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THE SUPREME COURT
OF THE STATE OF WASHINGTON

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ETC. J. ...

MUTUAL OF ENUMCLAW INSURANCE COMPANY,
Respondent and Cross-Petitioner,

v.

DAN PAULSON CONSTRUCTION, INC., a Washington
corporation, KAREN and JOSEPH MARTINELLI, and the
marital community composed thereof,

Petitioners.

**ANSWER TO PETITION FOR REVIEW AND
CROSS PETITION FOR REVIEW**

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I. ISSUES PRESENTED FOR REVIEW

A. ISSUES PERTAINING TO MARTINELLI'S PETITION

ISSUE 1. Did the Court of Appeals correctly hold that Mutual of Enumclaw did not act in bad faith when it attempted to identify whether any portion of the Arbitration Award constituted damages insured under the relevant insurance contracts?

ISSUE 2. When Mutual of Enumclaw's attempt to determine whether any portion of the Arbitration Award was insured did not harm the insured contractor's defense against the construction defect claims, did the Court of Appeals correctly hold that insurance coverage should not be extended for any uninsured portions of the Arbitration Award?

ISSUE 3. Because the Martinellis have failed to carry their burden of proof to establish which portions, if any, of the stipulated Arbitration Award are based upon insured claims against the contractor, did the Court of Appeals correctly hold Mutual of Enumclaw does not have any current duty to pay any portion of that Arbitration Award?

B. ISSUE PERTAINING TO MUTUAL OF ENUMCLAW'S CROSS PETITION FOR REVIEW

If this Court accepts review and reverses the Court of Appeals and therein reinstates the Partial Summary Judgment entered by the trial court, then the following issue must be resolved:

ISSUE 1. When the insured contractor and the claimants Martinellis entered into a stipulated Arbitration Award, was Mutual of Enumclaw entitled to participate in a hearing in which a Court would determine whether that stipulated award was reasonable and thus binding on Mutual of Enumclaw.

II. STATEMENT OF THE CASE

A. STATEMENT OF FACTS

1. Dan Paulson Construction, Inc. Builds the Martinelli House.

Dan Paulson Construction, Inc., (Paulson) entered into a written contract with Joseph and Karen Martinelli (Martinelli) to build a home in Friday Harbor, San Juan County. CP 49 – 53. The base construction price was \$1,365,000. CP 425. After certain changes, the final construction price was \$1,725,000. CP 427.

2. Martinellis' Claims Against Architect

After the Martinelli home was completed, they claimed defects existed. The Martinellis initially turned their attention to their architects, Olson Sundberg Kundig Allen (Architects). The Martinellis claimed the Architects were liable for alleged defects in the roof, exterior stone veneer, large columns in the home, hardwood floors, and windows. CP 297. All told, the Martinellis claimed the architects were responsible for approximately \$1,400,000 in costs that they believed would be incurred to repair the alleged design/construction defects and \$800,000 for “stigma” damages that would allegedly exist even after repairs were performed. CP 299-300. The Martinellis sued the Architects for such damages in March, 2002. CP 401. The Architects and Martinellis settled and the

Martinelli/Architect lawsuit was dismissed. CP 293 – 294. The Martinellis have refused to disclose the dollar amount of the settlement.

4. Arbitration Between Paulson and Martinellis And The MOE Defense

Having settled with the Architects, the Martinellis proceeded against Paulson in AAA Arbitration, as required by the construction contract. The construction defect claims asserted by the Martinellis against Paulson were the same defects the Martinellis had asserted against the Architects. CP 295 – 307. Paulson was represented by both his personal counsel, and counsel retained by MOE, who was defending Paulson under a reservation of rights. CP 28, 325-326.

On more than one occasion, MOE advised Paulson's personal attorney of the potential scope of insurance coverage available regarding the Martinelli claims, and the limitations on such coverage. CP 325 – 326; 332 – 333; 336. To determine insured and uninsured claims required that MOE know (1) who performed what work on the home, and (2) what construction defect resulted from each entity that performed work on the home, and (3) cost of repair for each defect. The individual at MOE responsible for the defense evaluated the three components relating to each defect claim, and provided settlement authority of \$550,000. CP 97 – 100. Settlement was not reached before arbitration.

