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No. 91069-3

SUPREME COURT OF THE STATE OF WASHINGTON

[Court of Appeals No. 45320-7-II]

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HARTFORD FIRE INSURANCE COMPANY,

Plaintiff/Appellant,

v.

COLUMBIA STATE BANK,

Defendant/Respondent.

Received
Washington State Supreme Court

JAN 29 2015

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**BRIEF OF AMICUS CURIAE**
**LIBERTY MUTUAL INSURANCE COMPANY**

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## TABLE OF CONTENTS

INTERESTS OF AMICUS CURIAE .......... 1

I. INTRODUCTION .......... 1

II. SURETIES AND THEIR ROLE IN THE CONSTRUCTION INDUSTRY .......... 2

III. SURETIES' RIGHT TO EQUITABLE SUBROGATION .......... 5

A. Hartford's Equitable Rights Arose When it Issued the Payment and Performance Bonds .......... 6

B. Hartford's Equitable Rights Became Enforceable Immediately Upon its Performance Under the Bonds .......... 6

C. Hartford's Equitable Rights Entitle it to All Outstanding Contract Funds as of the Time of Waka's Default .......... 7

IV. CONCLUSION .......... 10

## TABLE OF AUTHORITIES


**State Cases** **Page**

*Hartford Fire Insurance Company v. Columbia State Bank*,
__ Wn. App. __, 334 P.3d 87, 2014 Wash. App. LEXIS 2213 (No. 45320-7-II) ........ 1, 6, 8

*Levinson v. Linderman*,
51 Wn.2d 855, 322 P.2d 863 (1958) ........ 6, 8

*Nelson v. Nelson Neal Lumber Co.*,
171 Wash. 55, 17 P.2d 626 (1932) ........ 5

*Scott Galvanizing, Inc. v. N.W. Enviroservs., Inc.*,
120 Wn.2d 573, 844 P.2d 428 (1993) ........ 3

*Worden v. Smith*,
178 Wn. App. 309, 314 P.3d 1125 (2013) ........ 10

**Federal Cases**

*Capitol Indem. Corp. v. United States*,
71 Fed. Cl. 98 (7th Cir. 2006) ........ 8

*Capitol Indem. Corp. v. United States*,
41 F.3d 320 (7th Cir. 1994) ........ 8

*Commercial Ins. Co. v. Pacific-Peru Constr. Corp.*,
558 F.2d 948 (9th Cir. 1977) ........ 3

*Fidelity & Deposit Co. v. United States*,
183 Ct. Cl. 908 (1968) ........ 7

*In re E.R. Fegert, Inc.*,
88 B.R. 258 (9th Cir. BAP 1988) ........ 8

*In re: Massart Co.*,
105 B.R. 610 (W.D. Wash. 1989) ........ 4, 6, 8-9

*In re: Pacific Marine Dredging & Const.*,
79 Br. 924 (B.R. D. Or. 1987) ........ 4

**TABLE OF AUTHORITIES**
**(Continued)**

*Madison County Farmers Association v. American Employers' Ins. Co.*,
209 F.2d 581 (8th Cir. 1954) .................................................. 2

*National Shawmut Bank v. New Amsterdam Casualty Co.*,
411 F.2d 843 (1st Cir. 1969)..................................................... 9

*Reginella Construction, Ltd. v. Travelers Casualty and Surety Co. of America*,
949. F. Supp. 2d 599 (W.D. Pa 2013) ....................................... 2-3

*United Pacific Ins. Co. v. First National Bank of Oregon*,
222 F. Supp. 243 (D. Or. 1963) ................................................ 4

**Rules & Other Authority**

*Sterns, the Law of Suretyship 1* (5th Edition 1951) ....................... 2

## INTERESTS OF AMICUS CURIAE

Liberty Mutual Insurance Company ("Liberty") and its affiliates (Safeco Insurance Company of America), as the second largest surety writer in the State of Washington and with its home office for surety operations in Seattle, has a substantial presence in the State and works closely with the State's construction industry to provide financial credit instruments (bonds). The bonds Liberty provides assure project owners that contractors will complete their work and pay subcontractors, laborers, material suppliers and taxing authorities.

