No. 45320-7-II

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

HARTFORD FIRE INSURANCE COMPANY, a Connecticut corporation,

Plaintiff/Appellant,

v.

COLUMBIA STATE BANK, a Washington banking corporation,

Defendant/Respondent.

APPEAL FROM THE SUPERIOR COURT
FOR PIERCE COUNTY
THE HONORABLE GAROLD E. JOHNSON

BRIEF OF APPELLANT

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I. INTRODUCTION

This case presents both procedural and substantive questions for the Court. First, this case asks whether a trial court may disregard precedent from a higher court based on insignificant factual distinctions. Second, this case asks whether a bank may seize funds from a progress payment made to a general contractor for the benefit of subcontractors, suppliers and the contractor's surety on a public construction project, to reduce the general contractor's debt to the bank. The answer to both questions is no. The trial court improperly granted summary judgment dismissing the claims asserted by Hartford Fire Insurance Company ("Hartford") against Columbia State Bank ("the Bank") and improperly denied summary judgment against the Bank. This Court should reverse the trial court and direct judgment in favor of Hartford.

II. ASSIGNMENTS OF ERROR

The trial court erred when it (1) granted the Bank's Motion for Summary Judgment (CP 123); and (2) denied Hartford's Motion for Summary Judgment (CP 46).

III. ISSUES PRESENTED

When the trial court granted the Bank's motion for summary judgment and denied Hartford's motion for summary judgment it disregarded applicable Washington law. The trial court decided as a matter of law that the authority set forth in *Westview Investments, Ltd. v. U.S. Bank Nat. Ass'n*, 133 Wn.App. 835 (Div. 1 2006) and *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958) were not controlling and chose instead to follow the Ninth Circuit decision of *Reliance Ins. Co. v. U.S. Bank of Wash., N.A.*, 143 F.3d 502 (9th Cir. 1998). The trial court also concluded that no issues of material fact precluded summary judgment in the Bank's favor.

Did the trial court err when it granted the Bank's motion for summary judgment dismissing Hartford's causes of action on the grounds that *Westview Investments, Ltd. v. U.S. Bank Nat. Ass'n*, 133 Wn.App. 835 (Div. 1 2006) and *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958) were not controlling law and that Hartford had no right to trust funds swept by the Bank?

Did the trial court err when it denied Hartford's motion for summary judgment requesting relief against the Bank for misappropriation of trust funds, wrongful set-off and conversion on

the grounds that *Westview Investments, Ltd. v. U.S. Bank Nat. Ass'n*, 133 Wn.App. 835 (Div. 1 2006) and *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958) were not controlling law?

Did the trial court err when it determined no issues of material fact existed that would preclude summary judgment in the Bank's favor?

IV. STATEMENT OF THE CASE

A. Factual History.

1. Hartford Issued Payment and Performance Bonds to Waka Group, Inc.

Hartford acted as surety to Waka Group, Inc. ("Waka"), a general contractor, by issuing various surety bonds on behalf of Waka in connection with Waka's construction contracts.[1] On or about June 13, 2011, as partial consideration for Hartford's agreement to issue bonds to Waka, Hartford and Waka executed a General Indemnity Agreement ("GIA").[2] The GIA created an express trust for all project funds earned by Waka on projects bonded by Hartford.[3] The GIA states:

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[1] CP 64.
[2] *Id.*
[3] CP 68-77.

> Trust Fund. If a Bond is Underwritten in connection with the performance of any contract, the entire contract price shall be dedicated to the satisfaction of the obligations of the Bond and this Agreement. All money paid or any securities, warrants, checks or evidences of debt given under contracts relating to or for which a Bond has been issued **shall be impressed with a trust** for the purpose of satisfying the obligations of the Bond Underwritten for said contract and this Agreement and shall be used for no other purpose until all such obligations have been fully satisfied.[4]

In early 2012, Waka contracted with the General Services Administration ("GSA") to perform a project in Dalton, Alaska (the "Project") to renovate a border station.[5] On or about March 1, 2012, Hartford issued Performance and Payment Bond No. 52BCSGC8757 on behalf of Waka for the Dalton Project ("Bond").[6] Pursuant to the terms of the Bond, Hartford's obligations included the payment of all subcontractors and suppliers, as well as the completion of the Project, in the event of Waka's default.[7]

Waka's contract with the GSA also expressly required the funds paid to Waka be held in trust for Waka's subcontractors and suppliers.[8] The GSA contract incorporated Federal Acquisition

[4] CP 71 (emphasis added).
[5] CP 98.
[6] CP 79-82.
[7] *Id.*
[8] CP 344.

Regulation 52.232-5, which specifically mandated Waka to certify to the government with each request for payment: (1) a listing of amounts previously paid to each subcontractor on the project; (2) that all payments due to subcontractors and suppliers from previous payments have been made; and (3) that ***"timely payments will be made from the proceeds of this payment"*** to subcontractors and suppliers.[9]

2. Waka and the Bank.

Waka obtained a line of credit account and business checking account with the Bank.[10] Waka used these accounts for its business banking, which primarily consisted of obtaining progress payments from project owners and then issuing payments to its subcontractors and suppliers.[11] On the Dalton Project, the GSA would wire money directly into Waka's bank account.[12]

When approving Waka's line of credit, the Bank performed a detailed audit of Waka's accounting records and practices.[13] The purpose of the audit was for the Bank to evaluate Waka's accounting systems, including how money was received from

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[9] CP 347-349.
[10] CP 100, 104.
[11] CP 100, 102.
[12] *Id.*
[13] CP 102.

owners and paid out to subcontractors and suppliers.[14] The Bank was aware that Waka was a general contractor who regularly used subcontractors and suppliers.[15] The Bank was also aware that Hartford served as Waka's bonding company.[16]

In June 2012, Waka began having difficulty performing its work the Dalton Project.[17] On June 18, 2012, the Bank had an in-person meeting with Waka where the Bank advised that it would be calling Waka's line of credit.[18] Waka informed the Bank at that meeting that it would not be able to complete its ongoing projects, which included the Dalton Project, if the line of credit was revoked.[19]

3. Waka's Default and Hartford's Takeover.

Following Waka's meeting with the Bank, also on June 18, 2012, Hartford first learned of Waka's difficulties on the Dalton Project and that Waka's completion of the project was unlikely.[20]

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[14] *Id.*
[15] CP 101.
[16] *Id.*
[17] CP 99.
[18] CP 103.
[19] *Id.*
[20] CP 99.