Before the scheduled arbitration, Paulson's insurance coverage attorney made it clear to MOE that Paulson was a small construction company that would not be able to remain in business if the Martinellis received a substantial Arbitration Award and began collection efforts against Paulson. CP 221 – 222 (506).

Aware of Paulson's situation, MOE wanted to be in a position to promptly pay all insured aspects of any Arbitration Award. To accomplish that task, MOE needed to know the three components discussed above regarding any damages actually awarded by the arbitrator. MOE initially attempted to be in a position to promptly acquire that information by becoming an actual participant in the Martinelli/Paulson AAA Arbitration. MOE requested permission from Paulson to be allowed to intervene in the arbitration. CP 121. That request was rebuffed. As an alternative, MOE requested the opportunity to at least have its insurance coverage attorney attend the arbitration. That request was initially ignored and then specifically rejected by Paulson's insurance coverage attorney. CP 349.

With the Paulson/Martinelli arbitration scheduled to commence in early January, 2004, and having been rebuffed in its attempt to promptly learn the components of any award which might be entered by the

arbitrator, MOE decided to try another alternative. MOE commenced a Declaratory Judgment Action (“Coverage Action”).

In the Coverage Action, MOE issued a subpoena duces tecum with written questions and cover letter to the arbitrator which was returnable after the scheduled arbitration. CP 125 – 126; 133. As MOE explained to Paulson and the Martinellis, the purpose behind the written questions interposed to the arbitrator, was to allow MOE to segregate insured and uninsured damage elements and promptly pay any insured elements of an award. CP 151; 82.

In a letter to MOE counsel, Paulson and the Martinellis objected to the written questions which had been interposed by MOE to the arbitrator in the Declaratory Judgment Action. CP 141 – 143; 145-147. However, neither Paulson nor the Martinellis filed a motion in the Action to quash the discovery request. After the objections, MOE struck the subpoena addressed to the arbitrator.

MOE’s attempt to timely learn of potentially insured and uninsured damages actually awarded to the Martinellis was further compromised. On several occasions, Paulson’s insurance coverage attorney requested the Martinellis to agree to have the arbitrator enter a lump sum award, instead of following his usual practice of breaking the award into specific elements, as specified by AAA rules. CP 31 – 32; 156. The Martinellis

agreed. CP 32. The Paulson's insurance coverage attorney candidly admitted that the reason he wanted the entry of a lump sum Arbitration Award was so that any damages awarded to the Martinellis would not be segregated into insured and uninsured elements, which in turn he hoped would force MOE to pay all of the Martinelli's claims which were successful, whether insured or uninsured. CP 505 – 506.

The arbitration was not litigated to completion. Instead, during arbitration, Paulson and the Martinellis agreed to a settlement containing the following elements:

- A lump sum Arbitration Award of \$1, 300,000 in favor of the Martinellis against Paulson.
- Paulson would assign to Martinellis all insurance coverage and bad faith claims which might exist against MOE and Paulson would cooperate in the presentation of such claims.
- The Martinellis would not execute against Paulson the \$1,300,000 Arbitration Award and subsequent Judgment.

CP 167 – 172; 188 – 209.

Based upon the Paulson/Martinelli settlement, the AAA arbitrator entered an Arbitration Award of \$1,300,000. CP 178 – 179. Thereafter, the Martinellis engaged in a proceeding in San Juan Island Superior Court for confirmation of the Arbitration Award and entry of a Judgment. Such Confirmation Order and Judgment were entered in San Juan County

Superior Court, Cause Number 02-2-05152-0. CP 181-182. MOE was not a party in that proceeding.

B. STATEMENT OF PROCEEDINGS

1. Parties Claims and Counterclaims

In the present Coverage Action, MOE requested the Court to determine which portions, if any, of the Arbitration Award and associated Superior Court Judgment were payable by MOE. CP 1 – 2.

As the Assignees of Paulson’s insurance contract and bad faith/Consumer Protection Act claims against MOE, the Martinellis counterclaimed. CP 3 – 10; 914 – 921.

Though a party to the Action, Paulson had no economic interest in the outcome because he was protected by the Paulson/Martinelli “Covenant to Not Execute.”

