NO. 91069-3

SUPREME COURT OF THE STATE OF WASHINGTON
[Court of Appeals No. 45320-7-II]

Hartford Fire Insurance Company,

Plaintiff/Appellant,

v.

Columbia State Bank, Defendant/Respondent.

PETITION FOR REVIEW

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I. IDENTITY OF PETITIONER

Plaintiff/Petitioner Hartford Fire Insurance Company ("Hartford") asks the Supreme Court to accept review of the published decision of the Court of Appeals designated in Part II pursuant to the Washington Rules of Appellate Procedure, Rule 13.4(a); (b)(2); and (b)(4).

II. 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. Hartford's motion for reconsideration was denied. 2014 Wash. App. LEXIS 2600 (October 29, 2014). The Appendix includes copies of the decision and the order denying the motion for reconsideration.

III. ISSUES PRESENTED FOR REVIEW

1. Where a Public Construction Contract Provided that Progress Payments Were Impressed with a Trust for the Benefit of the Surety, Did the Court Of Appeals Opinion Holding that the Owner's Progress Payment to the Contractor Was Not Subject to an Express Trust Conflict with *Westview Investments, Ltd. V. U.S. Bank, N.A.*, 133 Wn. App. 835 (2006), Which Holds that Progress Payments Made Under Construction Contracts Held in Trust for a Specific Use Do Not Belong to

the Contractor and May Not Be Set Off to Repay a Bank Loan Where the Bank Knew or Had Reason to Know the Funds Were Held in Trust?

2. Did the Court of Appeals Opinion Holding that a Progress Payment Paid to a Defaulting Contractor by the Owner under a Public Construction Contract Whose Completion Was Guaranteed by a Bond Issued by a Surety Belonged to the Free Flow of Commerce and Was Properly Set Off by the Contractor's Third Party Bank Creditor Conflict with *Levinson v. Linderman*, 51 Wn. 2d 855 (1958), Which Holds that a Surety Is Equitably Subrogated to the Contractor's Right to Receive the Owner's Payments from the Time It Issued a Performance Bond?

3. If Not Reversed, Will the Court of Appeals' Opinion Holding that Payments from an Owner to a Defaulting Contractor and Which Are Expressly Impressed With a Trust Are Not Subject to an Express Trust Have a Substantial Negative Impact on Surety Bonding and Public Works Construction in the State?

4. If Not Reversed, Will the Court of Appeals' Opinion Holding that a Surety Does Not Have an Equitable Lien on Owner Payments to a Defaulting Contractor and that the Payments Belong to the Free Flow of Commerce and Are Subject to Being Set Off by the Contractor's Third Party Bank Creditor Have a Substantial Negative Impact on Surety Bonding and Public Works Construction in the State?

IV. STATEMENT OF THE CASE

A. Summary of the Underlying Events.

Waka Group, Inc. ("Waka"), contracted with the United States General Services Administration (the "GSA") to renovate a border station in Dalton, Alaska. CP 98. As in virtually all public construction contract contexts, the GSA required Waka to obtain a surety bond to guarantee completion of the work and payment of subcontractors, suppliers and materialmen. In order to induce Hartford to issue bonds on behalf of Waka, on June 13, 2011, Waka executed a General Indemnity Agreement ("GIA") with Hartford. CP 64. One week later, Waka opened a line of credit and established a collateral control account at Columbia State Bank. CP 218. On March 1, 2012, pursuant to the GIA, Hartford issued Performance and Payment Bond No. 52BCSGC8757 on behalf of Waka for the Dalton project (the "Bond"). CP 102. Thereafter, pursuant to its contract with the GSA, Waka commenced work.

On June 18, 2012, Waka stopped performing under the GSA contract, with 55-60% of the work unfinished, and notified Hartford that it would be unable to complete the job. CP 99. On June 20, 2012, Hartford and Waka notified the GSA of Waka's default, advised that Hartford would be taking over the project, and directed the GSA to make progress

payments to it. CP 86, 380. The GSA acknowledged Hartford's right to the contract funds and agreed to remit all future payments to Hartford. CP 88. The GSA had initiated an electronic progress payment to Waka earlier on June 20, and acknowledging Hartford as the completing surety was entitled to the contract balance, it attempted to stop that payment. CP 65. It was unable to stop the payment in time; hence, the funds were credited to Waka's account the following morning. CP 65, 108-09. The Bank immediately swept the funds, claiming a right to setoff against Waka's delinquent loan balance. *Id.* In response to Hartford's assertion that the progress payment consisted of trust funds and its request that the Bank deliver the funds to it, the Bank refused. CP 90, 117-18. Hartford proceeded to complete the construction project and to sue the Bank in Pierce County Superior Court for the disputed progress payment. The parties filed cross-motions for summary judgment in the trial court, and orders were entered in favor of the Bank. Hartford appealed. The resulting decision of the Court of Appeals is the subject of this petition.

B. The General Indemnity Agreement between Waka and Hartford Expressly Provides that All Money Paid Under the Contract for Which a Bond Had Been Issued Is Impressed With a Trust.