Ultimately, Waka ceased performing the Dalton Project with approximately 55-60% of the work left unfinished.[21]

After receiving the informal notice from Waka, Hartford commenced steps to take over and complete the Dalton Project.[22] On June 20, 2012, Hartford notified the GSA that it would be taking over the Project.[23] Waka provided formal written notice to Hartford of its inability to complete the Dalton Project on June 21, 2012.[24] To effectuate the takeover, Hartford and Waka requested the GSA transmit all Dalton Project progress payments directly to Hartford to facilitate completion of the job and to pay Waka's subcontractors and suppliers.[25] The GSA acknowledged Hartford's right to the Project funds and agreed to remit future payments to Hartford.[26]

4. The June 21, 2012 Progress Payment.

There are very few relevant facts necessary to evaluate the legal merits of this case. While three events that occurred on a single day – June 21, 2012 – could be seen as the events that caused this dispute, such a narrow view should not be taken. The

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[21] *Id.*
[22] CP 64.
[23] CP 86.
[24] CP 84.
[25] CP 86, 380.
[26] CP 88.

three June 21, 2012 events are set forth below; however, it should be noted that the only truly relevant event that occurred on June 21, 2012 is that the Bank swept the funds without making any inquiry as to the nature of the funds. Had the Bank fulfilled its legal duty to undertake such an inquiry, it would have discovered that the funds at issue had long since been impressed with a trust as established in both the GIA and the GSA contract.

Not only did the Bank wrongfully sweep the funds without inquiry, the Bank was never meant to receive the funds in the first place. When Hartford contacted the GSA on June 20, 2012, the GSA informed Hartford that the GSA had already initiated an electronic transmittal of a progress payment of $103,410.00 to Waka's bank account, but that it would immediately attempt to redirect this payment to Hartford.[27] Unfortunately, the GSA was unable to redirect the transfer to Hartford in time. Hence, despite the intentions of the GSA and Waka, the funds were deposited in Waka's checking account on or about June 21, 2012.[28]

Once the electronic transmission of the funds was complete, the Bank swept Waka's bank account of all funds to partially satisfy

[27] CP 65.
[28] *Id.*, CP 108-109.

the debt owed on Waka's line of credit.[29] The Bank chose to sweep the GSA funds without making any inquiry to Waka or the GSA as to whether the funds were trust funds.[30] Waka's bank statement showed the funds were swept on June 22, 2012; however, the Bank has alleged the funds were actually removed on June 21, 2012.[31]

On June 21, 2012, Hartford transmitted a letter to the Bank notifying the Bank of Waka's default and that any Project funds that had or may come into Waka's bank account were bonded trust funds to be held by the Bank for the benefit of Hartford and Waka's subcontractors and suppliers.[32] Unbeknownst to Hartford at the time, the Bank's sweep had allegedly occurred mere hours before the Bank received Hartford's letter. Following the receipt of Hartford's letter, the Bank denied Hartford's right to the trust funds and refused to return the swept funds to Hartford.[33]

Consistent with the express terms of the GIA, Hartford intended to use the progress payment funds to help complete the Project and to satisfy Waka's payment obligations to

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[29] CP 252.
[30] CP 220.
[31] CP 109, 252.
[32] CP 90.
[33] CP 117-118.

subcontractors, suppliers, and materialmen.[34] In August 2012, Hartford sent additional demands to the Bank for the return of the July 21, 2012 progress payment, but the Bank failed to comply.[35]

In total, Hartford incurred $750,804.00 in losses on bonds issued to Waka.[36] With regard to the Dalton Project, Hartford incurred losses of $365,868 associated with the completion of the work, including $100,350 in payments to Waka's subcontractors, suppliers and other materialmen.[37]

B. PROCEDURAL HISTORY.

On or about January 17, 2013, Hartford filed a complaint against the Bank in Pierce County Superior Court seeking relief for: (1) Misappropriation of Trust Funds; (2) Wrongful Setoff; (3) Conversion; and (4) Declaratory Relief.[38] The parties brought cross-motions for summary judgment, wherein Hartford sought recovery of the funds based on the Bank's misappropriation of the trust funds and wrongful setoff and the Bank sought dismissal of all of Hartford's claims.[39]

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[34] CP 65.
[35] CP 112-115; 120-122.
[36] CP 65.
[37] CP 374.
[38] CP 1-8.
[39] CP 46; 123.

Oral argument for both motions was held on August 9, 2013 before the Honorable Garold E. Johnson.[40] Hartford's motion explained that under the law set forth in *Westview Investments, Ltd. v. U.S. Bank Nat. Ass'n*, 133 Wn.App. 835 (Div. 1 2006), the Bank's sweep of the trust funds, and subsequent refusal to return the funds, was wrongful because the Bank knew or should have known the funds were trust funds to be held for the benefit of Hartford and Waka's subcontractors and suppliers.[41] Hartford further argued that, at a minimum, under *Westview*, the Bank had a duty to inquire as to the nature of the funds before sweeping the funds for its own benefit, and the Bank ignored this duty by essentially burying its head in the sand.[42] The Bank's failure to inquire was willful, wrongful, and could not result in its retention of the funds.