2. Cross Motions for Partial Summary Judgment and Trial Court Rulings

The parties filed cross-motions for Partial Summary Judgment. The issues relevant here, and the Court’s rulings, are described below.

The first issue was whether the issuance of the Subpoena Duces Tecum with written interrogatory questions and letters to the AAA arbitrator constituted acts of bad faith which caused harm to Paulson. In its initial ruling, the Trial Court ruled that MOE’s written discovery request to the AAA arbitrator and two letters, constituted discovery and

communications which were not permitted under the law, but that Paulson had not been harmed by such conduct. Therefore, the Trial Court ruled that MOE was not estopped from denying coverage for uninsured claims. CP 644 – 651.

The second issue was whether MOE was in bad faith for failing to yet pay any aspects of the Arbitration Award and associated Judgment. The Trial Court ruled that the failure to pay any aspect of the Arbitration Award and associated Judgment was not an act of bad faith, because the Martinellis had not yet established that any aspects of the stipulated Arbitration Award were insured. CP 652.

The third issue ruled on in the Summary Judgment proceeding was whether the stipulated Arbitration Award and subsequent Judgment confirming the Award was “reasonable.” The trial court ruled the Stipulated Award/Judgment was “reasonable”. CP 690.

The Martinellis then filed a Motion for Partial Reconsideration regarding the first issue. CP 657 – 662. The Martinellis noted that Paulson’s personal attorney had objected to the Subpoena Duces Tecum/written interrogatories issued by MOE in the Coverage Action. The Martinellis argued that the attorney fees incurred by Mr. Paulson in opposing the Subpoena Duces Tecum/written interrogatories constituted sufficient “harm” to Paulson to justify the Court holding that MOE was

estopped from denying insurance coverage for the entirety of the Arbitration Award. The Court ruled that such attorney fees constituted sufficient “harm” to estop MOE from denying coverage even if no portions of the Arbitration Award were insured. RP I, pages 1 – 4; CP 689-691; 1002-107. CP 689 – 691; 1002 – 1007.

The Trial Court then entered a “Judgment Nunc Pro Tunc” in the sum of the \$1,300,000 stipulated Arbitration Award, plus *Olympic Steamship* attorney fees/expenses and interest. CP 966 – 970; 979 – 983. This appeal followed.

III. THE MARTINELLIS’ PETITION FOR REVIEW SHOULD BE DENIED.

A. THE COURT OF APPEALS CORRECTLY HELD THAT MOE WAS NOT ESTOPPED FROM DENYING INSURANCE COVERAGE FOR ANY PORTIONS OF THE STIPULATED ARBITRATION AWARD THAT WERE NOT INSURED.

The Martinellis requested, and the trial court granted, an extension of the law regarding insurance coverage. The Court of Appeals corrected that error and held that MOE was not estopped to deny coverage for uninsured aspects of the stipulated Arbitration Award.

It is the general rule that the concept of estoppel may not be used to provide coverage under an insurance policy regarding claims that are not otherwise insured. *Carew Shaw & Bernasconi, Inc. v. General*

Casualty Co. of America, 189 Wash. 329, 336, 65 P.2d 689 (1937) (“... under no conditions can the coverage or restrictions on coverage be extended by the doctrine of waiver or estoppel”); *Estate of Hall v. HAPO Federal Credit Union*, 73 Wn. App. 359, 362-363, 869 P.2d 116 (1994). See, *Saunders v. Lloyd’s of London*, 113 Wn.2d 330, 336, 779 P.2d 249 (1989). The rationale for the rule is that an insurance company should not pay for losses for which it did not contract to provide coverage and did not collect a premium. *Saunders, supra*, 113 Wn.2d at 336.

In *Safeco Insurance Co. of America v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992), the court created a limited exception to the general rule that insurance coverage cannot be created by estoppel. The court held that under specific circumstances, acts or omissions by an insurance company defending a claim under a reservation of rights may preclude the insurer from denying coverage. The elements which must be examined regarding coverage by estoppel are as follows:

- Whether the insurance company engaged in conduct relating to the third party claim that constituted an act of bad faith.
- If the insurance company engaged in such bad faith conduct, it is presumed that the insured was harmed.