The GIA includes a provision entitled, "Trust Fund," which expressly provides that "all money paid...under contracts relating to or for which a Bond has been issued *shall be impressed with a trust....*" CP 13

(emphasis added). In sworn testimony, both Waka and Hartford confirmed their intention to create a trust. CP 100 at 14:12-17; CP 374; CP 380. The GIA also provides that Waka assigned to Hartford, *inter alia*, its rights under the bonded contract and to accounts, deferred payments and retainage in which it had an interest, further evincing the intent of the parties to create a trust as to all money paid under the contract. CP 13. Nevertheless, in affirming the trial court's summary judgment orders in favor of the Bank, the Court of Appeals concluded that the GIA did not create an express trust, and, for that reason, held that the progress payment was subject to being swept by the Bank as a third party creditor.[1] Longstanding Washington law defines an express trust:

> An express trust is one created by the act of the parties; and where a person has, or accepts, possession of money, promissory notes, or other personal property with the express or implied understanding that he is not to hold it as his own absolute property, but to hold and apply it for certain specified purposes, an express trust exists.[2]

As explained below, the undisputed evidence establishes each of these elements. The progress payment consisted of trust funds held by Waka for the benefit of Hartford, and the Court of Appeals decision was in error.

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[1] As a result of the Bank's action, Hartford, as Waka's surety, was required to cover the obligations which went unpaid. CP 374.

[2] This definition dates to *Tucker v. Brown*, 199 Wash. 320, 330-31, 92 P.2d 221 (1939), was reiterated in *Westview Investments, Ltd. V. U.S. Bank National Association*, 133 Wn. App. 835, 845-46, 138 P.3d 638 (2006) ("*Westview*"), and most recently in *In re Washington Builders Benefit Trust,* 173 Wn. App. 34, 58, 293 P.3d 1206 (2013).

1. Act of the Parties.

Execution of the GIA with its provision stating that money paid under the contract was impressed with a trust constituted the necessary affirmative act of the parties.

2. Possession of Money or Personal Property.

Waka came into possession of the progress payment when the payment was electronically transferred to its account at the Bank after it had defaulted on the construction contract, but before the GSA could stop the transfer. CP 65, 108-09.

3. Understanding That Money or Personal Property is to be Applied for Specified Purposes.

Both the "Trust Fund" and "Assignment" provisions of the GIA demonstrate the parties' understanding that contract funds, including the progress payment swept by the Bank, were not the absolute property of Waka. Consistent with the GIA's provisions stating that "the entire contract price shall be dedicated to the satisfaction of the obligations of the Bond and this Agreement," and that "All money paid ... shall be used for no other purpose until all such obligations have been fully satisfied," CP 13, Waka, as trustee, was required to apply the contract funds to satisfy the obligations guaranteed by the Bond. For the same purpose, the GIA provided that Waka "irrevocably assign[ed]" to Hartford all rights arising from any bonded contract." CP 13.

Despite this undisputed evidence, the Court of Appeals held that the GIA "did not establish a trust and that no trust existed" at the time of the progress payment. Slip. Op. at 9.

C. The Court of Appeals Declined to Follow *Westview*.

In *Westview*, the Court of Appeals reversed a summary judgment in favor of the defendant bank, which had swept the contractor's account and set off the funds against the contractor's delinquent loan balance, finding that an express trust had been established by the construction contract (despite the absence of express creation language in the contract; in fact, the word "trust" did not appear in the contract). 133 Wn. App. at 849.[3] The plaintiffs in *Westview* were the property owners ("akin" to the GSA in the instant case) rather than sureties, and the Court of Appeals found the case distinguishable for that reason. Slip Op. at 7. The Court did not, however, explain why this factual distinction was significant, and it was not significant because both the owners in *Westview* and the surety here were responsible for paying the costs to complete the respective construction projects, including payment of the contractors' financial obligations to subcontractors and materialmen.

[3] *Westview* was remanded for trial as to whether the bank knew facts which, under the circumstances, would lead a reasonably intelligent and diligent person to inquire whether the contractor was acting as a trustee of the progress payments. 133 Wn. App. at 849. Here, Hartford submitted evidence that Columbia Bank knew or should have known that Waka was acting as a trustee of the progress payment made by the GSA. CP 100-02.

The Court of Appeals also distinguished *Westview* based on the lack of evidence here that subcontractors were unpaid at the time the progress payment was deposited to Waka's account. *Id.* However, under Waka's contract with the GSA, the subcontractors must have been unpaid when the progress payment was made, since the purpose of the payment was to pay them. Waka's contract with the GSA required a certification from Waka before a progress payment could be made that, "All payments due to subcontractors and suppliers from previous payments received under the contract have been made, and *timely payments will be made from the proceeds of the payment covered by this certification....*" CP 348 (emphasis supplied) (footnote omitted).

In distinguishing *Westview*, the Court of Appeals also cited the provision in the construction contract at issue there requiring the general contractor to hold progress payments for the benefit of project subcontractors, noting the absence of such a requirement here. Slip Op. at 8. In fact, while Waka's construction contract with the GSA did not include such an explicit provision, it did require that Waka certify that the progress payment would be used to timely pay subcontractors. CP 348. Again, the Court of Appeals did not explain why this factual distinction had significance where, in both cases, the progress payment was made for the same reason, to pay subcontractors. Finally, the Court of Appeals

cited a lack of evidence that Hartford or Waka contemplated that project payments would be held to satisfy Bond obligations. Slip Op. at 8. However, the record included evidence that Waka was obliged under its construction contract with the GSA to use progress payments to pay subcontractors, CP 348, and that one of Hartford's primary obligations to Waka under the GIA was to pay subcontractors who had not been paid by the contractor. CP 64-65. Thus, the Court of Appeals overlooked the evidence that here, as in *Westview*, both the contractor and the party obligated to pay if the contractor did not pay contemplated that project progress payments would be used to satisfy the obligations of the guarantors.

