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No. 36340-2-II

COURT OF APPEALS,  
DIVISION TWO  
OF THE STATE OF WASHINGTON

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N. JACK ALHADEFF, *Plaintiff/Appellant*,

v.

KITSAP COMMUNITY FEDERAL CREDIT UNION dba KITSAP CREDIT UNION,  
*Defendant/Respondent.*

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BRIEF OF APPELLANT

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**I.**

**ASSIGNMENTS OF ERROR**

The trial court erred when it granted Defendant/Respondent Kitsap Community Federal Credit Union's motion for summary judgment dismissing all of the claims asserted by Plaintiff/Appellant N. Jack Alhadeff against Kitsap Community Federal Credit Union.

**II.**

**ISSUES PERTAINING TO ASSIGNMENT OF ERROR**

A. Did the trial court err when it concluded that plaintiff's sole remedy against defendant Kitsap Community Federal Credit Union was for breach of warranty under RCW 62A.5-110(1)(b), a cause of action that was not asserted by plaintiff in the court below?

B. Did the trial court err when it concluded that all of plaintiff's claims against defendant Kitsap Community Federal Credit Union are barred by the one-year statute of limitations in RCW 62A.5-115?

C. Did the trial court err when it concluded that defendant Kitsap Community Federal Credit Union owed no duties, had no contracts or other obligations recognized by the common law of the State of Washington that are applicable in this case, other than those arising under Letter of Credit No.

NZS488105, issued by Wells Fargo Bank, N.A.?

### III.

#### STATEMENT OF THE CASE

##### A. KCU Makes Construction Loan To Meridian

This action arises out of a construction loan (the “Construction Loan”) made by Kitsap Community Federal Credit Union, doing business as Kitsap Credit Union (“KCU”), on June 27, 2003 to The Meridian On Bainbridge Island, LLC (“Meridian”) to build a condominium project on Bainbridge Island known as The Meridian On Bainbridge Island (the “Project”). CP 61; ¶ 2. When KCU made its loan, the total cost to complete the Project was \$6,565,451, of which \$2,095,293 had already been paid by Meridian. *Id.* KCU made a loan of \$4,500,000. *Id.* A total of \$5,460,000 was needed by Meridian in order to complete construction of the Project: \$4,470,158, the actual costs to complete construction; and an additional \$990,000 to pay off the existing first deed of trust. *Id.* One condition of KCU’s loan commitment was that Meridian contribute additional funds for the Project by means of an irrevocable letter of credit in the amount of \$1,000,000.00 (the “LOC”) to be issued to KCU. *Id.* Upon drawing on the LOC, the funds were to be disbursed by KCU to Meridian as if they were additional loan proceeds to be

used by Meridian solely for development and construction of the Project. Together with KCU's loan proceeds of \$4.5 million, the LOC proceeds would cover the \$5,460,000 needed to complete construction of the Project under the budget approved by KCU. *Id.*

**B. Alhadeff Provides Letter Of Credit**

Upon the terms and conditions set forth in that certain Letter of Credit Agreement (the "LOC Agreement") with Meridian, plaintiff N. Jack Alhadeff caused his bank, Wells Fargo Bank, N.A. ("Wells Fargo") to provide to KCU the LOC in the amount of \$1 million, for the benefit of Meridian. CP 61; ¶ 3. Upon the request of Plaintiff, on July 2, 2003, Wells Fargo issued the LOC, No. NZS488105, to KCU. *Id.*

**C. KCU/Alhadeff Agreement**

Prior to entering into the LOC Agreement with Meridian, plaintiff asked KCU for a letter agreement setting forth the terms and conditions upon which he could rely in funding the LOC, *i.e.*, the consideration he was to receive from KCU in return for agreeing to fund the LOC. CP 61; ¶ 4. Plaintiff's attorney Michael D. Ross submitted a proposed letter agreement to KCU for its signature on June 27, 2003, which contained, *inter alia*, the following two provisions:

3. Kitsap Credit Union shall not draw upon the Letter of Credit in the event the Borrower is in default under the Construction Loan or an event exists that may, with the passage of time, constitute a default under the Construction Loan.

...

5. All amounts otherwise available for disbursement to Borrower shall be paid to you until you are paid in full. In addition, ten percent (10%) of the net proceeds from the sale of any portion of the Project shall be released to you in payment of the amounts owed by the Borrower to you.

CP 61-62; ¶ 4. On July 2, 2003, Douglas B. Chadwick, KCU's Director of Commercial Lending, sent Mr. Ross a revised letter agreement that did not contain paragraphs 3 and 5 set out above. In the accompanying email, Mr. Chadwick explained the exclusion of the subject paragraphs as follows:

2. Paragraph #5. We have eliminated this paragraph and suggest that the 10% net proceeds on the sale of units that was designated to Meridian be assigned by Meridian back to Jack. This is much cleaner for us and we would honor that assignment. Using an assignment is a better method for us.

3. Paragraph # 3 [*sic*] On each request for draws under the Letter of Credit we are required to affirm that there are no events of default and think this is sufficient protection.

CP 62; ¶ 4. In reliance on Mr. Chadwick's July 2, 2003 email, a copy of which is attached as CP 71-72, together with the Letter Agreement dated July 1, 2003, a copy of which is attached as CP 73-74, plaintiff agreed to fund the

LOC.

