NO. 91069-3

SUPREME COURT OF THE
STATE OF WASHINGTON

HARTFORD FIRE INSURANCE COMPANY,

Petitioner,

v.

COLUMBIA STATE BANK

Respondent.

THE SURETY & FIDELITY ASSOCIATION OF AMERICA'S AMICUS CURIAE MEMORANDUM IN SUPPORT OF PETITION FOR REVIEW

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I. STATEMENT OF INTEREST

The Surety & Fidelity Association of America ("SFAA") is a trade association of companies licensed to write fidelity and surety insurance in the United States. The 424 members of SFAA are the sureties on virtually all contract performance and payment bonds provided to meet the requirements of the Miller Act[1] for federal construction projects and provided on construction projects in Washington. SFAA collects statistics on premiums and losses for fidelity and surety bonds and files statistics with the state insurance departments. SFAA is licensed by the Washington Office of the Insurance Commissioner as a Rating Organization.

The outcome of this appeal is of great importance to SFAA and its members. The dedication of contract funds to pay contract obligations is critical to the surety's evaluation of its risk. The surety is exposed to loss if the cost to complete the work and pay the subcontractors and suppliers exceeds the contract amount. The surety seeks to

[1] 40 U.S.C. §§3131, *et seq.*

mitigate its exposure by assuring that the contract funds are properly applied to pay for completion of the work and compensation of the subcontractors and suppliers.

A surety asked to undertake the risk of a bond underwrites that risk based in part on the use of contract funds to pay contract obligations. If the contract funds can be diverted to pay the contractor's other debts, the surety's risk is increased and its underwriting standards necessarily are tightened making it more difficult for prospective contractors to qualify for bonds. If affirmed by this Court, the holding of the Court of Appeals will have a negative impact on the underwriting and availability of surety bonds for construction contractors in Washington.

SFAA will endeavor to avoid repeating the arguments already made by petitioner Hartford Fire Insurance Company ("Hartford") and by Liberty Mutual Insurance Company as an *amicus* in the Court of Appeals. Instead, SFAA will explain why it believes the issue before the Court of Appeals was controlled by federal law and provide controlling authority from the United States Supreme Court

that requires reversal of the result reached by the Court of Appeals.

II. ARGUMENT

The dispute between Hartford and respondent Columbia State Bank ("Bank") is over Bank's setoff of $103,410 from an account of Waka Group, Inc. ("Waka") to apply on a debt that Waka owed Bank. The source of the $103,410 was a payment wired by the United States General Services Administration ("GSA") to Waka's account. The payment was made under a contract between Waka and GSA for work on a project at the Dalton Cache Border Station in Haines, Alaska. At the time the payment was received, and at the time Bank made its setoff, Waka was in default on the Dalton project.

The Superior Court granted summary judgment to Bank and the Court of Appeals affirmed, holding that the indemnity contract between Waka and Hartford did not create an express trust and that Hartford did not possess an equitable lien on the progress payment transferred by GSA. SFAA respectfully suggests that the lower courts erred

because under federal law the progress payment made by GSA was subject to an equitable lien in favor of the unpaid subcontractors and suppliers who had worked on the Dalton project and that Hartford, when it paid said subcontractors and suppliers pursuant to its payment bond obligations, was subrogated to the subcontractors and suppliers' superior right to the payment.

Priority rights to contract funds earned on federal projects has been the subject of extensive litigation for over a century. In *Henningsen v. United States Fidelity & Guaranty Co.*, 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547 (1908) the contractor's payment bond surety and an assignee bank[2] disputed rights to $5,041.79 of contract funds which had been paid to the bank subject to an agreement to repay it if it was determined that the surety had a superior claim. The Court held that the surety was entitled to the fund. The Court followed its decision in *Prairie State National Bank v. United States*, 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412 (1896).

[2] The National Bank of Commerce of Seattle, Washington.

In *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 83 S.Ct. 232, 9 L.Ed.2d 190 (1962) the contract fund was paid to the contractor's trustee in bankruptcy but claimed by both the trustee and the payment bond surety. The Court stated the issue as "whether the surety had, as it claimed, ownership of, an equitable lien on, or a prior right to this fund before bankruptcy adjudication." 371 U.S. at 136, 83 S.Ct. at 235. The Court relied on *Prairie State Bank* and *Henningsen* and concluded:

> We therefore hold in accord with the established legal principles stated above that the Government had a right to use the retained fund to pay laborers and materialmen; that the laborers and materialmen had a right to be paid out of the fund; that the contractor, had he completed his job and paid his laborers and materialmen, would have become entitled to the fund; and that the surety, having paid the laborers and materialmen, is entitled to the benefit of all these rights to the extent necessary to reimburse it.