In concluding that the progress payment was not subject to an express trust, the Court of Appeals asserted that Hartford's position would lead to absurd results, specifically, that Waka could not have used progress payments to pay subcontractors or other project expenses until completion of the project and discharge of the Bond. Slip Op. at 8. However, that result would not follow because the Trust Fund provision of the GIA expressly provides that money paid

> [U]nder contracts relating to or for which a Bond has been written 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 satisfied.

CP 13 (emphasis added). In other words, the contract funds impressed with a trust were expressly authorized to be used to satisfy the obligations of the GIA, *i.e.*, to complete the project. Thus, existence of a trust would not have prevented Waka from using progress payments to pay subcontractors and other project expenses prior to completion of the project and discharge of the Bond.

D. The Court of Appeals Recognized that Hartford Was Equitably Subrogated to Waka's Right to Receive Payments from the GSA Upon its Issuance of the Surety Bond, but Found that the Progress Payment Was Not Subject to an Equitable Lien.

An equitable lien constitutes a charge or encumbrance upon property. *Nelson v. Nelson Neal Lumber Co.,* 171 Wash. 55, 61, 17 P.2d 626 (1932). The Court of Appeals properly recognized that "the equitable right of subrogation is created at the time the surety issues the payment and/or performance bonds," citing *Levinson v. Linderman*, 51 Wn. 2d 855, 864, 322 P.2d 863 (1958), and *In re Massart Co.*, 105 B.R. 610, 612 (W.D. Wash. 1989). Slip Op. at 10. Nevertheless, the Court concluded that, "Hartford had not obtained an equitable lien at the time Columbia [State Bank] took the money." *Id.* The Court attributed this apparent contradiction to the fact that at the time the Bank took the money, Hartford had not yet paid its obligations under the Bond; a lack of evidence that the subcontractors had not been paid at that time; and the fact that the

payment was a progress payment rather than retainage. However, because Hartford was subrogated to Waka's rights to receive payments from the GSA from the time it issued the Bond, every progress payment was encumbered by Hartford's equitable lien and could be used only to pay subcontractors and otherwise cover obligations which would accrue to Hartford if the contractor defaulted.[4] The progress payment at issue was received by Waka after it had gone into default, emphasizing the reason why it was subject to Hartford's lien. The Court of Appeals' conclusion that Hartford did not have an equitable lien on the money at the time the Bank took it cannot be reconciled with Hartford's subrogation rights as recognized by *Levinson* and acknowledged by the Court of Appeals itself.

The Court of Appeals justified its apparent contradictory conclusions by relying on the fact that at the time the Bank took the money, Hartford had not yet acted under its Bond. However, even if Hartford's right to enforce its lien did not arise until the time it made payment under the Bond, the issue is one of timing, and the fact that

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[4] The Court distinguished between progress payments and retainage by characterizing the former as belonging to the "free flow of commerce once they are properly paid over." Slip Op. at 10-11. That would be true, however, only if the progress payments were unencumbered when paid over. However, where, as here, the surety was equitably subrogated to the contractor's right to payment from the owner, its lien extended to both progress payments and retainage. *See In re E.R. Fegert, Inc.*, 88 B.R. 258, 261 (9th Cir. BAP 1988), *aff'd*, 887 F.2d 955 (9th Cir. 1989) ("We conclude that the surety would have been entitled to assert a lien for both any unpaid progress payments or funds held as retainage"), citing *National Shawmut Bk. of Boston v. New Amsterdam Cas. Co.*, 411 F.2d 843, 848 (1st Cir. 1969), and *American Fire & Cas. Co. v. First Nat. Bank of New York*, 411 F.2d 755, 758 (1st Cir. 1969).

performance under the Bond had not yet occurred at the time the Bank took the money did not justify the Court's holding that Hartford had no lien at that time and that the Bank was entitled to the money free and clear of Hartford's claimed right to the funds.[5] The dispute here is analogous to *Fidelity & Deposit Co. v. United States*, 183 Ct. Cl. 908 (1968), where a bank and a surety contested claims to allegedly earned but unpaid contract funds. The bank claimed a superior interest in the funds because the surety had not yet paid anything under its bond. The Court rejected the bank's claim, holding,

> 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 performance bond.