**D. Assignment of 10% of Net Proceeds**

The LOC Agreement between plaintiff and Meridian provides that ten percent (10%) of the net proceeds from the sale of any portion of the Project, that was otherwise payable at closing to Meridian, was to be paid to plaintiff in payment of amounts owed to him by Meridian. CP 62; ¶ 5. As a result of this assignment of proceeds, and KCU's agreement to honor such assignment, as described above, plaintiff had an absolute right to payment of ten percent (10%) of the net proceeds from the sale of any portion of the Project. *Id.*

**E. KCU Makes First Draw on LOC**

On May 11, 2004, KCU presented its sight draft to Wells Fargo on the LOC in the amount of \$415,000.00, which was accompanied by a letter of the same date, signed by Brett Jorgenson, Senior Vice President of KCU, which included the following certification:

The undersigned, an authorized officer of Kitsap Community Federal Credit Union, ("Kitsap") hereby certifies, under penalty of perjury, that all funds have been advanced (less any interest reserve) to the Meridian on Bainbridge Island, LLC (the "Borrower") under or in connection with that certain construction loan promissory note (the "Note") dated as of June 27, 2003 in the aggregate amount of \$4,500,000 established by Kitsap in favor of borrower, an "Event of Default" (as defined in the Note) has not occurred, no event exists that may, with the passage of time, constitute an "Event

of Default”, Borrower is currently not in default, . . . and Kitsap is now drawing the sum of \$415,000.

CP 63; ¶ 6. (Copies of this sight draft and accompanying letter are attached as CP 107-09).

**F. KCU Makes Second Draw on LOC**

On June 11, 2004, KCU presented its sight draft to Wells Fargo on the LOC in the amount of \$474,850.00, which was accompanied by a letter of the same date, signed by Mr. Jorgenson, which contained the same certification set out above, except for the last clause, which read as follows: “and Kitsap is now drawing the sum of \$474,850. CP 63; ¶ 7. (Copies of this sight draft and accompanying letter are attached as CP 110-12).

**G. KCU Makes Third Draw on LOC**

On July 8, 2004, KCU presented its sight draft to Wells Fargo on the LOC in the amount of \$110,150.00, which was accompanied by a letter of the same date, signed by Mr. Jorgenson, which contained the same certification set out above, except for the last clause, which read as follows: “and Kitsap is now drawing the sum of \$110,150.” With this third draw, the entire LOC was drawn upon. CP 63; ¶ 8. (Copies of this sight draft and accompanying letter are attached as CP 113-15).

**H. Meridian Changes the Scope of the Project**

Doug Chadwick testified at his deposition on March 12, 2007, that as early as April 2004, but certainly before May 11, 2004, the date of KCU's first draw on the LOC, with the approval of KCU, Meridian had changed the scope of the Project, with a revised budget at least a million dollars greater than the construction budget on which KCU's \$4,500,000 loan was based, and had already commenced to incur construction costs that were beyond Meridian's ability to pay. He testified as follows:

Q. So is it your testimony, then, that in the spring of 2004, perhaps even in April, Meridian had already commenced work that was above the budget that was approved in the four and a half million-dollar loan?

A. I believe so.

...

Q. In the spring of 2004, were you concerned or to your knowledge anyone else at the Credit Union concerned that Meridian would be able to pay the construction costs, the ongoing construction costs, based on the funding it already had in place?

A. Yes.

Q. So you were concerned that they would run out of money?

A. Yes.

Q. And that's because they presented this revised budget for at least an extra million dollars, right?

A. Yes.

Q. And they didn't have an extra million dollars?

A. That's correct.

Q. Is it fair to say that Mr. Jorgenson was aware of this concern as well?

A. Oh, yes.

Q. Is it fair to say that Mr. Jorgenson was aware at least by May 11, 2004 when he certified the first draw request to Wells Fargo Bank --

A. Yes.

CP 99-101. The increased construction costs that Meridian had already commenced to incur were based on changes in the scope of the Project that included a 9,925 sq. ft. expansion to the fourth floor of the building to include three commercial office suites and guest suites. The changes in the scope of the project added in excess of \$1 million to the cost to complete the Project.

CP 64; ¶ 9.

**I. No One Advises Alhadeff of Changes in the Scope of the Project**

Plaintiff did not learn of the changes in the scope of the Project, or the increased costs that were being incurred by Meridian, until long after KCU

drew all the funds on the LOC. CP 64; ¶ 10. If he had known of the changes and increased costs, plaintiff would have been able to protect his interests by ensuring that draw requests made on the LOC he had funded would be based upon accurate representations by KCU to Wells Fargo and, if necessary, by taking action to prevent Wells Fargo from honoring draw requests based on false or fraudulent certifications. *Id.* The two KCU employees who administered the Construction Loan—Doug Chadwick, Director of Commercial Lending and Brett Jorgenson, Senior Loan Officer—admitted in their depositions that they could not recall advising plaintiff of the change in scope and increased costs at any time prior to July 8, 2004, the date of KCU's last draw on the LOC. *Id.* By that point, the funds plaintiff provided through the LOC to Meridian to pay construction costs had been expended, primarily to protect the first position deed of trust of KCU. *Id.*

**J. KCU Admits Its Certifications In Connection With Draw Requests Were Not Correct**

Doug Chadwick admitted in his deposition that KCU had incorrectly certified to Wells Fargo Bank on each draw request on the LOC that there were no events of default, when it knew that events of default had, in fact, occurred. He testified as follows:

Q. Am I correct in assuming that each of the three certifications made by Mr. Jorgenson that appear in Exhibit 12 are inaccurate or defective for failing to reflect the event of default on the part of Meridian by failing to pay its first half 2004 real estate taxes?

