18.1 provides that a prevailing party is entitled to attorney fees on appeal if there is a basis for those fees in statute, contract, or equity.

Here, the trial court concluded that the WFS contract only provided for fees should WFS be required to enforce the contract. VRP 12/2/2011 at 8-9. Because WFS was not required to enforce the contract against the Applegates, it concluded that each party should bear its own attorney fees. *Id.* WFS has cross-appealed from that decision. CP 3824.

To the extent that either WFS or HHD persuade this Court that an award of attorney fees is warranted, particularly if they are warranted by a contract, any such entitlement to fees would apply equally to the Applegates. RAP 18.1; RCW 4.84.330. The Applegates respectfully request this Court to instruct the trial court that, should the Applegates prevail on remand and attorney fees are awardable, the trial court should include an award for fees incurred in this appeal.

F. CONCLUSION

Summary judgment dismissal of the Applegates' negligence and breach of fiduciary duty claims against WFS was improper. The banking practice of releasing funds over time through a progressive construction

loan involves much more than the mere arm's length bank transaction where the borrower signs a paper and the bank hands over the funds. It is a complex relationship where the bank may only release funds based upon work completed, and where builders may try to swindle borrowers by relying on a bank's indifference. The special circumstances test should apply to such loans, and place a duty of reasonable care upon the bank to ensure that funds are not looted, wasted, or converted. That is particularly true when the bank assures customers it is protecting their interests.

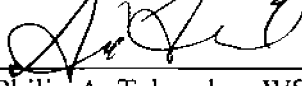
The special verdict form here misled the jury into believing the Applegates had no breach of contract claim unless WFS failed to provide a loan. This confusing form, which contradicted the Applegates' theory of the case and the jury instructions, likely affected the verdict.

The Applegates' fraud and conversion claims were eviscerated by the exclusion of key witnesses.

These critical errors necessitate a reversal and remand for a new trial. Should the Applegates prevail and attorney fees become awardable, they should be awarded both at trial and on appeal.

DATED this 25th day of October, 2012.

Respectfully submitted,



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<u>DECLARATION OF SERVICE</u>

On said day below I emailed a courtesy copy and deposited in the U.S. Postal Service for service a true and accurate copy of the Brief of Appellants/Cross-Respondents Richard and Karen Applegate in Court of Appeals Cause No. 43043-6-II to the following:

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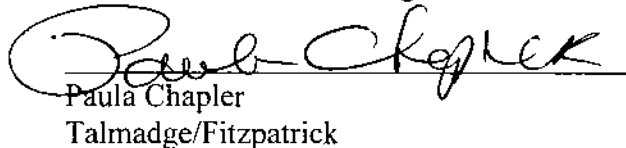
I declare under penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

DATED: October 25, 2012, at Tukwila, Washington.



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