183 Ct. Cl. at 912.

Another analogous case is *In re Massart*, 105 B.R. 610 (W.D. Wash. 1989), cited by the Court of Appeals, but not followed. Massart Company had entered into a construction contract with Pierce County; United Pacific issued a performance and payment bond for the project. Massart filed for bankruptcy prior to completion of the project, leaving various subcontractors unpaid. Pierce County paid a $202,744 progress payment to Massart's trustee in bankruptcy, which resulted in the surety

[5] It was undisputed that Hartford fully performed its obligations under the Bond. Hartford paid the subcontractors, suppliers and materialmen $100,350 on the Dalton project (and incurred an additional $265,518 in losses associated with the project). CP 374.

having to pay the laborers and materialmen. The surety sued the trustee for the progress payment. In defense, the trustee asserted that the surety's equitable rights did not arise until it paid Massart's debts, and since that occurred after Massart declared bankruptcy, the funds belonged to the bankruptcy estate for distribution to creditors. After the Bankruptcy Court granted summary judgment in favor of Massart's bankruptcy trustee, the surety appealed. Citing *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 139, 83 S.Ct. 232, 9 L .Ed. 2d 190 (1962),[6] and other supporting authority, Judge Barbara Rothstein reversed the order, holding that United Pacific's equitable rights arose at the time it signed on as surety under the bond, and as a consequence, Massart did not have a legal or equitable interest in the progress payment at the time it declared bankruptcy. Since the progress payment was not the property of the bankruptcy estate, the trustee was required to turn it over to the surety. *Massart*, 105 B.R. at 612-13.

The Court of Appeals' decision affirming the trial court's summary judgment orders in favor of the Bank cannot be reconciled with Hartford's recognized subrogation rights, this Court's decision in *Levinson*, or the U.S. Bankruptcy Court's persuasive decision in *In re Massart*.

[6] *Pearlman* was also cited by the Court here.

V. ARGUMENT WHY REVIEW SHOULD BE ACCEPTED

A. The Opinion of the Court of Appeals that Progress Payments Made Under Construction Contracts Held in Trust for a Specific Use Belong to the Contractor and May Be Swept to Repay a Bank Loan Although the Bank Knew or Had Reason to Know the Funds Were Held in Trust Conflicts with *Westview Investments, Ltd. v. U.S. Bank National Association*, 133 Wn. App. 835 (2006).

The Court of Appeals did not follow *Westview*, purportedly because factual differences made the precedent distinguishable. However, as demonstrated above, critical analysis of the "distinctions" cited by the Court reflect that either the Court failed to acknowledge evidence obviating the distinction or that the distinction lacked significance for purposes of *Westview*'s application, or both. More specifically, both the owners in *Westview* and the surety here were similarly situated in that both were required to complete the project and pay subcontractors and other project expenses; both in *Westview* and here, the contractor was obligated to use progress payments to pay subcontractors; both in *Westview* and here the contractor and the owner contemplated that progress payments would be used to pay subcontractors; and both in *Westview* and here, subcontractors were unpaid at the time the progress payment was made.[7]

The Court's Opinion cannot be reconciled with *Westview*.

[7] Even if the evidence that Waka's subcontractors were unpaid was insufficient, the record was clear that the job was only 55-60% completed at the time Waka defaulted, so the progress payment funds were indisputably necessary to pay other project expenses.

B. The Opinion of the Court of Appeals that a Progress Payment Paid to a Defaulting Contractor by the Owner Under a Bonded Public Construction Contract Was Not Subject to an Equitable Lien in Favor of the Surety Responsible for Completing the Project and Paying Subcontractors Conflicts with *Levinson v. Linderman*, 51 Wn.2d 855 (1958).

In *Levinson, supra*, 51 Wn.2d 855, this Court cited *Scarsdale Nat. Bank & Trust Co. v. United States Fidelity & Guaranty Co.*, 264 N.Y. 159,163, 190 N.E. 330 (1934), as expressing its view of the applicable rule of law governing the creation of an equitable lien in favor of a surety under a public construction contract. The New York court stated:

> 'The bonding company succeeded to all these rights of the State [the owner], under the principle of subrogation. Having completed the work in behalf of the State, it was subrogated to all the rights of the State as against the contractor. This was not a right given to it by the judgment of the court, or arising at the time of the default. It was implicit in its undertaking and agreement with the State. *This equitable right of subrogation was created...at the time the defendant executed its bond as surety to the State....'*

51 Wn.2d at 864 (emphasis supplied).

In its opinion, the Court of Appeals acknowledged the holding in *Levinson* that the right of equitable subrogation is created at the time the surety issues the payment and/or performance bonds. Slip Op. at 10. However, it concluded that the surety does not obtain an equitable lien until it suffers a loss by making payments pursuant to its obligation under the bond. *Id.* The Court supported its conclusion by citing *Massart*, 105

B.R. at 612. The surety in *Massart* first paid a subcontractor after the contractor had declared bankruptcy. The Bankruptcy Court had determined that its equitable lien arose at that point, making the lien inferior to the trustee's lien. The District Court reversed, holding, as did this Court in *Levinson*, that the surety's right of equitable subrogation arose when it executed its bonds. "[A]s a consequence," the Court concluded,

> Massart did not have a legal or equitable interest in the progress payment at the time it declared bankruptcy. Thus...the progress payment was not the property of the bankruptcy estate, and the trustee should turn over the progress payment to United Pacific.

Id. at 613. Bluntly, the authority relied upon by the Court of Appeals stands for exactly the opposite proposition than that for which it was cited.