A. That's correct.

Q. If Mr. Jorgenson in his first draw request, May, 11, 2004 on the Letter of Credit, had correctly certified with respect to events of default and said that there was an event of default, would the Credit Union have been able to draw on the Letter of Credit on that date?

A. We would not have made the request.

Q. You would not have made the request. Why is that?

A. Because there existed an event of default.

Q. So the proper certification could not have been made?

A. That's correct.

Q. Is that also true for the draw request dated June 11, 2004, that if you had been aware of the defaults either in failing to pay real estate taxes or in the Rain City Contractors's lien, that the Credit Union would not have made the June 11, 2004 draw request?

A. That's correct.

Q. And is the same thing true for the draw request dated July 8, 2004?

A. Yes.

Q. If those draw requests were not made, then the Letter of

Credit would not have been drawn upon and Mr. Alhadeff would have been refunded his \$1 million; isn't that correct?

A. Well, if no draw had been made, there would be nothing to refund.

Q. But the Letter of Credit had a period of duration, did it not; it had to be drawn upon or not by a certain date; isn't that true?

A. I believe so.

Q. What happens if it's not drawn upon by the last date of its term?

A. Then you can't draw on it, it expires.

CP 96-8. Thus, KCU admitted that each of its three certifications to Wells Fargo contained gross misrepresentations of fact. These misrepresentations may rise to the level of fraud, given that KCU's own files reveal its knowledge of the defaults at the time of each of the three draws on the LOC.

**K. Meridian Applies For Additional Loan From KC**

When KCU took its three draws on the LOC, the Construction Loan was fully disbursed and Meridian was already in default under the Construction Loan and without funds to complete the Project. CP 64; ¶ 11. By September 2004, Meridian owed in excess of \$1.1 million in unpaid invoices for work done on the Project. *Id.* Meridian requested KCU to provide additional funding. *Id.* The Project's costs to completion were

estimated by KCU to have increased an additional \$2,178,895. *Id.* KCU agreed to advance to Meridian an additional \$1,350,000, with the estimated \$828,895 in additional funds needed to complete the Project to be paid by Meridian from other sources. *Id.* On September 30, 2004, Meridian executed an additional note to KCU in the principal amount of \$1,350,000. *Id.*

**L. KCU Declares Default On The Construction Loan**

On November 29, 2006, KCU formally declared the Construction Loan to be in default. On April 9, 2007, plaintiff received a Notice of Trustee's Sale under KCU's first position deed of trust against the eleven remaining unsold condominium units in the Project. CP 65; ¶ 12.<sup>1</sup> Plaintiff understands that Meridian has no assets other than the Project itself. *Id.* Although the members of Meridian are parties to this lawsuit, their guaranty of Meridian's obligations to plaintiff under the Letter of Credit Agreement are limited to their membership interest in Meridian. *Id.* Thus, because of KCU's alleged breaches of contract, misrepresentation and negligence in the way it drew down the LOC and administered the Construction Loan—which

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<sup>1</sup>The Trustee's sale was scheduled for July 6, 2007, then continued to July 27, 2007. On July 25, 2007, *i.e.*, after the hearing on KCU's motion for summary judgment in the court below, Meridian filed a petition for relief under Chapter 11 of the United States Bankruptcy Code in the U. S. Bankruptcy Court for the Western District of Washington, Case No. 07-13408. Meridian's Chapter 11 filing does not affect the ongoing litigation, including this appeal, against any party other than Meridian, against which the litigation in the court below is stayed under 11 U.S.C. ¶ 362(a).

Doug Chadwick testified was the first commercial construction loan ever made by KCU, a fact that might explain the way the loan was administered—the Project, although completed, became a financial disaster for plaintiff. *Id.* There appears to be little prospect of being paid the approximately \$1,600,000.00 plaintiff is owed by Meridian under the LOC Agreement. Meridian has no assets other than the Project and is now in a Chapter 11 proceeding.

**M. Plaintiff's Claims Against KCU**

Plaintiff has asserted eight causes of action against KCU:

1. First Cause of Action. Breach of KCU's agreement to make valid certifications to Wells Fargo Bank upon drawing on the LOC.
2. Second Cause of Action. Breach of KCU's agreement to pay to plaintiff ten percent of the net proceeds from sales of individual condo units.
3. Third Cause of Action. A promissory estoppel claim based on KCU's promise that it would not take draws on the LOC if it could not make the certifications with respect to the absence of any Events of Default under the note dated June 27, 2003.
4. Fourth Cause of Action. A negligence claim based on KCU's

failure to exercise reasonable care when making its certifications of fact to Wells Fargo upon drawing on the LOC that such certifications were accurate and truthful.

5. Fifth Cause of Action A negligence claim based on KCU's failure to exercise reasonable care when making the representations upon which plaintiff relied in agreeing to fund the LOC. One such representation was KCU's agreement and, by implication, its ability, to honor Meridian's assignment to plaintiff of ten percent (10%) of the net proceeds from the sale of any portion of the Project. Plaintiff alleged that, when making this representation, KCU knew, or in the exercise of reasonable care, should have known, that Michael Mastro, the beneficiary under the second deed of trust against the Project, could prevent the distribution of net proceeds of sale of any portion of the Project to any party other than to KCU to reduce the amount of KCU's senior deed of trust. KCU had a duty to disclose this information to plaintiff and failed to do so. KCU's failure to disclose this information rendered its statement, *i.e.*, that it would honor Meridian's assignment to plaintiff of ten percent (10%) of the net proceeds from the sale of any portion of the Project, deceptive and misleading.