The Court of Appeals' Decision, *Hartford Fire Insurance Company v. Columbia State Bank*, __ Wn. App. __, 334 P.3d 87, 2014 Wash. App. LEXIS 2213 (No. 45320-7-II), filed September 9, 2014 (the "Decision") raises serious concerns that will have a substantial impact on surety bonding and public works construction in the State. This is the first decision in the State of Washington (of which Liberty is aware) that finds contract funds are not impressed with a trust and the surety does not have an equitable lien on contract funds to satisfy project completion and payment of subcontractors.

## I. INTRODUCTION

Liberty joins in the arguments raised in Hartford Fire Insurance Company's ("Hartford") Petition for Review. The

Decision overlooks or misconstrues several key elements in finding that neither an express trust nor an equitable lien existed in favor of Hartford when General Services Administration ("GSA") made an unintended payment to Waka Group Inc. ("Waka"), and in finding that Columbia State Bank (the "Bank") had priority to the funds.

## II. SURETIES AND THEIR ROLE IN THE CONSTRUCTION INDUSTRY

Suretyship is a "contractual relationship whereby one person engages to be answerable for the debt or default of another." *Sterns, the Law of Suretyship 1* (5th Edition 1951). While an insurance policy is a two party contract, in which the primary obligation flows directly from the insurer to the insured, the contract of suretyship is a three-party contract, consisting of the owner/obligee, the contractor/obligor (principal/obligor), and the surety. *E.g., Madison County Farmers Association v. American Employers' Ins. Co.*, 209 F.2d 581, 583 (8th Cir. 1954). Both surety bonds and insurance involve a payment of premiums in exchange for payment in the event of an agreed on contingency. However, that is where the similarities end. In a traditional CGL policy, the pricing of the premium is based on pooling of the risk of a fortuitous loss, *Reginella Construction, Ltd. v. Travelers Casualty and Surety Co. of America*, 949 F. Supp. 2d 599, 612 (W.D. Pa. 2013), *aff'd* 2014 U.S. App. Lexis 10834 (3rd Cir. 2014), and the insurer agrees to indemnify the principal who owns the policy. Surety bonds, on

the other hand, are three party contracts in the nature of a financial credit instrument. A surety's pricing of a premium is not based on the risk of the fortuitous loss, but rather on the assumption the surety will be reimbursed in the event of a default and the surety's loss. *Id.* at 611. The principal/contractor purchases the bond from the surety, not for its own benefit, but for the benefit of the project owner and, unlike insurance contracts, the principal/contractor agrees to indemnify the surety if claims are filed. *Id.*

At the time a surety bond is purchased, the surety requires the principal and the owners of the business to sign an indemnity agreement. Indemnity agreements are essential to minimize the risk to the surety in posting the bond, as unlike banks, sureties typically do not take collateral from the principal/contractor. The indemnity agreements provide broad rights to the surety.

Equity generally implies a right to indemnification in favor of surety when the surety pays off a debt for which the principal is liable. *Commercial Ins. Co. v. Pacific-Peru Constr. Corp.*, 558 F.2d 948, 953 (9th Cir. 1977). In Washington, "[i]ndemnity agreements are interpreted like any other contract[]." *Scott Galvanizing, Inc. v. N.W. Enviroservs., Inc.*, 120 Wn.2d 573, 580, 844 P.2d 428 (1993). Resort to implied indemnity principals is unnecessary when express indemnification contracts exist, and the surety is "entitled to stand upon the letter of the contract and its undertaking." *Pacific-Peru Constr. Corp.*, 558 F.2d at 953.

The lynchpin of the surety relationship is the availability of

contract funds immediately upon the default of the contractor. That is the reason indemnity agreements, such as the one in this case, impress contract funds with a trust and ensure proper application of the funds to completion of projects and payment of labor and material claims. In addition, similar to the GSA contract in this case, most, if not all, public owners require contractors to certify that the funds to be paid will be used exclusively for those purposes. These rights have been historically recognized and applied not only by courts in this State, but all over the country. *See, e.g., In re: Massart Co.*, 105 B.R. 610, 613 (W.D. Wash. 1989); *United Pacific Ins. Co. v. First National Bank of Oregon*, 222 F. Supp. 243, 249 (D. Or. 1963); *In re: Pacific Marine Dredging & Constr.*, 79 Br. 924, 928 (B.R. D. Or. 1987).

Should the Decision be upheld, it will undoubtedly have a substantial impact on the surety industry in this State, either discouraging sureties from posting performance and payment bonds for public works projects, or causing sureties to significantly raise premiums to cover risks that were not previously accounted for. In addition, it could affect the credit capacity and hence the ability of small contractors to be awarded public contracts. This increase in price and credit restriction, in turn, will likely discourage public entities within the State from approving new projects, or result in a significant increase in costs to taxpayers in Washington.