Additionally, Hartford argued that under the law set forth in *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958), Hartford had an equitable lien on the funds, giving Hartford a priority right to the funds over the rights of the Bank.[43]

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[40] *See* Verbatim Report of Proceedings.
[41] CP 46-62.
[42] *Id.*
[43] *Id.*

The Bank's motion argued that *Westview* was distinguishable and that the court should look to *Reliance Ins. Co. v. U.S. Bank of Wash., N.A.*, 143 F.3d 502 (9th Cir. 1998) to find that the Bank seizure of the funds was not wrongful.[44]

At oral argument the trial court stated that it found *Westview* factually distinguishable from the current case. The court stated:

> Because in that particular case [*Westview*] there was a pattern, wasn't there, of here come the payments. We pay the subbers; then we can draw the money off that goes to the bank. That was a pattern established in the case before the incident arose, before the default arose.
>
> In this case the money was coming in and being disbursed out without any indication at all that there were – that there were labor claims. This was a [Miller Act] case as opposed to the *Westview* case, which is a material and mechanic lien type case.
>
> . . .
>
> [T]his case is distinguishable, considerably distinguishable in my mind from the *Westview* case. There was a pattern. There was a known problem going on with that particular entity, the contractor, there. This was an owner contract. This wasn't a surety stepping in. That's kind of a minor distinction; I agree with that.
>
> Nevertheless this case is different. And I look at this as a case, there was moving these funds over for quite some time without any objection, and suddenly there's a problem that really isn't that clear that they

[44] CP 123-146.

> knew much about it. They didn't even know the bond was in place as far as I can tell.[45]

Based on the oral argument transcript it appears the trial court's granting of summary judgment was entirely based on the trial court's misperception that *Westview* was inapplicable to the current dispute. It is not clear from the record the basis on which the trial court found Hartford did not have an equitable lien on the funds pursuant to *Levinson v. Linderman*, 51 Wn.2d 855, 322 P.2d 863 (1958).

V. ARGUMENT

This case presents a fairly straight forward question of law, the determination of which will have substantial impact on the construction industry in Washington. The case also raises questions regarding the ability of a trial court to disregard precedent from a higher Washington court. The trial court's determination that *Westview* is not controlling law – based on insignificant and incorrect factual determinations – has created a result that directly contravenes established Washington law.

Westview unequivocally holds that a bank may not seize funds from a contractor's account if the bank knows, or should

[45] *See* Verbatim Report of Proceedings at p. 4, ln. 12-21; p. 24, ln. 2-14.

know, that the funds are to be held in trust, and that the bank has a duty to inquire as to the nature of the funds prior to seizing the funds. The trial court made a significant departure from the plain rule laid out in *Westview* by adding an additional requirement, i.e., there must also be some sort of a pattern of practice regarding the deposits into the bank account. This constitutes error for several reasons. First and foremost, the *Westview* court did not impose such a requirement. Second, even assuming it did, the trial court failed to articulate what precise pattern the trial court believed needed to exist in order for *Westview* to apply. Lastly, the facts determined by the trial court to distinguish the *Westview* case are not supported by the record or are disputed facts that would preclude summary judgment.

This issue is of vital importance to the construction industry in Washington. Unlike a bank that may obtain various types of collateral to secure a line of credit, sureties rely on indemnity agreements and their equitable subrogation rights to project contract funds for security in the event that a bonded contractor defaults on its obligations. These sources of collateral are what help ensure that sureties are able to meet their obligations and to

step in and complete construction projects that benefit the people of this State. The recognition and enforcement of the trust fund nature of the contract funds is critical. If the law set forth in *Westview* is nullified, or so factually limited that it ceases to have precedential value, sureties in Washington will have to drastically alter their bonding practices.

Additionally, the trial court's holding creates the unseemly result where the express trust on the money is essentially abolished and entitlement turns almost entirely on when the Bank received notice from Hartford that the funds are imposed with a trust. That is, even if the funds are unquestionably trust funds (as is the case here), a bank can sidestep the consequences of that characterization by electing not to inquire about their nature and racing to sweep them before the parties legally entitled to the funds have a chance to put the institution on actual notice. The law should not, and does not, reward such underhanded practices.

A. Standard of Review.

Questions of law and conclusions of law are reviewed without deference to the trial court's determinations.[46] The

[46] *Sunnyside Valley Irr. Dist. v. Dickie*, 149 Wash. 2d 873, 880, 73 P.3d 369, 372 (2003).

standard of review on an order of summary judgment is also *de novo*, with the appellate court performing the same inquiry as the trial court.[47] The Court considers the facts, and the inferences from the facts, in a light most favorable to the nonmoving party.[48] The Court may grant summary judgment if the pleadings, affidavits, and depositions establish that there is no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law.[49]

The instant appeal involves cross-motions for summary judgment. Thus, the Appellant requests the Court determine whether the trial court erred in granting the Bank's motion for summary judgment, and whether the trial court also erred in denying Hartford's motion for summary judgment.

B. *Westview* is the Controlling Law in Washington on This Issue.

1. The Trial Court Erred by Not Applying *Westview*.

A bank that has knowledge sufficient to require inquiry whether funds deposited by a general contractor into its bank

[47] *Smith v. Safeco Ins. Co.*, 150 Wn.2d 478, 483, 78 P.3d 1274, 1276 (2003).
[48] *Jones v. Allstate Ins. Co.*, 146 Wn.2d 291, 300-01, 45 P.3d 1068, 1073 (2002).
[49] *Id.*

account are trust funds cannot set off the funds to pay a debt owed the bank by the general contractor.[50] As explained below, that is precisely what happened in this case and such a result cannot stand under Washington law.