6. Sixth Cause of Action. A conversion claim for wrongfully

obtaining the funds represented by the LOC under false pretenses.

7. Seventh Cause of Action. An equitable claim under the doctrine of money had and received on the grounds that KCU is not entitled in equity to retain the \$1 million represented by the draws it made on the LOC.

8. Eighth Cause of Action. A negligence claim for failing to advise plaintiff of the changes in the scope of the Project, and their effect on the viability of the Project, prior to the first draw on the LOC.

**N. Procedural History**

Plaintiff filed his original Complaint For Monies Due On Promissory Note And Deed Of Trust, For Reservation Of Right To Foreclose And To Enforce Personal Guaranty on April 18, 2006. On August 30, 2006, plaintiff filed his Amended Complaint For Damages For Breach Of Contract, Negligence, Conversion, etc., under which he added KCU as a party defendant and asserted additional claims. KCU answered the Amended Complaint and subsequently filed its Motion for Summary Judgment, CP 23-26, which was heard on April 27, 2007. On May 14, 2007, the trial court entered its Order Granting Motion Of Defendant Kitsap Community Federal Credit Union For Summary Judgment, CP 145-47, which order was certified

as a final order under CR 54(b). Plaintiff timely filed his notice of appeal from said order on May 23, 2007. CP 143-47.

#### IV.

#### SUMMARY OF ARGUMENT

KCU's sole argument on summary judgment can be summarized as follows: 1) all of the causes of action asserted against it by plaintiff arise under Article 5 of the Uniform Commercial Code, RCW 62A.5-101, *et seq.*; 2) the statute of limitations for actions under Article 5 is one year; 3) this lawsuit was filed more than one year after plaintiff's causes of action accrued. As a consequence, KCU argued, all of plaintiff's causes of action against KCU are time-barred. The trial court accepted KCU's argument and summarily dismissed all of plaintiff's claims against it.

The trial court erred in concluding that any, much less all, of plaintiff's claims arise under Article 5 of the UCC and are time-barred under RCW 62A.5-115.

Plaintiff's claims do not arise under the UCC, nor are they governed or displaced by the UCC. The statute of limitations under Article 5, RCW 62A.5-115, applies only to actions brought to enforce a right or obligation arising under Article 5 of the UCC; plaintiff did not sue to enforce such a

right or obligation. RCW 62A.5-110(1)(b) does not displace plaintiff's common-law and equitable claims, which are independent of any claims plaintiff might have asserted under the UCC.

## V.

### ARGUMENT

#### A. Standard Of Review

In an appeal of a trial court's grant or denial of a motion for summary judgment, the appellate court engages in the same analysis as the trial court; its review is *de novo*. *Sequim v. Malkasian*, 157 Wn.2d 251, 261, 138 P.3d 943 (2006). A summary judgment motion under CR 56(c) can be granted only if the pleadings, affidavits, depositions, and admissions on file demonstrate that there is no genuine issue as to any material fact, and that the moving party is entitled to judgment as a matter of law. *Barrie v. Hosts of Am., Inc.*, 94 Wn.2d 640, 642, 618 P.2d 96 (1980).

In this case, the trial court did not find any material facts in dispute. The trial judge ruled as a matter of law that the issues raised on KCU's motion for summary judgment are governed by Article 5 of the Uniform Commercial Code as codified in RCW 62A.5-101, *et seq.* and that all of plaintiff's claims against defendant KCU are barred by the one-year statute of limitations in RCW 62A.5-115. The errors committed by the trial court

consisted in its application of the law to the undisputed facts.

**B. Explanation of Letters of Credit**

This case involves the application of Article 5 of the Uniform Commercial Code (the “UCC”), which is entitled “Letters Of Credit,” and codified in Washington as RCW 62A.5-101, *et seq.* No reported decision of a Washington appellate court appears to address Article 5 of the UCC. The Washington Comments to Article 5, upon its enactment in 1965, commence with the following statement:

Since most of the problems which can arise in letter of credit transactions have not reached the Washington court, annotating Article 5 to the Washington law is not a worthwhile enterprise.

Washington Comments [1965 Enactment] to Article 5, RCW 62A.5-101, *et seq.* The sections of Article 5 of the UCC that are relevant on this appeal, RCW 62A.5-110, 62A.5-111 and 62A.5-115, were revised in 1997, with the result that there is very little case law in any jurisdiction addressing these relevant sections of Article 5.

A review of some basic definitions is in order to understand the operation of Article 5. In the LOC transaction, plaintiff was the “applicant,” who is the “person at whose request or for whose account a letter of credit is issued.” RCW 62A.5-102(1)(b). Wells Fargo Bank was the “issuer,” RCW

62A.5-102(1)(I), and KCU was the “beneficiary,” which “means a person who under the terms of a letter of credit is entitled to have its complying presentation honored.” RCW 62A.5-102(1)(c). A “letter of credit” is defined as:

a definite undertaking that satisfies the requirements of RCW 62A.5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

RCW 62A.5-102(1)(j).

