No. 91069-3

SUPREME COURT
OF THE STATE OF WASHINGTON

HARTFORD FIRE INSURANCE COMPANY,

Appellant,

v.

COLUMBIA STATE BANK,

Respondent.

COLUMBIA STATE BANK'S ANSWER TO BRIEF OF AMICUS CURIAE LIBERTY MUTUAL INSURANCE COMPANY

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I. ARGUMENT

Amicus Curiae Liberty Mutual Insurance Company ("**Liberty**") asserts the Washington Court of Appeals "misapplied the doctrine of equitable subrogation" in this case because the Court of Appeals' published decision does not focus on the date the bonded contractor defaulted on the Project, which is "the dispositive, triggering event" in Liberty's view. [1] Liberty cites to *Nelson v. Nelson Neal Lumber Co.*, 171 Wash. 55, 60-61, 17 P.2d 626 (1932) for the proposition that "[i]mmediately 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 the default." [2] (Emphasis added).

While the Bank agrees that a surety can, to some extent, obtain enforceable equitable subrogation rights *following its performance*, Hartford wrongly seeks to recover in this case an earned progress payment that the Bank owned *before* Hartford ever peformed under its bond. When Hartford performed under its bond several weeks after the Bank came to own this progress payment, title to this payment had already passed to the Bank. Hence, this payment was not comprised of "outstanding funds" that Hartford could lay claim to under *Nelson*.

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[1] Brief of Amicus Curiae Liberty Mutual Insurance Company at 5.
[2] Liberty's amicus brief at 5.

The fact is the *Nelson* case that Liberty has cited does not support Hartford's position. *Nelson* "discussed the doctrine of equitable liens in an action by stockholders against officers of a company alleging the conversion of insurance proceeds." *Geer v. Tonnon*, 137 Wn. App. 838, 846, 155 P.3d 163 (2007). In discussing *Nelson*, the *Geer* court noted that "*Nelson* was 'not an action to impress the insurance proceeds with an equitable lien and enforce it'" and that *Nelson* held "an equitable title or right is not enough to support an action for conversion." *Id.* (citing *Nelson*, 171 Wash. at 64, 17 P.2d 626). This explains why the *Nelson* court affirmed the dismissal of the plaintiffs' action for conversion based on the precursor to CR 12(b)(6). *Nelson*, 171 Wash. at 64, 17 P.2d 626.

The trial court was right to dismiss Hartford's conversion claim against the Bank on summary judgment. CP 6, CP 391. Even if *Nelson* somehow supported Hartford's quest for an equitable lien, *Nelson* shows that any such lien "is not enough to support an action for conversion." *Nelson*, 171 Wash. at 64, 17 P.2d 626.

Liberty claims that Hartford had equitable rights upon Waka's default on the Project that allowed Hartford's subrogation rights to reach back to the date of Waka's default. [3] Liberty has noticeably failed to cite to any legal authority in support of this claim. Regardless, the Court of

[3] Liberty's amicus brief at 5.

Appeals recognized that Hartford's subrogation rights did not become enforceable until it actually performed under its bond. *Hartford Fire Ins. Co. v. Columbia State Bank*, 183 Wn. App. 599, 611, 334 P.3d 87 (2014) ("there is no evidence that Hartford had suffered or performed work at a loss at the time of the progress payment. The right to be indemnified does not arise until money has actually been expended.")

Liberty asserts that once Hartford assumed control of the Project and then paid money out under its bond, Hartford could then use this performance to lay claim to the earned progress payment that the Bank received and applied to Waka's matured debt with the Bank on June 21, 2012, some weeks earlier. [4] But this cannot possibly be the case, as a ruling in this vein would be flatly contrary to the law of bank deposits in Washington, which is rooted in decades' worth of Washington Supreme Court jurisprudence.

Under Washington law, if the bank depositor has a debt with a bank that has matured — like contractor Waka did in this case — the bank may exercise its right of setoff as to the deposit. *E.g., In re Estate of Adler*, 116 Wash. 484, 489, 199 P. 762 (1921). This means "the bank may apply the deposit ... to the payment of the debt due it by the depositor[.]" *Sterling Savings Bank v. Air Wisconsin Airlines Corp.*, 492 F.Supp.2d

[4] Liberty's amicus brief at 5.

1256, 1261 (E.D.Wash. 2007). A bank deposit is either general or special; a deposit is *presumed* to be a general deposit, but if a depositor asks a bank to accept a deposit for a specific purpose, and the bank agrees to the request, the deposit is a special deposit. *E.g., Sterling Savings Bank*, 492 F.Supp.2d 1256; *see also Washington Shoe Mfg. Co. v. Duke*, 126 Wash. 510, 514, 218 P. 232 (1923). The title to a general deposit passes immediately to the bank. *Sterling Savings Bank*, 492 F.Supp.2d 1256. In contrast, title to a special deposit does not pass to the bank; instead, the bank becomes a trustee and holds the money in a fiduciary capacity. *Id.* The key inquiry as to whether a bank deposit is special or general is whether the bank knew or should have known that the deposit was tendered in trust for a special purpose. *Id.* at 1261.