Westview involved a contractor that suffered escalating financial difficulties that eventually forced it to cease operations.[51] The contractor maintained several accounts with U.S. Bank, including a line of credit and a business bank account.[52] When U.S. Bank became concerned about the contractor's financial condition, it tied the contractor's bank account to a sweep account. U.S. Bank also obtained certain information regarding the contractor's finances.[53] Once U.S. Bank utilized the sweep account, the process was such that at the end of each day, U.S. Bank would sweep any funds remaining in the account on that day. At the same time, U.S. Bank was also issuing loans to the contractor on its line of credit to ensure that the contractor could pay its outstanding obligations, including those to subcontractors and suppliers.

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[50] *Westview* 133 Wn.App. at 839.
[51] *Id.* at 841.
[52] *Id.*
[53] *Id.*

For example, in November 2001, the contractor received a progress payment from a project owner, Westview, for $771,762.93, most of which should have been paid to the contractor's subcontractors and suppliers. U.S. Bank swept this payment and applied it to the contractor's outstanding line of credit. The following day, at the request of the contractor, U.S. Bank advanced the contractor $794,000. Similarly, in December 2001, on the same day that U.S. Bank swept a $749,962.13 progress payment, it also advanced $673,000 to the contractor on the line of credit. However, by January 2002, U.S. Bank refused to advance any more funds to the contractor, but did continue to sweep the contractor's bank account. On January 25, 2002, the contractor went out of business.

The lawsuit was subsequently initiated by Westview, and another project owner, Tukwila Self Storage, LLC, both of whom were forced to pay lien claims initiated by the contractor's unpaid subcontractors and suppliers. When the contractor went out of business it still owed more than $550,000 to its subcontractors on the Westview project and roughly $309,000 to subcontractors and suppliers on the Tukwila project. Both owners paid these claims

directly, and then brought suit against U.S. Bank seeking reimbursement under the theory that the swept progress payments were trust funds to held for their benefit. The trial court dismissed both owners' claims on summary judgment.

On appeal, Division 1 first evaluated whether the contractor's contracts with the owners created trusts. Both the Westview and Tukwila contracts contained a clause that stated:

> [*P*]*ayments received by the Contractor for Work properly performed by Subcontractors and suppliers shall be held by the Contractor for those Subcontractors or suppliers who performed Work or furnished materials, or both, under contract with the Contractor for which payment was made by the Owner.* Nothing contained herein shall require money to be placed in a separate account and not commingled with money of the Contractor, shall create any fiduciary liability or tort liability on the part of the Contractor for breach of trust or shall entitle any person or entity to an award of punitive damages against the Contractor for breach of the requirements of this provision.[54]

Division 1 determined that this contract language "evinces an express understanding on the part of the general contractor that it is not to hold the progress payments as its absolute property" but to hold the payments for the benefit of subcontractors. Therefore, the Court held an express trust was created by the contract language.

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[54] *Id.* at 846 (emphasis added).

Once it was determined the funds were, in fact, trust funds, the Court evaluated whether U.S. Bank had misappropriated those funds. Quoting *Chang v. Redding Bank of Commerce*, the Court stated:

> If a bank ***actually knows*** that sums deposited in the account of one of its debtors belong to a third person, it cannot apply such funds against the debtor's obligation to it. A bank is ***also denied the right to set off*** a third person's sums in its debtor's account against the debtor's obligation to it where it lacks actual knowledge or notice that the sums belong to a third person, but has ***knowledge of circumstances sufficient to necessitate inquiry*** concerning the sums.[55]

The Court stated the evidence submitted by the two owners showed that: (1) U.S. Bank knew the account holder was a general contractor; (2) U.S. Bank knew most of the contractor's accounts receivable were payments made by owners for the benefit of others; and (3) U.S. Bank received a substantial amount of financial information from the contractor.[56] Based on these facts, Division 1 reversed summary judgment and held there was a triable issue of fact as to whether U.S. Bank had sufficient information to inquire as

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[55] *Id.* at 850 (emphasis added).
[56] *Id.* at 850 - 851.

to the nature of the funds before sweeping the funds from the contractor's account.[57]

There was also a question of fact in *Westview* as to whether the owners had actually been damaged by U.S. Bank's actions. While this question is not directly pertinent to the instant issue, it is relevant to Hartford's claim of conversion against The Bank. U.S. Bank argued that while it did sweep the progress payments, it also issued loans to the contractor and, therefore, the misappropriated funds were ultimately recovered by the contractor. The Court held the issue of damages was best left to the trier of fact. With regard the conversion claim, the Court stated that the claim survived summary judgment, and was only subject to the owners proving their damages caused by U.S. Bank's actions.

2. Hartford is Entitled to Judgment as a Matter of Law When *Westview* is Properly Applied.

"When the Supreme Court of Washington has not addressed an issue, an existing Court of Appeals decision is the law that must be followed on the issue."[58]

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[57] *Id.* at 851.
[58] *American Discount Corp. v. Shepherd*, 129 Wn.App. 345, 355, 120 P.3d 96 (2005).

In the instant case, the trial court failed to follow *Westview*, while providing little explanation for its decision. The trial court's attempt to distinguish *Westview* on factual grounds is unfounded. As a result of its erroneous decision to discard *Westview*, the trial court did not evaluate whether the funds seized by the Bank are trust funds such that the Bank had a duty to inquire prior to seizing the funds for its own benefit.

Westview is the only case decided by a Washington Court that addresses the question of who has priority over trust funds deposited into a general contractor's account that are then swept by the bank, to whom the contractor also owes a debt. As this is precisely the issue in the instant case, it is perplexing how the trial court determined that it did not need to perform the evaluation of the case as set forth in *Westview*.

There are two main issues addressed in *Westview* that make the case applicable to the current dispute. First, whether the contracts created a trust. Second, whether the bank knew the funds were trust funds or had sufficient information to give rise to a duty to inquire.