The LOC funded by plaintiff was simply called a “letter of credit” that was “irrevocable,” a term that is not defined in Article 5, but is otherwise defined as follows:

***irrevocable letter of credit.*** A letter of credit in which the issuing bank guarantees that it will not withdraw the credit or cancel the letter before the expiration date; a letter of credit that cannot be modified or revoked without the customer’s consent.

*Black’s Law Dictionary* 915 (7<sup>th</sup> ed. 1999). Two of the most common types of letters of credit, whose definitions are not provided in Article 5, but through custom and usage, are “commercial” (or “documentary”) letters of credit and “standby” letters of credit. A “commercial” or “documentary” letter of credit is used as a method of payment by the applicant/buyer,

typically in a sale of goods, and is payable by the issuer bank—the applicant/buyer’s bank--when the beneficiary/seller presents to the issuer a document such as a certificate of title or an invoice. *Black’s Law Dictionary* 915 (7<sup>th</sup> ed. 1999). Such a commercial or documentary letter of credit is most commonly used in an international transaction.

A “standby” letter of credit, on the other hand, is

used to guarantee either a monetary or a nonmonetary obligation (such as the performance of construction work), whereby the issuer agrees to pay the beneficiary if the customer [applicant] defaults on its obligation.

*Black’s Law Dictionary* 916 (7<sup>th</sup> ed. 1999). Thus, the “standby” letter of credit is posted as security for the contractual performance of some party, often the “applicant” itself. The applicant provides the letter of credit of its bank as security for the applicant’s payment of monies, or other performance, under an agreement with a third party, usually the beneficiary of the letter of credit. In the event of a default in making payment under the underlying contract by the party whose performance under said contract is “secured” or guaranteed by the standby letter of credit, the beneficiary is entitled to draw on the letter of credit to obtain payment under the underlying contract. In this sense, a standby letter of credit is the functional equivalent of a payment or performance bond issued by a surety.

A standby letter of credit typically calls for a document reciting that the issuer's account party has defaulted on a contractual obligation. *See State ex rel. MO. Highway & Transp. Comm'n v. Morganstein*, 703 S.W.2d 894, 898-99 (Mo. banc 1986); John F. Dolan, *The Law Of Letters Of Credit*, P 1.04, at 1-16 ( rev. ed. 1996).

*Global Network Tech. v. Regional Airport Auth.*, 122 F.3d 661, 664, n. 2 (8<sup>th</sup> Cir. 1997).

Although the LOC in the instant case was not issued in connection with a sale of goods, but, instead, was a financing vehicle whereby plaintiff essentially made a loan of \$1 million to Meridian in the form of the LOC issued by Wells Fargo to be drawn upon by KCU and its proceeds disbursed by KCU to Meridian for the construction of the Meridian Project, it can, nonetheless be characterized as a "commercial" or "documentary" letter of credit. The subject LOC **cannot**, however, be characterized as a "standby" letter of credit because it does not share the one critical element that defines a "standby" letter of credit, *i.e.*, plaintiff's LOC was **not** posted as security—or to "stand by"-- for the contractual performance of any party; instead, the LOC was a payment vehicle, intended to provide additional funding to Meridian to complete construction of the Meridian project under the budget approved by KCU in connection with KCU's construction loan to Meridian of \$4.5

million.<sup>2</sup>

In the case at bar, the “document” specified in the LOC was a “statement” to be provided to the issuer—Wells Fargo—by KCU, which included the following certification:

The undersigned, an authorized officer of Kitsap Community Federal Credit Union, (“Kitsap”) hereby certifies, under penalty of perjury, that all funds have been advanced (less any interest reserve) to the Meridian on Bainbridge Island, LLC (the “Borrower”) under or in connection with that certain construction loan promissory note (the “Note”) dated as of June 27, 2003 in the aggregate amount of \$4,500,000 established by Kitsap in favor of borrower, an “Event of Default” (as defined in the Note) has not occurred, no event exists that may, with the passage of time, constitute an “Event of Default”, Borrower is currently not in default, . . . and Kitsap is now drawing the sum of {insert amount}.

(A copy of the LOC is attached as CP 104-05.)<sup>3</sup> KCU admitted that it made false certifications to Wells Fargo on each of its three draws on the LOC.

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<sup>2</sup>In oral argument on the motion for summary judgment, counsel for KCU characterized the subject LOC as a “sort of a stand-by arrangement, . . .” RP 4, line 25 to 5, line 1. Such a characterization is as unfair as it is incorrect.

<sup>3</sup>The Court should note that, as opposed to the typical standby letter of credit, which requires presentation of a document reciting the default of the party whose performance is guaranteed by the standby letter of credit, the LOC issued by Wells Fargo required KCU’s written certification that Meridian was **not** in default under its Construction Loan from KCU.

**C. Plaintiff's Claims Do Not Arise Under The UCC, Nor Are They Governed Or Displaced By The UCC**

Although the LOC involved in this lawsuit is a letter of credit as defined under Article 5 of the UCC, it does not follow that the UCC displaces all other law in connection with a dispute that involves a letter of credit. RCW 62A.5-103 defines the scope of Article 5 as follows: “(1) This Article applies to letters of credit and to *certain* rights and obligations arising out of transactions involving letters of credit.” (Emphasis added). The Official Comments to UCC §5-103 explain the limited scope of Article 5 and the applicability of other rules of law:

2. Like all of the provisions of the Uniform Commercial Code, Article 5 is supplemented by Section 1-103 and, through it, by many rules of statutory and common law. Because this article is quite short and has no rules on many issues that will affect liability with respect to a letter of credit transaction, law beyond Article 5 will often determine rights and liabilities in letter of credit transactions. Even with letter of credit law, the article is far from comprehensive; it deals only with “certain” rights of the parties.