371 U.S. at 141, 83 S.Ct.at 237.

At page 10 of its opinion in the instant case, the Court of Appeals relied on three factors to find that Hartford did not have an equitable lien on the contract fund at the time Bank made its setoff. First, the Court of

Appeals stated, "[b]ut the right of *enforcement* under equitable subrogation becomes available only after" the surety pays a loss. On the date of the setoff, of course, Waka had just admitted default and Hartford had not yet made payments. The Court of Appeal's error was a misunderstanding of subrogation. At the time of the setoff, the unpaid subcontractors and suppliers themselves had the equitable lien that was superior to the Bank's right of setoff. As the Court said in *Pearlman*, "the laborers and materialmen had a right to be paid out of the fund." When Hartford subsequently paid them, it acquired by subrogation their pre-existing rights in the contract fund.

Second, the Court of Appeals found that "there is no evidence that the Dalton Project subcontractors or suppliers had not been paid." Hartford disputes that finding, and it is certainly inconsistent with the fact that they were later paid by Hartford when they could not have performed further work for Waka since Waka had been defaulted. However, there is certainly no evidence the subcontractors and suppliers had been paid. Therefore, if the payment status

of the subcontractors and suppliers on June 21 or 22, 2012, is a material fact, summary judgment for Bank must be vacated and this matter remanded to the Superior Court to determine that fact.

Finally, the Court of Appeals distinguished between retainage and progress payments. It stated, "However, no retained or unpaid funds existed in this case. Instead, a direct deposit of a progress payment went into Waka's account." The Court thought that a progress payment was part of the free flow of commerce whereas retainage presumably would not have been. It is true that the fund in *Pearlman* was contract retainage, but subsequent federal decisions have rejected the argument that the equitable lien of the unpaid subcontractors and suppliers, and sureties subrogated to their rights, is limited to contract retainage. *See, e.g.*, *Balboa Insurance Co. v. United States*, 775 F.2d 1158, 1162 (Fed.Cir. 1985) ("we can discern no reasonable basis for the Government's distinction between retainages and progress payments when, as in this case, the surety

informed the Government of the contractor's alleged breach before the payment was disbursed."

If this were a suit against the Government for disbursing payments over the surety's objection, then the Government's interest in seeing the project completed would be a factor.[3] In the instant case, however, Waka had already defaulted, GSA was not looking to Waka to complete, and Bank not GSA is the party from whom the surety seeks to retrieve the contract payment.

The fund at issue in this case was a progress payment on a federal project. Each of the parties was aware of its origin. The existence of an equitable lien against such a progress payment is a matter of federal law, and pursuant to well-established precedent, the unpaid subcontractors and suppliers had a right to be paid ahead of Bank as Waka's assignee. When Hartford paid the subcontractors and suppliers, it became subrogated to their priority right in the contract payment and can recover it from Bank.

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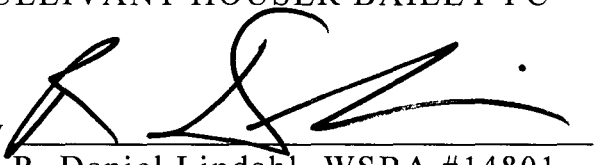
[3] See, *Balboa*, 775 F.2d 1158; *Argonaut Insurance Co. v. United States*, 434 F.2d 1362 (Fed. Cir. 1970).

III. CONCLUSION

SFAA respectfully urges this Court to grant Hartford's Petition for Review so that it can correct the errors of the Superior Court and Court of Appeals and avoid the adverse consequences of allowing diversion of contract funds to pay the contractor's assignee rather than the subcontractors and suppliers whose work earned the payment or the surety who paid them and is subrogated to their rights.

DATED: December 22, 2014.

BULLIVANT HOUSER BAILEY PC

By 

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CERTIFICATE OF SERVICE

I certify that on December 22, 2014, I mailed a copy of the foregoing The Surety & Fidelity Association of America's Amicus Curiae Memorandum in Support of Petition for Review to the persons listed below, at the addresses indicated, by United States first class mail, postage prepaid.

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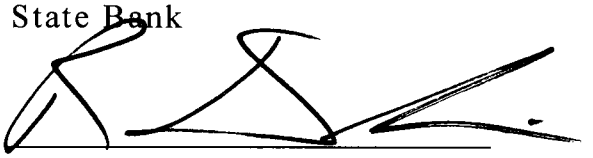

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