## III. SURETIES' RIGHT TO EQUITABLE SUBROGATION[1]

Liberty respectfully contends that the Court misapplied the doctrine of equitable subrogation. The Court's analysis focuses on issues of timing but ignores the dispositive, triggering event: when the contractor defaulted. The contractor's default is the line in the sand that creates the risk the project will grind to a halt and obligates the surety to step in. Immediately upon the contractor's default, the surety's equitable lien provides a remedy of equitable subrogation, which entitles the surety, following its performance, to all outstanding funds as of the time of default. *See Nelson v. Nelson Neal Lumber Co.*, 171 Wash. 55, 60-61, 17 P.2d 626 (1932) (an equitable lien is a remedy for a debt).

Here, Hartford acquired an equitable lien when it executed the bonds and Hartford's equitable rights became enforceable after it made payments on the bonds. Hartford's equitable lien entitled it to be subrogated to the rights of Waka and GSA as of the time of Waka's default, and GSA's *subsequent* and *mistaken* payment to the Bank did not affect Hartford's then-existing rights.

The Court appears to have misapprehended the difference between (1) when Hartford's equitable rights *arose*, (2) when the equitable rights became *enforceable* and (3) *what* enforceable equitable right or remedy Hartford possessed.

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[1] Liberty fully supports Hartford's position in its Petition for Review that the funds at issue were subject to an express trust. Liberty chose to focus its brief, however, on the Court's equitable subrogation analysis.

A. Hartford's Equitable Rights Arose When It Issued The Payment and Performance Bonds.

It is undisputed that Hartford's right to an equitable lien on contract funds arose the moment it executed the payment and performance bonds. Decision at ¶ 27; *Massart*, 105 B.R. at 612 ("[surety's] equitable lien on the progress payments extends back to the date it executed the payment and performance bonds").

B. Hartford's Equitable Rights Became Enforceable Immediately Upon Its Performance Under The Bonds.

The Court concluded that Hartford had no enforceable rights at the time the Bank swept the progress payment because Hartford had "not yet . . . suffered or performed work at a loss at the time of the progress payment." Decision at ¶ 28. The Court appears to have misconstrued the *Massart* court's statement that the surety's equitable rights do not "'become enforceable until the surety suffers a loss by making payments pursuant to the obligation under the bond.'" 105 B.R. at 612.

Hartford's actions at the time of the disputed progress payment only affect *when*, not *if*, Hartford could enforce its equitable subrogation rights. *See Levinson v. Linderman*, 51 Wn.2d 855, 864, 322 P.2d 863 (1958) ("[t]he equity in favor of the surety company *arose* at the time of the giving of its bond. The right *became available* when the surety company completed the work at a loss."). Liberty readily concedes that if Hartford had never

performed under the bonds, than it undeniably would have been unable to enforce its rights. Hartford, however, fully performed.

The current case is analogous to *Fidelity & Deposit Co. v. United States*, 183 Ct. Cl. 908 (1968). In *Fidelity*, a bank and surety contested one another's right to allegedly earned, but unpaid contract funds. The bank, similar to the Bank here, argued that it was entitled to the contract balance because the "contract balance . . . was earned by [c]ontractor prior to default and prior to [s]urety's payment of anything under its bond." *Id.* at 911. The court disagreed and stated as follows:

> All that is necessary for the surety to prevail is that the contractor be in default as a matter of fact; and that as a result of such default, the surety has become obligated to pay under its payment or performance bond. The surety's *potential rights become an actuality* when it pays the obligations of its principal. *Thereupon, the surety's rights of subrogation relate back to the date of the execution of the surety bonds.*

*Id.* at 912 (emphasis added).

As in *Fidelity*, Hartford's "potential right" of equitable subrogation became a reality when it performed under the bonds, and Hartford is entitled to enforce its equitable rights.

C. Hartford's Equitable Rights Entitle It To All Outstanding Contract Funds As Of The Time Of Waka's Default.

The Court did not reach the issue of what equitable rights or remedies Hartford possessed following its performance under the bonds. The Court instead relied on an inapplicable distinction

between "retained or unpaid funds" and "progress payments," noting that progress payments belong to the "free flow of commerce once they are properly paid over."[2] Decision at ¶ 29. *See, e.g., In re E.R. Fegert, Inc.*, 88 B.R. 258, 261 (9th Cir. BAP 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989) ("[w]e conclude that the surety would have been entitled to assert a lien for both any unpaid progress payments or funds held as retainage.").