UCC §5-103, Official Comment 2. Washington’s version of Section 1-103, mentioned in the Comment set out above, states as follows:

Unless displaced by the particular provisions of this Title, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake,

bankruptcy, or other validating or invalidating cause shall supplement its provisions.

RCW 62A.1-103. The Official Washington Comment to this section states in pertinent part as follows:

This section is in accord with several of the earlier uniform laws. . . It is also in accord with RCW 4.01.010, which preserves the common law in Washington save where in conflict with legislation or contemporary mores.

RCW 62A.1-103, Official Comments. The Official Comments to the UCC emphasize that the principles of law and equity, which remain applicable unless specifically displaced by provisions of the UCC, are not limited to those enumerated in Section 1-103: “The listing [of the various principles of law and equity] given in this section is merely illustrative; no listing could be exhaustive.” UCC §1-103; Official Comment 3. Washington courts have acknowledged the mandate of RCW 62A.1-103 and have held that under RCW 62A.1-103, common-law principles regarding commercial transactions, not specifically replaced by the UCC, are adopted. *See e.g., George Lumber Co. v. Brazier Lumber Co.*, 6 Wn.App. 327, 493 P.2d 782 (1972) (common law principles not specifically replaced by the UCC are adopted by it); *Syrovoy v. Alpine Resources*, 122 Wn.2d 544, 859 P.2d 51 (1993) (common law principles apply to matters that generally are governed by the UCC but

are not specifically addressed by the Code). Plaintiff is unaware of any reported decision of any court from any jurisdiction which has held that Article 5 displaces *all* other civil law in connection with *any and all* causes of action involving a letter of credit.

Plaintiff's claims, all of which arise under either common-law or equitable principles, can be broken down as follows:

a. Two are common-law breach of contract claims: First Cause of Action for breach of the underlying contract with KCU based on KCU's breach of its agreement to make valid certifications to Wells Fargo Bank upon drawing on the LOC; Second Cause of Action for breach of the agreement to pay to plaintiff ten percent of the net proceeds from sales of individual condo units.

b. Four are common-law tort claims: Fourth Cause of Action for negligence based on KCU's failure to exercise reasonable care in making its certifications of fact to Wells Fargo that such certifications were accurate and truthful; Fifth Cause of Action for negligent misrepresentation for failure to exercise reasonable care when making the representations upon which plaintiff relied in agreeing to fund the LOC; Sixth Cause of Action for conversion; and Eighth Cause of Action for negligence for failing to advise

plaintiff of the changes in the scope of the Project, and their effect on the viability of the Project, prior to the first draw on the LOC.

c. Two are equitable claims: Third Cause of Action for promissory estoppel; Seventh Cause of Action for money had and received.

Professors White and Summers have observed as follows with respect to Article 5 of the UCC:

Most of Article 5's provisions deal with the rights and obligations between the beneficiary and the issuer. A few of the provisions deal with the rights and duties between the applicant and the issuer. However, Article 5 does not much concern itself with the reimbursement contract between the applicant and the issuing bank ***nor does it deal at all with the underlying contract between the applicant and the beneficiary.***

J. White & R. Summers, *Uniform Commercial Code*, vol. 3, 120 (1995) (emphasis added). Indeed, the Official Comments to the UCC specifically state that the contract between the applicant (here, plaintiff) and the beneficiary (here, KCU) is **not** governed by Article 5:

The contract between the applicant and beneficiary is not governed by Article 5, but by applicable contract law, such as Article 2 or the general law of contracts.

UCC §5-102, Official Comment 3. Thus, the trial court's ruling that plaintiff's two breach of contract claims, in addition to the tort and equitable claims, are all governed by Article 5, was erroneous.

**D. The Statute Of Limitations Under Article 5, RCW 62A.5-115, Applies Only To Enforcement Of A Right Or Obligation Arising Under Article 5 Of The UCC; Plaintiff Did not Sue To Enforce Such A Right Or Obligation**

The statute of limitations under Article 5, RCW 62A.5-115, provides as follows:

**An action to enforce a right or obligation arising under this Article** must be commenced within one year after the expiration date of the relevant letter of credit or one year after the cause of action accrues, whichever occurs later. A cause of action accrues when the breach occurs, regardless of the aggrieved party's lack of knowledge of the breach.

(Emphasis added). By its own terms, the statute of limitations under RCW 62A.5-115 does not apply in this case because none of plaintiff's causes of action was brought to "enforce a right or obligation arising under" Article 5.

This point is clarified in the Official Comments as follows:

2. This section applies to all claims for which there are remedies under Section 5-111 and to other claims made under this article, such as claims for breach of warranty under Section 5-110.

UCC §5-115, Official Comment 2. RCW 62A.5-111 provides no remedies to an applicant against a beneficiary and plaintiff has not asserted a breach of warranty claim against KCU under RCW 62A.5-110(1)(b). Accordingly,

none of plaintiff's eight causes of action is brought to enforce a right or obligation that **arises** under Article 5; instead, each cause of action is based on general principles of common law or equity that are **not** displaced by Article 5 of the UCC.