Because the title to a general deposit passes immediately to the bank, Hartford cannot change the character of this deposit after the fact by virtue of enforceable subrogation rights that it obtained in the weeks after the setoff. A ruling in favor of Hartford here would be contrary to Washington law, lead to absurd results, and completely undermine both this state's banking system and established commercial practices.

Liberty cites to *Levinson v. Linderman*, 51 Wn.2d 855, 864, 322 P.2d 863 (1958) to support the idea that Hartford's post-setoff performance somehow entitles it to the progress payment that the Bank

received and applied to Waka's debt with the Bank on June 21, 2012. [5] But the surety in *Levinson* performed under its bond and *then* used this performance to invoke the doctrine of equitable subrogation to lay claim to the funds at issue. *Id.* at 855, 322 P.2d 863. Moreover, the funds at issue in *Levinson* concerned retainage, which as seen from the Court of Appeals' decision makes them different from earned progress payments under applicable case law such as *Capitol Indemn. Corp. v. United States,* 41 F.3d 320, 325 (7th Cir. 1994) ("Funds intended from the inception of a contract to settle potential claims differ vastly from progress payments, which belong to the free flow of commerce from the time they are properly paid over."). Thus, *Levinson* provides no support for Hartford's position.

Liberty asserts this case is analogous to *Fidelity & Deposit Co. v. United States*, 183 Ct. Cl. 908 (Fed.Cl. 1968). [6] But *Fidelity* is inapplicable to this case. The surety in *Fidelity* paid out hundreds of thousands of dollars to unpaid project laborers in accordance with its bond before it sought to recover the contract balance from the project owner, namely the federal government. *Id.* Here, Hartford wrongly seeks to recover an earned progress payment that the Project owner paid to the Bank before Hartford paid anything under its bond.

[5] Liberty's amicus brief at 6.
[6] Liberty's amicus brief at 7.

Liberty has also cited a bankruptcy decision entitled *In re E.R. Fegert, Inc.*, 88 B.R. 258, 261 (9th Cir. BAP 1988), *aff'd* 887 F.2d 955 (9th Cir. 1989) to support the idea that earned progress payments are not treated differently from retainage or unpaid funds in cases such as this. [7] But *Fegert* made reference to *unpaid* progress payments as opposed to *paid* progress payments. *Id.* at 261. Further, *Fegert* was a bankruptcy preference case that held a bankrupt contractor's payments to its subcontractors prior to bankruptcy were not avoidable preferences under section 547 of the bankruptcy code. *Id. Fegert* is nothing at all like this case, and it provides no support for Hartford's position.

Liberty also seeks to distinguish two federal decisions that the Court of Appeals cited in its published decision by arguing that these decisions are inapplicable because they do not "involve disputes over funds paid *after* a contractor's default." [8] The Court of Appeals noted in its decision that one of these cases, *Capitol Indem. Corp. v. United States*, 71 Fed.Cl. 98, 102 (Fed.Cl. 2006), cited the United States Supreme Court's decision in *Prairie State Nat'l Bank of Chicago v. United States*, 164 U.S. 227 (1896). *Hartford Fire Ins. Co. v. Columbia State Bank*, 183 Wn. App. 599, 611, 334 P.3d 87 (2014). Thus, the Court of Appeals' decision reflects the proposition that "[o]rdinarily a surety asserts the

[7] Liberty's amicus brief at 8.
[8] Liberty's amicus brief at 8, footnote 2 (emphasis in original).

doctrine of equitable subrogation to acquire retained contract funds that are still in the government's possession after performance of the contract is complete" is supported not just by *Capitol*, but also by the Supreme Court's ruling in *Prairie State*. Liberty has not taken issue with *Prairie State* or the Court of Appeals' citation to that decision.

The Court of Appeals cited the second federal decision at issue, *Capitol Indem. Corp. v. United States*, 41 F.3d 320, 325 (7th Cir. 1994), for the proposition that "[p]rogress payments differ from retained funds because progress payments are funds that belong to the free flow of commerce once they are properly paid over." *Hartford*, 183 Wn. App. at 611, 334 P.3d 87. *Capitol* reflects that this rule is well-established in decisions from Illinois and also the Eighth Circuit, namely *International Fidelity Ins. Co. v. United States*, 949 F.2d 1042, 1046 (8th Cir. 1991). Moreover, this rule has also been adopted in multiple Ninth Circuit decisions, including *Bank of Arizona v. Nat'l Sur. Corp.*, 237 F.2d 90, 93-94 (9th Cir. 1956) (holding contractor's bank could keep earned progress payments that it received despite surety's subrogation rights). Thus, the fact is Liberty has no good reason to complain about the Court of Appeals' citation to the two *Capitol* decisions, as those decisions reference well-established rules of law that are, in fact, applicable to this case.