- The insurance company can rebut the presumption of harm by showing by a preponderance of evidence that its act or omission did not harm or prejudice the insured.
- If the insurance company overcomes the presumption of harm, and establishes that the insured was not harmed or prejudiced, then the insurance company is not estopped from denying coverage for uninsured claims.

In the present case, the Court of Appeals held that the conduct of MOE did not constitute an act of bad faith and that the attorney fees incurred by Paulson when he objected to the discovery request was not the type of harm justifying invoking coverage for uninsured claims. Those two holdings were correct.

Regarding the alleged act of “bad faith”, the Martinellis contend that the discovery requests issued by MOE in the Action, and the accompanying explanation letters from legal counsel, constituted an act of bad faith which could have tainted the arbitration proceeding. In its opinion, the Court of Appeals noted the strategy engaged in by Paulson and the Martinellis leading up to the arbitration was clearly intended to hide from MOE the insurance coverage determinative facts regarding any Arbitration Award entered. In holding that MOE’s conduct did not constitute an act of bad faith, the Court of Appeals stated as follows:

Paulson's strategy was not illegally improper, but it did force MOE to face two unreasonable options: risking a bad faith claim by litigating coverage issues prior to the arbitration, or paying the entire settlement amount regardless of whether it was based on covered claims. As a last resort, MOE chose a third option: the subpoena and cover letters to the arbitrator. This tactic, while somewhat clumsy, did not amount to bad faith. The ex parte cover letters were improper, and we do not accept MOE's argument that issuing a subpoena to an arbitrator is analogous to proposing special interrogatories to a jury, which has been allowed in certain cases where the interest of the insured will not be compromised. Nevertheless, MOE had a reasonable need to know the elements of a potential damage award. An insurer's enhanced duty to its insured when defending under a reservation of rights does not encompass a duty to stand by and do nothing while its insured strategically eliminates his personal liability by negotiating a lump sum settlement and assigning his claims, while simultaneously preventing the insurer from determining which portions of the settlement award are covered and which are not.

Court of Appeals at p. 10. The Court was correct. MOE's conduct was not an act of bad faith.

Regarding the harm element which must be found before coverage by estoppel can be invoked, the Court of Appeals correctly held that the Martinellis were seeking an unwarranted expansion of law. Specifically, the only harm sustained by Paulson as a result of MOE's contact with the arbitrator, consisted of the attorney fees incurred to the Paulson's personal attorney in objecting to the discovery issued in the Action. That is not the nature of harm which justifies invoking coverage by estoppel.

In every case in which this Court has invoked coverage by estoppel, or remanded back to the trial court for further proceedings, the act or omission by the insurance company created harm/prejudice to the insured **regarding the underlying tort lawsuit**. Stated differently, no case has invoked coverage by estoppel where it was determined that the insured had not been harmed/prejudiced regarding defense of the underlying tort lawsuit, as was found by the trial court in the present case. *Safeco Insurance Co. of America v. Butler, supra* (allegations that the insurance company improperly delayed defense investigation of tort claim and/or attempt to use defense of tort claim to establish Mr. Butler's uninsured status); *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 951 P.2d 1124 (1998) (bad faith refusal to provide a defense to tort claim); *Truck Insurance Exchange v. Vanport Homes, Inc.*, 147 Wn.2d 751, 761, 58 P.3d 276 (2002) (bad faith refusal to provide a defense); *Besel v. Viking Ins. Co. of Wisconsin*, 146 Wn.2d 730, 49 P.3d 887 (2002) (bad faith failure to effectuate a settlement within the insurance policy limits); *Smith v. Safeco Insurance Co.*, 150 Wn.2d 478, 78 P.3d 1274 (2003) (alleged bad faith failure to disclose insured's policy limits to the claimant, thereby inhibiting settlement within policy limits).

In each of the above cases, the insurance company's act or omission did, or could have, increased the insured's economic exposure

to the tort claimant. As explained by the court in *Coventry Associates v. American States Insurance Co.*, 136 Wn.2d 269, 284, 961 P.2d 933 (1998), in the above described instances “...coverage by estoppel is an appropriate remedy because the insurer contributes to the insured’s loss [personal exposure to tort claimant] by failing to fulfill its obligation in some way.” There is no evidence that MOE’s communications to the Arbitrator did contribute to Paulson’s economic exposure to the Martinellis. Both the trial court and Court of Appeals so found.