In the present case, an express trust was created over the funds by both Waka's GIA with Hartford and Waka's contract with the GSA. The GIA states: "All money paid ... under contracts relating to or for which a Bond has been issued ***shall be impressed with a trust*** for the purpose of satisfying the obligations of the Bond Underwritten for said contract and this Agreement and shall be used for no other purpose until all such obligations have been fully satisfied."[59] The GSA contract required Waka to certify to the government with each request for payment that timely payments would be made from the proceeds of the payment to subcontractors and suppliers.[60] The language of the GIA is even stronger than the contract language in *Westview*, as the GIA clearly states the funds are "impressed with a trust". Waka acknowledged its obligation to use progress payments to satisfy obligations to subcontractors and suppliers, and when it defaulted on the GSA contract, took steps to assist Hartford with obtaining the progress payment.

As the funds were unquestionably trust funds under the GIA and Waka's GSA contract, the question then becomes whether the

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[59] CP 71; *emphasis added.*
[60] CP 347-349.

Bank knew the funds were trust funds or had adequate information to require inquiry into the nature of the funds. The facts here are similar to those in *Westview*. As in that case, here it is undisputed that the Bank was aware that Waka was a general contractor who regularly paid subcontractors and suppliers from progress payments received from owners. Further, the Bank was also aware the funds at issue were deposited into Waka's account by a public construction project owner (the GSA treasury).[61]

The few factual differences between this case and *Westview* actually render this case even more compelling. Unlike in *Westview*, where U.S. Bank was sweeping the account on a regular basis, in the instant case, the Bank made a specific decision to sweep the progress payment.[62] The Bank had not swept Waka's account prior to June 21, 2012. Thus, if anything, the Bank's duty to inquire was even greater than U.S. Bank's duty in *Westview*. In *Westview*, U.S. Bank had swept the contractor's account for months without any objection from any party and also while still providing loans for the contractor's business operations. Here, the Bank swept Waka's account after it had refused to extend Waka's

[61] CP 248.
[62] CP 252.

line of credit, a decision the Bank was aware would prevent Waka from completing its projects. Therefore, knowing that Waka did not have the line of credit to pay subcontractors and suppliers, and knowing that the payment from the GSA was for work performed on a public construction project, the Bank made a conscious, specific decision to sweep Waka's account without inquiring as to the nature of the funds. Simply put, the Bank unjustifiably ignored the trust fund nature of these funds and, instead, put its own interests ahead of Waka's subcontractors, suppliers and surety.

Proper application of *Westview* mandates a determination in Hartford's favor. The Bank was aware Waka was a general contractor who regularly used subcontractors and suppliers on projects. The Bank had evaluated and audited Waka's accounting systems that were primarily used to receive payments from project owners and, in turn, to make payments to subcontractors and suppliers. The Bank also knew that Hartford acted as surety to Waka by providing construction bonds to Waka. The Bank knew Waka was working on a project for the federal government and was receiving payments from the GSA. Lastly, the Bank was also aware that Waka had no funds to continue its operations once the

Bank revoked the line of credit. This evidence is sufficient to establish that the Bank had actual knowledge that the progress payment it swept belonged to other parties. Even assuming these factors did not establish actual knowledge, certainly they gave rise to an undeniable, unavoidable duty for the Bank to inquire. Accordingly, judgment should have been rendered in favor of Hartford as a matter of law.

The above conclusion is beyond dispute from both a legal and a logical standpoint. Indeed, to hold that an institution possessing the information that the Bank had in this case does not give rise, at minimum, to a duty to inquire, would render *Westview* meaningless. To give any meaning to *Westview's* inquiry requirement, the threshold of information possessed by the Bank cannot be *de facto* knowledge of the status of the funds. There must be a line between the information that would create actual notice and inquiry notice, if the latter is to have any true application and effect. Moreover, the effect of the law should not be to reward or encourage banks to be purposefully ignorant in order to avoid their duty to inquire and line their own pockets to the detriment of parties legally entitled to funds held in trust.

The Bank possessed more than enough information to know that the funds from the June 21, 2012 progress payment belonged to third parties, including Waka's subcontractors, suppliers and surety. Despite this, the Bank took no action to inquire as to whether the GSA payment was impressed with a trust. The trial court erred when it disregarded the Bank's duty to inquire under Washington law and ruled in favor of the Bank.

3. A Distinguishable Federal Circuit Case Should Not Override Washington Law.

State courts are the ultimate expositors of state law.[63] Even the determination of state law by a state appellate court is binding upon federal courts.[64] Federal courts defer to state courts "...because interpretation of state law is not a core function of the federal courts. [Federal courts] lack the expertise to interpret state laws. More importantly, [federal courts] lack authority to rewrite or re-interpret state law."[65]

Rather than following the established Washington law set forth in *Westview*, the trial court chose to follow a decision from the Ninth Circuit Court of Appeals, *Reliance Ins. Co. v. U.S. Bank of*

[63] *Mullaney v. Wilbur*, 421 U.S. 684, 691 (1975); *see Powell v. Ducharme*, 998 F.3d 710, 713 (9th Cir. 1993).
[64] *Hicks v. Feiock*, 485 U.S. 624, 629-30, 630 n.3 (1988).
[65] *Sarausad v. Porter*, 503 F.3d 822, 824 (9th Cir. 2007).