Liberty also asserts that "[i]mmediately upon Waka's default,

Hartford's equitable lien entitled it to receipt of all outstanding contract funds, including the earned, but undistributed progress payment." [9] Tellingly, Liberty has failed to cite any legal authority in support of this proposition. However, the *National Shawmut Bank of New Amsterdam Casualty Co.* case, 411 F.2d 843 (1st Cir. 1969) that Liberty subsequently cites references the surety's ability to lay claim to earned but unpaid progress payments. *Id.* at 846. But it is undisputed that the progress payment at issue in this case was not "unpaid"; this payment was in fact paid into Waka's collateral control account at the Bank on June 21, 2012, before Hartford obtained enforceable subrogation rights, and the Bank immediately therafter exercised its right of setoff. As such, *Nat'l Shawmut* provides no support for Liberty's position.

Liberty complains that "[t]he facts here are unique because GSA mistakenly paid Waka *after* Waka's default and *after* Hartford assured GSA that Hartford would perform its obligations." [10] But it appears that Waka did not formally acknowledge its default until Waka tendered its default letter to Hartford dated June 21, 2012 (CP 84), which was the same date that the progress payment arrived at the Bank. Meanwhile, it is undisputed that Hartford paid out no money under its bond until weeks after the date of the setoff, and Hartford did not actually take over the

[9] Liberty's amicus brief at 9.
[10] Liberty's amicus brief at 9.

Project until July 13, 2012, several weeks after the date of the setoff. CP 156. As such, Liberty cannot fairly say that "the progress payment was neither properly paid nor properly withheld." [11]

In reality, if the progress payment at issue was not properly withheld, Hartford undoubtedly would have sued the federal government. After all, Hartford has sued the government before, and it knows full well that it can recover from the government when the government abuses its discretion in disbursing earned progress payments. *See, e.g., Hartford Fire Insurance Co. v. United States*, 108 Fed.Cl. 525 (Fed.Cl. 2012).

Liberty claims that allowing the Bank to retain the progress payment "would grant the Bank a clear windfall, which equity should avoid." [12] But according to Waka, the Bank contributed no less than $50,000 to $60,000 to the Project at issue. CP 293. Moreover, when the Bank exercised its setoff rights on June 21, 2012, Waka owed more than $434,495.79 on its $500,000.00 line of credit with the Bank. CP 221. The reality is the Bank did not receive a windfall by recouping a portion of the money that Waka owed to the Bank after Waka defaulted on its credit line.

Finally, Liberty has stated it "joins in the arguments raised" in Hartford's petition for review. [13] However, Liberty has chosen not to

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[11] Liberty's amicus brief at 9.
[12] Liberty's amicus brief at 10.
[13] Liberty's amicus brief at 1.

examine any of cases the Bank has previously cited that hold the general agreement of indemnity between the surety and the bonded contractor does not create an express trust that enables the surety to lay claim to earned progress payments. *E.g., In re Construction Alternatives, Inc.*, 2 F.3d 670, 677 (6th Cir. 1993); *Acuity v. Planters Bank*, 362 F.Supp.2d 885, 892 (W.D. Ky 2005); *In re Eastern Paving Co.*, 293 B.R. 704 (Bankr.E.D.Mich. 2003). Liberty has also not explained why this Court should not, in the event review is granted, follow the reasoning of *Reliance Insurance Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502 (9th Cir. 1998), which applied Washington law. *Reliance* held that a contractor's construction lender could keep an earned progress payment that it received even though the contractor's surety demanded this payment from the lender before the lender exercised its right of setoff. *Id.*

II. CONCLUSION

Liberty's arguments in support of Hartford's position are unavailing. The Court should deny Hartford's petition for review.

RESPECTFULLY SUBMITTED this 18 day of February, 2015.

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DECLARATION OF SERVICE

I, Jennifer Fernando, am a legal assistant with the firm of Eisenhower Carlson PLLC, and am competent to be a witness herein. On February 18, 2015, at Tacoma, Washington, I caused a true and correct copy of Columbia State Bank's Answer to Brief of Amicus Curiae Liberty Mutual Insurance Company to be served upon the following in the manner indicated below:

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

DATED this 18th day of February, 2015, at Tacoma, Washington.

Jennifer Fernando