In sum, *Massart* is consistent with *Levinson*, but the Court of Appeals' decision here is not. Indeed, the Court of Appeals' analysis not only misinterprets *Massart*, but it eviscerates *Levinson*, since, as seen here, holding a right of equitable subrogation from the time the bond is issued is meaningless unless the surety also has the immediate right to an equitable lien on the owner's payments to the contractor.

C. The Court of Appeals Opinion Holding that Funds Impressed With a Trust Are Not Subject to an Express Trust Will Have a Substantial Negative Impact on Surety Bonding, the Cost of Public Works Construction in the State and Small Business.

The purpose of a performance bond is to ensure a construction project's completion and the payment of subcontractors, suppliers and materialmen in the event the contractor defaults on its contractual obligations to the owner. Indemnity agreements like the GIA typically impose trusts on owner payments under construction contracts to ensure that the payments are used solely to satisfy the contractor's obligations under the contract, or the surety's obligations to complete the project and satisfy all related financial obligations in the event of a default by the contractor. If the Court of Appeals' published Opinion is not reversed, and progress payments made to contractors under the construction contract are available to be expended by the contractor for any purpose and subject to collection by third party creditors despite language in the contract impressing a trust upon the payments, as the Opinion concludes, the result will be higher pricing for surety bonds and/or projects that will not be built, alternatives which negatively impact the public interest. Where the contract is for a public construction project, the practical impact will be forebearance by governmental entities within the State from authorizing new construction or a significant increase in costs to their taxpayers.

In addition, if the Court of Appeals' published Opinion is not reversed it is likely to have a negative impact on small business in Washington. If sureties can no longer rely on the full contract balance as a source of collateral in the event of a contractor's default, they will be less likely to issue bonds for smaller contractors, most of whom do not have significant capital to protect the surety against a loss. The result would be sureties issuing bonds only for large contractors. In that event, many small contractors will be unable to stay in business.

D. The Court of Appeals Opinion Holding that Until a Surety Satisfies Project Completion and Payment of Subcontractors, the Surety Does Not Have an Equitable Lien on Monies Paid by the Owner to the Contractor and the Monies Belong to the Free Flow of Commerce and Therefore Are Subject to Being Swept by the Contractor's Bank Creditor Will Have a Substantial Negative Impact on Surety Bonding, the Cost of Public Works Construction in the State and Small Business.

To Hartford's knowledge, the decision in this matter is the first and only published opinion in Washington holding that a surety issuing a payment and performance bond to guarantee the completion of a public construction project and satisfy project completion expenses does not have an equitable lien on progress payments made by the owner to the contractor pursuant to the construction contract.

In making its determination that the bankruptcy trustee for the general contractor was obliged to disgorge the funds subject to the surety's

equitable lien in *In re Massart*, *supra*, 105 B.R. 610, the District Court relied upon public policy, stating:

> [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.

Id. at 613, quoting *United Pacific Ins. Co. v. First National Bank of Oregon*, 222 F. Supp. 243, 250 (D. Ore. 1963).

The policy rationale recognized in *Massart* applies equally to this case. This Court of Appeals' decision will either discourage sureties from issuing performance and payment bonds for government construction projects within Washington outright or cause them to significantly raise premiums. If the Court of Appeals' published Opinion is not reversed, and progress payments made to the contractor under the construction contract are part of the "free flow of commerce," free of a surety's equitable lien and therefore available to be expended by the contractor for any purpose and subject to collection by third party creditors, as the Opinion concludes, the result will be higher pricing for surety bonds and/or projects that will not be built, alternatives which negatively impact the public interest. Where the contract is for a public construction project, the practical impact will be forebearance by governmental entities within

the State from authorizing new construction or a significant increase in costs to their taxpayers. In addition, since sureties who can no longer rely on the full contract balance as a source of collateral in the event of a contractor's default will be less likely to issue bonds for smaller contractors, small business in Washington is likely to be negatively impacted.

VI. CONCLUSION

For the foregoing reasons, this Court should grant review and reverse the Court of Appeals.

RESPECTFULLY SUBMITTED this 1st day of December, 2014.

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IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

HARTFORD FIRE INSURANCE COMPANY, Appellant, v. COLUMBIA STATE BANK, Respondent.	No. 45320-7-II PUBLISHED OPINION

MELNICK, J. — Hartford Fire Insurance Company (Hartford) appeals from the superior court's grant of summary judgment dismissal of Hartford's claims against Columbia State Bank (Columbia) and the superior court's denial of Hartford's summary judgment motion. Hartford had issued bonds for Waka Group Inc. (Waka), a general contractor, and made payments under one bond when Waka defaulted on a project. Hartford argues that it was entitled to recover progress payment funds Columbia removed from Waka's collateral control account because Waka had a contractual obligation to hold progress payments in trust for Hartford's benefit to provide reimbursement for bond payments, and that Columbia knew or should have known the funds were held in trust. In the alternative, Hartford argues that it had an equitable lien on the progress payment funds that was superior to Columbia's right to the funds.

We hold that the contract between Hartford and Waka did not create an express trust and that Hartford did not possess an equitable lien on the progress payment funds. As a result, we hold that Hartford is not entitled to recover the funds from Columbia. We affirm the superior court's summary judgment dismissal of Hartford's claims.