Wash. N.A.[66] *Reliance* was decided **eight years prior** to *Westview* and, as such, the Ninth Circuit made its ruling based on what it assumed would be the law in Washington.[67] The *Reliance* court specifically found that state law governed the dispute and stated:

> Application of state law, producing uniformity within a state, makes it easier for small local firms to use the same practices and the same inexpensive forms on all their projects, and for those involved in the industry to use routine practices that can be administered by personnel untrained in the law. If legislative reforms are needed, state government is more accessible to the various interests. In disputes between lenders and sureties over payments already made by the federal government, state law rather than federal law is the proper source of authority.[68]

Given this statement, once Washington courts decided the issue – choosing to set the standard in this State not as actual knowledge, but instead as actual knowledge ***or*** "knowledge of circumstances sufficient to necessitate inquiry . . ." – *Reliance* was effectively overruled in Washington. Therefore, further consideration of *Reliance* by this Court is unnecessary. That said, as explained below, even assuming this Court does not reject

[66] *Reliance Ins. Co. v. U.S. Bank of Wash. N.A.*, 143 F.3d 502 (9th Cir. 1998)
[67] *Id.* at 508.
[68] *Id.* at 505-506.

Reliance outright, careful examination of the case reveals that it is inapplicable to this matter.

In *Reliance,* the Ninth Circuit held that absent actual knowledge the funds are trust funds, a bank may set off deposits in a general contractor's account against a debt owed by the contractor to the bank. *Reliance* does not address, or even appear to consider, the question of whether the bank had a duty to inquire as to the nature of the funds when the funds are impressed with an express trust. Importantly, in *Westview*, Division 1 makes no citation to *Reliance* and does not appear to have considered the case in its decision. This makes sense, since, as noted above, federal courts do not determine state law.

Again, setting aside the inapplicability of *Reliance*, there are significant factual distinctions between that case and the current dispute. Most notably, the funds at issue in *Reliance* were not impressed with an express trust. While the surety in *Reliance* did make a *constructive* trust argument, the Ninth Circuit evaluated the case based on which party, the surety or the bank, had a priority interest to the funds.[69] As the court essentially rejected the surety's

[69] *Id.* at 507.

constructive trust theory, it held the trust question would only be a consideration if the bank knew a trust existed.[70]

As no express trust existed in *Reliance*, the court's evaluation focused on a balance of equities. The timeline of events in *Reliance* differed from the current dispute, as the surety in *Reliance* had been aware for several weeks that the general contractor had stopped paying its subcontractors yet did not take any action to notify the bank of these claims. The court found that the surety's silence during this timeframe contributed to the events that caused the dispute. These facts are substantially different than the instant case. Here, despite the fact that it was focused on fulfilling its obligations to complete the Project, Hartford made swift, diligent efforts to have the progress payment redirected. Further, Hartford promptly sent correspondence to the Bank to confirm the trust fund nature of the funds and stake its claim to the monies. In short, Hartford was anything but silent, and did nothing to contribute to the events that caused this dispute.

Based on the forgoing, *Reliance* is wholly inconsistent with the subsequently decided Washington law as established in

[70] *Id.*

Westview. As *Reliance* did not involve an express trust and contains no legal evaluation of a bank's ability to sweep trust funds, it cannot govern in this case. Additionally, the *Reliance* holding is problematic in that it creates a situation where entitlement to the funds becomes a matter of timing. For example, if a bank makes no effort to inquire regarding the true ownership of funds that come into its possession even though circumstances indicate they may be impressed with a trust and then sweeps the funds, the bank is entitled to keep the funds. It also creates a situation that promotes purposeful ignorance on the part of banks, while diminishing an owner's or surety's right to trust funds merely because notice was sent hours or perhaps even minutes after the set-off occurs. As evidenced in this case, modern banking allows funds to be electronically transmitted into an account and those funds can be swept by the bank almost instantaneously. As such, notice provided to the bank the same day as the money is deposited, which is what occurred in this case, can be deemed too late – despite a surety's or owner's unquestionable right to the funds. Such a result has not been, and should not be, permitted by the courts of this State.

C. The Trial Court's Factual Determinations Are Not Supported by the Record.

In distinguishing *Westview* from the current case, the trial court made certain factual determinations that are unsupported by the record. It also disregarded undisputed facts. During oral argument, the trial court stated:

> And I look at this as a case, there was moving these funds over for quite some time without any objection, and suddenly there's a problem that really isn't that clear that they knew much about it. They didn't even know the bond was in place as far as I can tell.

It appears from this statement that the trial court assumed Waka's bank account had been regularly swept without objection. However, this assumption is not supported by any evidence in the record. In fact, it is directly contradicted by the Declaration of David Stiffler of the Bank, which states that the Bank did not take action to sweep Waka's account until June 21, 2012.[71] Thus, the June 21, 2012 sweep of the progress payment was the first time funds in Waka's account had been swept by the Bank. While the Bank denied having actual knowledge that the progress payment was impressed with an express trust or that there were any unpaid subcontractors or suppliers on the Project, it admits knowing that

[71] CP 218-220.

the swept funds were from the GSA for a federal construction project.[72]

It is possible the trial court confused the facts of the instant case with the facts of *Westview*, where the funds were continuously swept from the contractor's account. Notably, nowhere in the analysis portion of the case does it state that the *Westview* court considered the fact that U.S. Bank had swept the contractor's bank account regularly. Furthermore, the *Westview* court gives no significance to the fact that U.S. Bank did not receive actual notice that the funds were trust funds until months after the funds had been swept.

The factual distinctions between *Westview* and the instant case provide additional support to Hartford's entitlement. This was a specific seizure by the Bank of funds the Bank knew were a payment from the GSA. This knowledge gave the Bank a stronger duty to inquire as to the nature of the funds. Another factual distinction that supports Hartford's entitlement to the funds is that, unlike in *Westview*, the progress payment in this case was never intended to be received or possessed by the general contractor.

[72] CP 220.

Both Waka and the GSA took steps to attempt to redirect the progress payment to be sent to Hartford instead of to Waka's bank account. But for the fact that the electronic transmission of the funds could not be stopped quickly enough by the GSA, this dispute would not exist.