Under Washington case law cited by the Court, a surety's equitable lien entitles it to all *post-default* funds. *Massart*, 105 B.R. at 613 ("'when a surety executes a bond . . . there arises, in the surety's favor, an equitable right to or lien on the funds the owner properly withholds from the contractor'"); *Levinson*, 51 Wn.2d at 863 ("'where a surety performs under a performance bond *after* the default of the contractor, it is entitled to an equitable lien on funds previously withheld by reason of the contractor's default . . .'"). This bright-line rule makes sense as the contractor's default immediately triggers the surety's duty of performance. The purpose of the bonds is to ensure the project's completion and payment of all necessary parties, and an equitable lien arises to ensure that all

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[2] In support of its argument regarding the alleged distinction, the Court relied on a pair of distinguishable Seventh Circuit decisions, neither of which involve disputes over funds paid *after* a contractor's default. *See Capitol Indem. Corp. v. United States*, 71 Fed. Cl. 98, 100-01 (7th Cir. 2006) (dismissing surety's claims because the disputed progress payments were made before the contractor's default); *Capitol Indem. Corp. v. United States*, 41 F.3d 320, 326 (7th Cir. 1994) ("conclusion that [contractor] did not default until after the IRS issued its lien disposes of [surety's] . . . right of equitable subrogation in other valid claims").

contract funds are directed to those ends (and not to pay the contractor's general creditors). *See Massart*, 105 B.R. at 613 (the surety deserves compensation for its performance no less than if it had actually performed the contract).

Immediately upon Waka's default, Hartford's equitable lien entitled it to receipt of all outstanding contract funds, including the earned, but undistributed progress payment. As stated in *National Shawmut Bank v. New Amsterdam Casualty Co.*, 411 F.2d 843 (1st Cir. 1969):

> *Prior to default*, the contractor had the right to assign progress payments and *had the Bank received payment*, it could not (absent circumstances amounting to fraud) have been divested by the surety. *But upon default,* the surety which is obligated to complete the work steps into the shoes of the government – not of the contractor which on default has forfeited its rights. It is subrogated . . . to the government's right to apply to the cost of completion *the earned but unpaid progress payments in its hands at the time of default*.

*Id.* at 848 (emphasis added).

The facts here are unique because GSA mistakenly paid Waka *after* Waka's default and *after* Hartford assured GSA that Hartford would perform its obligations. As a result, the progress payment was neither properly paid nor properly withheld. Contract owners do not typically make payments to defaulting contractors and absent Hartford's assurances, it is inconceivable GSA would have distributed funds in its hands at the time of default to Waka.

GSA's attempt, albeit a failed attempt, to redirect its payment to Hartford clearly indicates GSA's intent to pay Hartford. Allowing the Bank to retain the mistakenly transferred payment would grant the Bank a clear windfall, which equity should avoid. *Worden v. Smith*, 178 Wn. App. 309, 330, 314 P.3d 1125 (2013) ("[t]he purpose of the doctrine [of equitable subrogation] is 'to avoid a person's receiving an unearned windfall . . . .'").

## IV. CONCLUSION

For the foregoing reasons, this Court should grant review, reconsider the issues raised in appeal, and issue a new opinion reversing the Court of Appeals and entering judgment for Hartford.

RESPECTFULLY SUBMITTED this ____ day of ___________, 20__.

STEWART SOKOL & LARKIN LLC

By: ______________________________
Jan D. Sokol, WSBA #30962
*Of Attorneys for Amicus Curiae Liberty Mutual Insurance Company*

**CERTIFICATE OF SERVICE**

The undersigned certifies under penalty of perjury under the laws of the State of Washington that on the 23rd day of December, 2014, I caused a true and correct copy of the MOTION OF LIBERTY MUTUAL INSURANCE COMPANY TO FILE AMICUS CURIAE BRIEF to be delivered to counsel in the manner indicated as follows:

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DATED this 24th day of December, 2014 in Portland, Oregon.

s/ Jan D. Sokol
Jan D. Sokol, WSBA #30962

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Attached please find Motion of Liberty Mutual Insurance Company to file Amicus Curiae Brief.