FACTS

Hartford issued performance and payment bonds as surety for Waka's construction contracts. On June 13, 2011, as partial consideration for this arrangement, Hartford and Waka executed a General Indemnity Agreement (Indemnity Agreement). The Indemnity Agreement included a "Trust Fund" provision, which stated:

> 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.

Clerk's Papers (CP) at 13 (emphasis added).

Waka needed to obtain working capital to complete its projects. On June 14, 2011, Waka executed and delivered a commercial line of credit agreement and note (Note) along with a business loan agreement to Columbia. An addendum to the business loan agreement titled "Control Account," stated that Waka

> shall deposit all cash, instruments and other proceeds received from the operation of [Waka's] business into an account established with [Columbia] within two (2) business days after receipt of such amounts (the "Control Account"). . . . [Columbia] is authorized to pay down the unpaid Loan balance, on a daily basis, from funds in the Control Account.

CP at 245. At the same time, Waka executed and delivered a commercial security agreement to Columbia to provide collateral for the Note. The security agreement provided Columbia with a Uniform Commercial Code (UCC) article 9 security interest in Waka's inventory, equipment, chattel paper, accounts, general intangibles, and the products and proceeds thereof, whether then owned or later acquired. On June 20, Columbia timely perfected its security interest in the collateral by filing a UCC financing statement.

In early 2012, Waka contracted with the General Services Administration (GSA) for a project on the Dalton Cache Border Station in Haines, Alaska (Dalton Project). On March 1, pursuant to the Indemnity Agreement, Hartford issued a performance bond and a payment bond for the Dalton Project.

For its projects, including the Dalton Project, Waka had automatic deposit payments made into its collateral control account with Columbia. Waka then used that money to pay its subcontractors and suppliers. The Note matured on May 30, 2012, and Waka failed to repay the loan evidenced by the Note. On or about June 18, Columbia met with Waka's president and told him it was going to call Waka's loan.

At approximately the same time, after learning that Waka would be unable to complete the project, Hartford began taking steps to take over and complete the Dalton Project pursuant to its obligations under the bonds. On June 20, Hartford notified the GSA that it would be completing the Dalton Project and requested that the GSA direct all future progress payments to Hartford. Also in mid-June, Waka notified the GSA that it would not be able to complete the Dalton Project.

On June 21, Waka sent the GSA a letter directing it to send all future payments for the Dalton Project to Hartford. The GSA agreed, but despite its attempts, it could not stop a progress payment in the amount of $103,410 from being deposited into Waka's collateral control account with Columbia. On that same day, Hartford sent Columbia a letter notifying Columbia of the trust fund language in its Indemnity Agreement with Waka. It instructed Columbia to hold the Waka funds in trust for the benefit of Hartford and other trust beneficiaries. However, Columbia had already applied the $103,410 GSA progress payment to Waka's outstanding loan balance.[1]

[1] This event occurred on June 21 but the bank statement reflects the transfer occurring on June 22.

On June 25, the GSA sent Hartford an official demand letter to complete the Dalton Project pursuant to its obligations under the performance bond. On July 13, Hartford and the GSA executed a takeover agreement for Hartford to complete the Dalton Project, and four days later Hartford made its first payment to subcontractors under its bond obligations.

On August 10, Hartford sent Columbia a letter requesting that the $103,410 progress payment be released to Hartford. Columbia responded it had no obligation to return the funds and declined the request. In January 2013, Hartford filed a lawsuit against Columbia for misappropriation of trust funds, wrongful setoff, conversion, and declaratory relief.

Hartford moved for summary judgment and argued that the money deposited on June 21 went into a trust fund for its benefit and that Columbia had sufficient notice of this fact. Hartford also argued that it had an equitable lien on the funds. Columbia also moved for summary judgment and argued that the progress payment was not a trust fund deposit and that Columbia had no way of knowing of Hartford's claim to the money when GSA deposited it. The superior court granted Columbia's motion for summary judgment and dismissed Hartford's complaint with prejudice. Hartford appeals the superior court's grant of summary judgment in favor of Columbia and the superior court's denial of its motion for summary judgment.

ANALYSIS

I. STANDARD OF REVIEW

We review an order for summary judgment de novo, engaging in the same inquiry as the trial court. *Loeffelholz v. Univ. of Wash.*, 175 Wn.2d 264, 271, 285 P.3d 854 (2012). Summary judgment is proper if "the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." CR 56(c). We construe

all facts and their reasonable inferences in the light most favorable to the nonmoving party. *Loeffelholz*, 175 Wn.2d at 271. Summary judgment is proper only if reasonable persons could reach but one conclusion from the evidence presented. *Bostain v. Food Express, Inc.*, 159 Wn.2d 700, 708, 153 P.3d 846 (2007).

II. EXPRESS TRUST

Relying on *Westview Investments, Ltd. v. U.S. Bank National Association*, 133 Wn. App. 835, 138 P.3d 638 (2006), Hartford argues that Waka was contractually obligated to hold the Dalton Project progress payments in trust for the benefit of Waka's subcontractors and Hartford and that Columbia either knew or should have known this fact. As a result, Hartford maintains that the funds did not belong to Waka and Columbia had no right to take them to repay Waka's debt. We disagree and hold that the contract language did not create an express trust. Because no express trust existed here, *Westview* does not apply and Hartford's argument fails.