Importantly, the trial court incorrectly focused on what the Bank did not know, rather than what it did know. In fact, the Bank's ignorance of certain facts only increases its duty to inquire as to the status of the funds. For example, the Bank alleges it was not directly aware that Hartford had provided bonds on the Project. However, the Bank was aware Waka had no way of paying its debts once the line of credit was revoked. The Bank was also aware that as a general contractor, Waka used payments from project owners to pay its subcontractors and suppliers. Thus, basic logic would lead to the conclusion that Waka would not be able to pay its subcontractors and suppliers once the Bank swept the payment. Even without actual knowledge that Waka's subcontractors and suppliers would be unpaid, the above facts are sufficient to create a duty to inquire. Knowledge of the bonds would not have increased the Bank's duty to inquire. The question is not

whether the Bank should have known the funds were intended for Hartford or another third party. The question is whether the Bank should have inquired to determine if the funds were purely the property of Waka. Based on the undisputed facts regarding what the Bank did know, reasonable minds could not differ in concluding the Bank had a duty to inquire. The trial court erred in assuming facts not supported by the record and by disregarding the facts surrounding the Bank's knowledge.

D. Hartford Possessed an Equitable Lien Over the Funds.

A surety that completes a contractor's work pursuant to a performance bond, stands in the position of the owner of the property "to the extent at least that [the surety is] entitled to sufficient of the money to be paid on the contract to save themselves from loss on their contract of suretyship, and the contractor cannot make a valid contract, by assignment or otherwise, the effect of which is to deprive the sureties of this right."[73]

Levinson also involved a situation where a surety was required to take over and complete the work of a defaulted contractor. A dispute arose between the surety, a judgment

[73] *Levinson v. Linderman*, 51 Wn.2d 855, 862, 322 P.2d 863 (1958).

creditor of the contractor, and the contractor's bank, to which the contractor had assigned its contract payments in exchange for a loan from the bank.[74] The trial court held that the bank had priority over the surety to the contract funds.[75]

On review, the Supreme Court of Washington held the issue was not one of priority, but the validity of the contractor's assignment of the funds to the bank. The Court stated:

> Assignees of a contractor of funds to be earned in public work take with notice of the terms of the contract and of the undertaking of the contractor's surety.[76]
>
> ...
>
> An assignment of a sum of money due or to become due will pass to the assignee only so much as a construction of the instrument shows was intended to pass; and the assignee may take nothing where the assignor of money due or to become due under a contract which he must perform defaults without anything due or owing.[77]
>
> ...
>
> It is a well settled doctrine that, where the sureties on a contractor's bond complete the contract on his abandonment of it, they stand in the position of the owner of the property to which the contract relates, to the extent at least that **they are entitled to sufficient of the money to be paid on the contract**

[74] *Id.* at 858.
[75] *Id.*
[76] *Id.* at 860.
[77] *Id.* at 861.

> **to save themselves from loss on their contract of suretyship, and the contractor cannot make a valid contract, by assignment or otherwise, the effect of which is to deprive the sureties of this right.**[78]

The *Levinson* Court held the surety's entitlement to the funds stems from the doctrine of equitable subrogation, which entitles a surety that completes a project for a defaulted contractor to an equitable lien on the remaining contract funds.[79]

Similarly, in *In re Massart*, 105 B.R. 610 (W.D. Wash. 1989) the District Court, applying Washington law, evaluated whether a surety had an equitable lien over project funds that were transferred to the general contractor's bankruptcy trustee prior to the surety paying the contractor's debts. The District Court, reversing a ruling from the Bankruptcy Court, held that while the surety's equitable lien could not be *enforced* until the surety had made a payment (thus incurring a loss), that the equitable lien on the project funds was *created* when the payment and performance bonds were issued for the project.[80] Hence, at the time the project funds were transmitted to the trustee, the surety had a lien on the funds. The court further stated that the surety had a superior right

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[78] *Id.* at 862 (emphasis added).
[79] *Id.* at 863.
[80] *In re Massart*, 105 B.R. at 612 (emphasis added).

to the funds as a matter of equity because the surety had intervened and performed the obligations of the contractor.[81] The *Massart* court also held the surety's rights were supported by public policy and quoted a case from a District Court in Oregon to support its decision:

> Finally, the court finds that as a matter of public policy, United Pacific should have a superior lien on the progress payment. The District Court for the District of Oregon once again has stated this in clear and persuasive terms.
>
> > [T]he existence of this equitable lien in the law of suretyship ***is an absolute necessity in this day and age of municipal corporations and others requiring the posting of bonds on public and other construction work.*** If no such right or lien existed it would be difficult, if not impossible, to entice another to act as a surety.
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> *United Pacific Ins. Co. v. First National Bank of Oregon,* 222 F.Supp. at 250.[82]

Based on the law of *Levinson* and *Massart*, Hartford's equitable lien on the funds was created when it issued the bonds for the Project, and that lien continued to exist on June 21, 2012, providing Hartford with a superior right over those funds long before they were swept by the Bank. Any agreements between

[81] *Id.* at 613.
[82] *Id.*

Waka and the Bank regarding the assignment of project funds cannot override Hartford's lien. It is not clear from the trial court's statements at oral argument what consideration, if any, the trial court gave to the fact Hartford had a preexisting equitable lien on the funds. Regardless of the reasoning, the trial court erred in failing to enforce Hartford's equitable lien over the funds that existed well before the Bank swept the funds. The Supreme Court of Washington has recognized the importance of a surety's right to subrogation to contract funds. These equitable rights, as described in *Levinson* and *Massart*, confirm the Bank cannot have a prior interest in the funds over that of Hartford. Therefore, the trial court erred in granting the Bank's motion for summary judgment in light of Hartford's equitable lien over the swept funds.