It is interesting to note that, in the court below, KCU argued as follows: "It is Kitsap Credit Union's position that the claims that are the subject of this lawsuit are time barred [*sic*] because ***they arose out of an Article 5 transaction*** and were brought more than one year after they accrued." KCU's Reply, p. 4, ll. 20-22 (emphasis added). The trial judge accepted this position, concluding as follows:

But I find the sole relationship between your client and this financial institution [KCU] was set up under the letters [*sic*] of credit that he was the applicant for.

RP 32. RCW 62A.5-115 does **not**, however, apply to "claims [that] arose out of an Article 5 transaction," as KCU argued, or to claims that arose under a "relationship," as the trial court concluded; instead, the statute applies to "an action to enforce a right or obligation arising under" Article 5. The difference is significant: Certainly, plaintiff's claims arose out of the LOC, and plaintiff would not have had a "relationship" with KCU but for the LOC; but plaintiff has not sought "to enforce a **right or obligation arising** under"

Article 5. Plaintiff's claims all arise under the general principles of common law or equity. Indeed, Article 5 is not even mentioned in the Amended Complaint!

**E. RCW 62A.5-110(1)(b) Does Not Displace Plaintiff's Common-Law And Equitable Claims**

The trial court ruled that all of plaintiff's claims are subsumed under the warranty provisions of RCW 62A.5-110, and, because of the one-year limitation period for filing an action under RCW 62A.5-110, are time-barred.

RCW 62A.5-110(1)(b) provides as follows:

(1) If its presentation is honored, the beneficiary warrants:

...

(b) To the applicant that the drawing does not violate any agreement between the applicant and beneficiary or any other agreement intended by them to be augmented by the letter of credit.

The gist of the warranty under RCW 62A.5-110(1)(b) is that KCU's three draws on the LOC did not violate any **agreement**, *i.e.*, either an agreement between KCU and plaintiff *inter se*, or, some "other agreement intended by [KCU and plaintiff] to be augmented by the letter of credit." Thus, the warranty is given with respect to some agreement to which the

beneficiary (here, KCU) is a party. The Official Comments to UCC § 5-110 make it clear what the beneficiary's warranty is, and what it is not:

It is **not** a warranty that the statements made on the presentation of the documents presented are truthful nor is it a warranty that the documents strictly comply under Section 5-108(a) [dealing with issuer's rights and obligations]. It is **a warranty that the beneficiary has performed all the acts expressly and implicitly necessary under any underlying agreement** to entitle the beneficiary to honor.

UCC § 5-110, Official Comment 2 (emphasis added). Simply stated, under RCW 62A.5-110(1)(b) the beneficiary warrants to the applicant that the beneficiary has performed all the acts the beneficiary is obligated to perform **under some agreement** that entitles the beneficiary to have its presentation honored by the issuer. If KCU cannot point to some "agreement" to which its alleged warranty under RCW 62A.5-110(1)(b) might relate, then, in that event, there is no statutory warranty under RCW 62A.5-110(1)(b).

KCU took the position in the court below that it had no contractual relationship with plaintiff: "There is simply no relationship between the parties other than that arising from the Letter of Credit." CP 123, ll. 5-7. *Quaere*: If there was no "agreement" between the beneficiary and applicant--as KCU argued is the situation in the case at bar--then what is the "agreement" to which KCU is a party under which KCU warranted that it

performed all the acts it was obligated to perform in order to entitle it to have Wells Fargo Bank honor its draw requests? KCU did not identify any such “agreement” to which it is a party, with respect to which its conduct could give rise to a claim to plaintiff under RCW 62A.5-110(1)(b). KCU did, however, refer to the LOC as the “underlying transaction” and stated that “[a]ny breach of warranty [under RCW 62A.5-110(1)(b)] arises when the Credit Union draws on the Letter of Credit in violation of express or implied obligations of the Letter of Credit transaction.” CP 125, II. 10-12. The language--and the logic--of the statute requires the existence of an “agreement” under which the warranty arises. Professors White and Summers observe that the letter of credit itself is not the “agreement” with respect to which the beneficiary gives its warranty under UCC § 5-110:

We believe that it is an express or an implied condition of the typical underlying commercial contract--**but not the letter of credit itself, of course**--that the beneficiary have properly performed in order for it to have a right *vis a vis* the applicant to draw under a letter of credit.

J. White & R. Summers, *Uniform Commercial Code*, vol. 3, 164 (1995) (emphasis added).

Plaintiff has asserted two causes of action for breach of contract: First Cause of Action for breach of KCU’s agreement to make valid certifications

to Wells Fargo Bank upon drawing on the LOC; Second Cause of Action for breach of the agreement to pay to plaintiff ten percent of the net proceeds from sales of individual condo units. The First Cause of Action is a contract with respect to KCU's entitlement to draw on the LOC, *i.e.*, KCU agreed to make valid certifications on its draw requests under the LOC to Wells Fargo. KCU breached this agreement three times, giving rise to a breach of the warranty under the first clause of RCW 62A.5-110(1)(b), *i.e.*, "that the drawing does not violate any agreement between the applicant and beneficiary . . . ." What is important here is **not** that KCU's conduct constitutes a breach of the first clause of the RCW 62A.5-110(1)(b) warranty; what **is** important is that, even though plaintiff **could have** asserted a warranty claim against KCU, **he still has a direct cause of action against KCU for breach of the underlying agreement.**

All commentary on the subject is of the same view: A breach of warranty of the underlying contract does **not** displace a common-law breach of contract claim.