Express trusts are "'[t]hose trusts which are created by contract of the parties and intentionally.'" *In re Wash. Builders Ben. Trust*, 173 Wn. App. 34, 58, 293 P.3d 1206 (quoting *Farrell v. Mentzer*, 102 Wash. 629, 632, 174 P. 482 (1918), *review denied*, 177 Wn.2d 1018 (2013). "'An express trust is one created by the act of the parties; and, where a person has, or accepts, possession of money, promissory notes, or other personal property with the express or implied understanding that he is not to hold it as his own absolute property, but to hold and apply it for certain specified purposes, an express trust exists.'" *Westview*, 133 Wn. App. at 845-46 (quoting *State v. Southard*, 49 Wn. App. 59, 63 n.3, 741 P.2d 78 (1987)).

In *Westview*, Division One of this court held that two provisions in a contract between a project owner and a general contractor created an express trust. 133 Wn. App. at 846. In that case, a contractor secured a line of credit with U.S. Bank. *Westview*, 133 Wn. App. at 840. The

contractor then entered into separate agreements with Westview Investments and Tukwila Self Storage (owners) to perform construction work on their specified properties. *Westview*, 133 Wn. App. at 841, 844. The owners wired progress payments to the contractor's cash collateral account at U.S. Bank. *Westview*, 133 Wn. App. at 842-44. The owners made the payments for the labor and materials the contractor provided on the project. *Westview*, 133 Wn. App. at 842-44. U.S. Bank applied the money to the contractors' lines of credit. *Westview*, 133 Wn. App. at 843-44. The contractor went out of business before completing the construction work for the owners. *Westview*, 133 Wn. App. at 843. When the contractor went out of business, it did not pay the subcontractors in full. *Westview*, 133 Wn. App. at 843. The owners paid the subcontractors and then filed suit claiming that the progress payments were funds held in trust for the benefit of the subcontractors. *Westview*, 133 Wn. App. at 843.

The contracts between the contractor and the owners stated, "The Contractor shall promptly pay each Subcontractor, upon receipt of payment from the Owner, out of the amount paid to the Contractor on account of such Subcontractor's portion of the Work, the amount to which said Subcontractor is entitled," and "payments 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." *Westview*, 133 Wn. App. at 846 (emphasis added). The *Westview* court held that the "contract language evinces an express understanding on the part of the general contractor that it is not to hold the progress payments as its own absolute property but to hold and apply them for certain specified purposes, that is, for the benefit of the subcontractors." 133 Wn. App. at 847.

The primary objective in contract interpretation is to ascertain the mutual intent of the parties at the time they executed the contract. *Int'l Marine Underwriters v. ABCD Marine, LLC*, 179 Wn.2d 274, 282, 313 P.3d 395 (2013). Washington follows the "objective manifestation theory" of contract interpretation, under which the focus on the reasonable meaning of the contract language to determine the parties' intent. *Hearst Commc'ns, Inc. v. Seattle Times, Co.*, 154 Wn.2d 493, 503, 115 P.3d 262 (2005).

Here, Hartford argues that a provision in its Indemnity Agreement with Waka titled "Trust Fund," creates an express trust.[2] The provision states:

> 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.

CP at 13 (emphasis added).

Westview is distinguishable from this case. In *Westview*, the property owner and the contractor agreed to the establishment of the trust for the benefit of the subcontractors. 133 Wn. App. at 841, 844, 846. Here, the surety sits in a different position than the property owner. The GSA is akin to the owners in *Westview*. In *Westview*, the subcontractors were not paid in full. 133 Wn. App. at 843. Here, there is no evidence the subcontractors were not paid at the time of the $103,410 deposit.

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[2] Hartford also argues a provision in the contract between the GSA and Waka creates an express trust. But that provision merely states that the GSA will make progress payments, what the contractor must include in its requests for progress payments, and that the contractor must certify that the progress payment requests are proper. The provision does not require Waka to hold any funds for the benefit of the subcontractors or demonstrate any intent by the parties to create an express trust.

Further, the contract provisions in *Westview* expressly stated that the general contractor had to hold the payments for the benefit of project subcontractors. 133 Wn. App. at 846. Here, there is no such requirement. Even though the provision in the Indemnity Agreement is titled "Trust Fund" and stated that project payments would be "impressed with a trust" to satisfy bond obligations, the language does not demonstrate an express understanding that Waka would *hold* progress payments in trust. CP at 13. Additionally, there is no evidence that Hartford or Waka contemplated that project payments would be held to satisfy bond obligations. Instead, until mid-June 2012, Waka was free to spend the funds without any oversight of Hartford and for work performed on multiple projects.

Hartford's argument that all project payments were immediately impressed with a trust to satisfy some future, contingent bond liability would lead to absurd results. We avoid interpreting statutes and contracts in ways that lead to absurd results. *Forest Mktg. Enters., Inc. v. Dep't of Natural Res.*, 125 Wn. App. 126, 132, 104 P.3d 40 (2005). Under this argument, Waka could not use project payments to pay subcontractors or pay for other project expenses until completion of the project and discharge of the bond. Obviously, this result is not what the parties intended. Instead, it appears that the contract language provides for the creation of an express trust at some point in the future, after Hartford actually made payments under the bond.