E. The Bank Committed Conversion When it Refused to Return the Funds to Hartford.

Conversion is the act of willfully interfering with any chattel, without lawful justification, whereby any person entitled thereto is deprived possession of it.[83] Conversion can occur when money is wrongfully received or when the party charged with the conversion

[83] *Westview*, supra, at 852.

is under obligation to return the money to the person claiming it.[84] Evidence of the knowledge, intent, or bad faith of the defendant is not necessary to prove conversion.[85] Conversion is committed by the act of the defendant to exercise dominion over the property, regardless of whether the defendant believes it has proper ownership of the property.[86] In *Westview*, discussed above, the court held there was sufficient evidence to support the claim of conversion, though a question of fact existed in that case regarding damages.

In the present case, the only reason the Bank received the funds at issue is because the Project owner, the GSA, was not able to stop payment on the transfer of the funds. Waka also intended the payment to be redirected to Hartford. Accordingly, the Bank's receipt of the funds was wrongful, as the GSA did not intend for the funds to be transferred following Waka's default. Even if it could be argued that the Bank's receipt of the funds was not wrongful, the Bank had an obligation to return the funds when it learned of Hartford's superior interest in the funds.

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[84] *Id.*
[85] *Judkins v. Sadler-Mac Neil*, 61 Wn.2d 1, 3-4, 376 P.2d 837 (1962).
[86] *Id.*

In order for the Bank to have a right to the funds and thereby avoid having committed conversion, the swept funds must first have rightfully been in Waka's possession. That is, the Bank could use the funds to pay Waka's debt if Waka properly had a property interest in the funds. But such a scenario is not supported by the facts of this case – which establish that Waka never had a right to the funds at issue. The GIA and the GSA contract mandate that the contract funds are not the property of Waka. Further, Waka agreed that the funds should be paid directly to Hartford and that Waka had no right to the funds. There is no circumstance where the Bank has a right to the funds if Waka had no right to the funds.

The Bank has willfully retained possession of funds to which it has no legal right, both because the funds are trust funds and because Hartford had an equitable lien over the funds; hence, the elements of conversion have been satisfied. Lastly, unlike in *Westview* there is no question of fact as to whether Hartford has been damaged by the Bank's actions. It has expended considerable amounts completing the Project, without the benefit of the payment the Bank has wrongfully retained. There is no dispute as to the amount of Hartford's damages, which is simply the

$103,410.00 in Project funds that were included in the Bank's sweep. The trial court wrongfully rejected Hartford's conversion claim without explanation as to how the elements of conversion were not met. Irrespective of the reasoning, the trial court unquestionably erred when it determined that the Bank did not commit conversion when it refused to return the funds to Hartford, given Hartford's legal entitlement to the funds.

F. Public Policy Concerns Support the *Westview* and *Levinson* Holdings and Judgment for Hartford.

Public construction projects in Washington require contractors to provide bonds that guarantee full performance of the contract and payment to all subcontractors and suppliers.[87] If the contractor defaults on its contractual obligations, the bonds provide security to the project owners that the surety will step in and assume the contractor's obligations.[88] The cost of the bonds, however, does not correspond to the obligation of the surety in the situation of a default by the contractor. [89] Surety bonds are not priced like insurance policies, which are priced based on actuarial

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[87] *See* RCW 39.08.010.

[88] KEVIN LYBECK, ET AL., THE LAW OF PAYMENT BONDS 2-3 (2nd ed. 2011); LAWRENCE MOELMANN, ET AL., THE LAW OF PERFORMANCE BONDS 3 (1999).

[89] *See* Udelman, Surety Contractors: Are Sureties Becoming General Liability Insurers? 22 Ariz. St. L.J. 469, 478 (1990).

tables that allow insurance companies to spread the insurance company's risk.[90] Rather, surety bonds are secured by indemnity agreements with the bond principals, which require, among other things, that the principal-contractor hold contract payments in trust for the benefit of the surety and bond claimants.[91]

As recognized by the Western District in *Massart* in its quotation of the District Court in Oregon, if sureties lose their entitlement to the contract funds upon a contractor's default, it will become increasingly difficult to entice sureties to provide contractors' bonds in Washington. The likely result will be that the cost of bonds in Washington will substantially increase as sureties attempt to provide additional security for themselves to compensate for their loss of entitlement to contract funds.

Although public contracts require the contractor to obtain the necessary bonds, the cost of obtaining the bonds is included within the contract price and, thus, paid by the public owner. Therefore, the increased cost of bonds would directly increase the costs of public construction projects – to the detriment of Washington taxpayers. To do so, while giving banks an unwarranted windfall by

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[90] *Id.*

[91] LAWRENCE MOELMANN, ET AL., THE LAW OF PERFORMANCE BONDS 77-78 (1999).

retaining funds that are the legal property of others, violates public policy.

VI. CONCLUSION

This Court should reverse and remand with instructions that the trial court shall enter judgment in favor of Hartford.

Respectfully submitted this 22nd day of November, 2013.

WATT, TIEDER, HOFFAR & FITZGERALD, L.L.P.

By: _____

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CERTIFICATE OF SERVICE

The undersigned certifies under penalty of perjury under the laws of the state of Washington that on the 22nd day of November, 2013, I caused true and correct copy of the BRIEF OF APPELLANT to be delivered to counsel in the manner indicated as follows:

Alexander S. Kleinberg Eisenhower & Carlson 1201 Pacific Avenue, #1200 Tacoma, WA 98402 *Attorney for Defendant*	☐ Hand delivery/Messenger ☐ Facsimile: 253-272-5732 ☐ U.S. Mail, postage prepaid thereon ■ Email: akleinberg@eisenhowerlaw.com

DATED this 22nd day of November, 2013 in Seattle, Washington.

/s/ Lana Ramsey