The Official Comment to RCW 62A.5-110 is quite clear:

In most cases the applicant will have a direct cause of action for breach of the underlying contract. This warranty has primary application in standby letters of credit or other circumstances where the applicant is not a party to an

underlying contract with the beneficiary.

UCC §5-110; Official Comment 2. Professors White and Summers state as follows:

In most commercial letters of credit cases the warranty will **not** give the applicant more than it already has. **In those cases the very same act that will be a breach of the warranty is likely also to be a breach of an underlying contract and so give the applicant a claim under Article 2 of the UCC or other law.** Note, however, that the applicant's rights under Article 5 are unlikely to be coextensive with those under Article 2. For example, Article 2 allows consequential damages but Article 5 does not; **Article 5 has a one-year statute of limitations, Article 2 has a four-year statute**; Article 5 authorizes the recovery of lawyer's fees, Article 2 does not.

J. White & R. Summers, *Uniform Commercial Code*, vol. 3, 164 (4<sup>th</sup> ed. 1995) (emphasis added). Professor Anderson concurs:

The precise parameters and utility of this [5-110(1)(b)] warranty need to be understood.

This is a warranty that the beneficiary has duly performed whatever acts were implicitly or expressly necessary under any underlying agreement between the parties to entitle the beneficiary to honor of the credit.

...

**The applicant will seldom need this warranty where the breached "agreements" are contracts between the beneficiary and the applicant themselves. Under these circumstances, the applicant is adequately protected by being able to recover from the beneficiary for breach of**

**the underlying contract.**

L. Lawrence, *Anderson On The Uniform Commercial Code*, vol. 7A, 603 (3<sup>rd</sup> ed. 2001) (emphasis added).

Finally, a publication of the Business Law Section of the American Bar Association comments as follows:

Article 5 itself indicates where it yields to other law. The warranty and subrogation provisions of §§ 5-110 and 5-117 essentially direct that other law be applied to matters that might otherwise be viewed as exclusively governed by Article 5 and for which Article 5 deliberately provided no right or remedy. Similarly, Article 5 indicates where other law, alone or in combination with Article 5, governs LC proceeds.

**Article 5 should not change the ultimate rights of the applicant *vis-a-vis* the beneficiary under other law. For example, if an applicant reimburses an issuer that has honored the beneficiary's documents, then the applicant's rights and remedies against the beneficiary should depend on law outside Article 5.**

J. Barnes, J. Byrne & A. Boss, *The ABCs of the UCC, Article 5: Letters of Credit*, 71 (1998) (emphasis added).

In the instant case, Article 5 provides no remedy for any of the claims asserted by plaintiff against KCU. To reverse the ruling below, this Court does not need to determine whether any of plaintiff's claims have merit; the Court need only determine that one or more of plaintiff's causes of action against KCU is **not** "an action to enforce a right or obligation arising under

Article 5 of the UCC. Any such claim is not, as a matter of law, within the scope of the RCW 62A.5-115 one-year statute of limitations and should not have been dismissed.

## **VI.**

### **CONCLUSION**

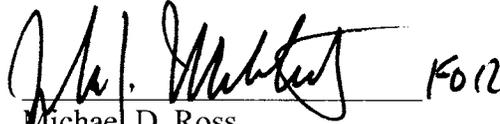
None of plaintiff's claims is displaced by the warranty provisions of RCW 62A.5-110, and, because of the one-year limitation period for filing an action under RCW 62A.5-110, time-barred. None of plaintiff's causes of action was brought to "enforce a right or obligation arising under" Article 5, the predicate to application of the one-year limitation period of RCW 62A.5-115. This Court should recognize that, although the circumstances surrounding the issuance of, and the drawing on the LOC, are, obviously, central to this case, not one of plaintiff's eight causes of action involves "rights and obligations" arising under the breach of warranty provisions of RCW 62A.5-110.

The order granting summary judgment should be reversed and the

plaintiff's claims against KCU remanded for trial on their merits.

RESPECTFULLY submitted this 1st day of October, 2007.

ROSS LAW ADVISORS PLLC

Handwritten signature of Michael D. Ross in black ink, written over a horizontal line. To the right of the signature, the number "15012" is handwritten.

Michael D. Ross  
WSBA No. 13891

LAW OFFICE OF JOHN J. MITCHELL

Handwritten signature of John J. Mitchell in black ink, written over a horizontal line.

John J. Mitchell  
WSBA No. 12757  
Attorneys for Appellant  
N. Jack Alhadeff

COURT OF APPEALS  
WASHINGTON

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**CERTIFICATE OF SERVICE**

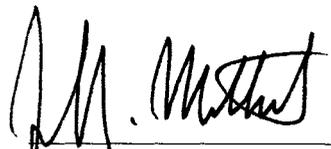
STATE OF WASHINGTON  
BY John J. Mitchell  
DEPUTY

JOHN J. MITCHELL declares as follows:

On October 1, 2007, I deposited into the U.S. Mail, with postage prepaid, a copy of the Brief of Appellant in this matter addressed to the attorney for Respondent as follows:

Frank R. Siderius, Esq.  
Siderius Lonergan & Martin LLP  
500 Union St., Ste. 847  
Seattle, WA 98101

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct. Executed at Seattle, Washington on October 1, 2007.

  
\_\_\_\_\_  
John J. Mitchell