Here, the contract language did not establish an immediate trust. And the trust provision was not triggered until Hartford started making payments under the bond in July. Thus, at the time the GSA deposited the $103,410 progress payment into Waka's account and Columbia took the money to satisfy its debt, no express trust existed.

We hold that the Indemnity Agreement did not establish a trust and that no trust existed. Accordingly, Columbia had no duty to inquire if the funds were being deposited into a trust account.

III. EQUITABLE SUBROGATION

Hartford next argues that it possessed an equitable lien on the progress payment funds under the principles of equitable subrogation and that its lien was superior to Columbia's. Because Hartford had not suffered a loss at the time the progress payment at issue was deposited, it did not possess an equitable lien.

Equitable subrogation allows a party who satisfies another's obligation to recover from the party primarily liable for the extinguished obligation. *Columbia Cmty. Bank v. Newman Park, LLC*, 177 Wn.2d 566, 573, 304 P.3d 472 (2013). "The right of 'legal' or 'equitable' subrogation arose as a 'creature of equity' and 'is enforced solely for the purpose of accomplishing the ends of substantial justice.'" *In re Hamada*, 291 F.3d 645, 649 (9th Cir. 2002) (quoting *Memphis & L.R.R. Co. v. Dow*, 120 U.S. 287, 302, 7 S. Ct. 482, 30 L. Ed. 595 (1887)).

Sureties who are forced to pay their principal's debts are entitled to be reimbursed. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 136-38, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962). This right of subrogation occurs even without a contractual promise. *Pearlman*, 371 U.S. at 136-37. Sureties have an equitable right to be indemnified from the retained funds. *Pearlman*, 371 U.S. at 136-38 ("Traditionally sureties compelled to pay debts for their principal have been deemed entitled to reimbursement. . . . And probably there are few doctrines better established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed."). "[W]here 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, at least to the extent of the surety's expenses." *Levinson v. Linderman*, 51 Wn.2d 855, 863, 322 P.2d 863 (1958) (citations and internal quotation marks omitted).

However, Hartford had not obtained an equitable lien at the time Columbia took the money from Waka's account for two reasons. First, the equitable right of subrogation is created at the time the surety issues the payment and/or performance bonds. *Levinson*, 51 Wn.2d at 864; *see also In re Massart Co.*, 105 B.R. 610, 612 (W.D. Wash. 1989). But the right of *enforcement* under equitable subrogation becomes available only after the "surety suffers a loss by making payments pursuant to the obligation under the bond." *Massart*, 105 B.R. at 612 (internal quotation marks omitted); *see also Levinson*, 51 Wn.2d at 864 (right of equitable subrogation became available when the surety completes the work at a loss).

Here, Hartford argues that it has a superior right to the $103,410 progress payment because it had an equitable lien in the Dalton Project progress payments beginning on June 21, 2012 when it issued its bonds for the Dalton Project. But Hartford had not yet acted under its performance bond at the time of the $103,410 deposit and there is no evidence that the Dalton Project subcontractors or suppliers had not been paid. Thus, 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. *See Massart*, 105 B.R. at 612.

Second, "[o]rdinarily a surety asserts the doctrine of equitable subrogation to acquire retained contract funds that are still in the government's possession after performance of the contract is complete." *Capitol Indem. Corp. v. United States*, 71 Fed. Cl. 98, 102 (2006) (citing *Prairie State Nat'l Bank of Chicago v. United States*, 164 U.S. 227, 17 S. Ct. 142, 41 L. Ed. 412 (1896)). However, no retained or unpaid funds existed in this case. Instead, a direct deposit of a progress payment went into Waka's account with Columbia. Progress payments differ from

retained funds because progress payments are funds that belong to the free flow of commerce once they are properly paid over. *Capitol Indem. 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.").

Accordingly, we hold that Hartford did not possess an equitable lien in the progress payment that is superior to Columbia's right to the progress payment.[3] We affirm the superior court's granting of summary judgment to Columbia and its order dismissing Hartford's claims.

Melnick, J.

We concur:

Johanson, C.J.

Maxa, J.

[3] Because Hartford's express trust and equitable subrogation arguments fail, it has no right to claim any entitlement to the funds. Accordingly, we need not address Hartford's conversion argument.

IN THE COURT OF APPEALS OF THE STATE OF WASHINGTON

DIVISION II

HARTFORD FIRE INSURANCE COMPANY,

Appellant,

v.

COLUMBIA STATE BANK,

Respondent.

No. 45320-7-II

ORDER DENYING MOTION FOR RECONSIDERATION

APPELLANT moves for reconsideration of the Court's **September 9, 2014** opinion.

Upon consideration, the Court denies the motion. Accordingly, it is

SO ORDERED.

PANEL: Jj. Johanson, Maxa, Melnick

DATED this 29th day of October, 2014.

FOR THE COURT:

Johanson, C.J.
CHIEF JUDGE

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APPENDIX

CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury under the laws of the State of Washington that on the 1st day of December, 2014, I caused a true and correct copy of the foregoing Petition for Review to be delivered by email and United States mail to the following counsel of record:

Counsel for Defendant/Respondent:

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DATED this 1st day of December, 2014, at Seattle, Washington.

Diane Bulis
Legal Assistant