The Martinellis do not cite, nor have we been able to locate, even a single case in the United States in which it was found that the insurance company’s conduct did not in any way negatively impact the insured’s position regarding the underlying tort claim, in which coverage by estoppel was invoked. *E.g.*, Joseph E. Edwards, *Negligence Or Bad Faith In Conducting Defense As Ground Of Liability To Insured*, 34 ALR 3d 533 (1970); Douglas R. Richmond, *Truly “Extra Contractual” Liability: Insurer Bad Faith In The Absence Of Coverage*, 29 Tort and Ins. L. J. 740 (1994).

In summary, “bad faith” is not a free-floating concept that automatically grants coverage by estoppel. The “bad faith” must affect an “important benefit of the insurance contract.”

In *Tank* we did not address what remedy is available for an insurer’s bad faith handling of a claim under a reservation

of rights. We now hold that where an insurer acts in bad faith in handling a claim under a reservation of rights, the insurer is estopped from denying coverage. (Emphasis added).

Safeco Insurance v. Butler, 118 Wn.2d 383, 823 P.2d 499 (1992) (emphasis added).

Once an insurer breaches an important benefit of the insurance contract, harm is assumed, the insurer is estopped from denying coverage, and the insurer is liable for the judgment. The insurer who in bad faith refuses to acknowledge its broad duty to defend is no less liable than the insurer who accepts the duty to defend under a reservation of rights, but then performs the duty in bad faith.

Kirk v. Mt. Airy Ins. Co., 134 Wn.2d 558, 951 P.2d 1124 (1998) (Emphasis added).

The Court of Appeals correctly noted that the attorney fees incurred by Paulson in objecting to the discovery requests in the Coverage Action was not a form of harm which would justify invoking the coverage by estoppel, stating:

Furthermore, unlike *Butler*, the alleged harm stemmed from MOE's attempt to determine coverage issues rather than from bad faith in defending the underlying tort lawsuit.

The Court of Appeals, p. 14.

The Martinellis neither cite precedent nor provide compelling policy reasons for expanding the concept of coverage by estoppel under the facts of this case.

B. THE COURT OF APPEALS CORRECTLY HELD THAT MOE WAS NOT CURRENTLY OBLIGATED TO PAY ANY PORTION OF THE STIPULATED ARBITRATION AWARD/JUDGMENT.

As an alternative method of attempting to establish insurance coverage by estoppel, the Martinellis, as Paulson's assignee, alleged that MOE should have paid some portion of the stipulated Arbitration Award after it was entered. The Martinelli's position is incorrect for three reasons.

First, the alleged wrongful failure to pay some of the Arbitration Award is an act or event occurring after completion of the underlying construction defect litigation between Paulson and the Martinellis. The Martinellis neither cite case law nor present argument supporting the claim that the concept of coverage by estoppel should be expanded to include events occurring after resolution of the claims against the insured.

Second, the Martinellis do not allege nor explain how Paulson, the insured, has been harmed by the failure of MOE to currently pay. Harm to the insured must exist to create coverage by estoppel. *Safeco Ins. Co. v. Butler, supra*. Here, Paulson has been exonerated from the Judgment entered in favor of the Martinellis. There was no harm to Paulson.

Third, as the Court of Appeals correctly held, the fact that MOE conceded that some of the damages claimed by the Martinellis would be insured, does not establish what portions, if any, of the stipulated

Arbitration Award were insured under the Paulson/MOE insurance contracts. As the ones seeking insurance coverage for the Award, the Martinellis have the burden of establishing all elements necessary to create insurance coverage for an award. *Oberton v. Consolidated Insurance Co.*, 145 Wn.2d 417, 424-425; 431, 38 P.3d 322 (2002). As both the trial court and Court of Appeals correctly held, the Martinellis did not establish whether any portions of the Arbitration Award were insured. As of today, MOE has no rationale basis to determine what sum, if any, it might pay. Washington law is clear, if an insurance company has a reasonable basis to withhold payment, its refusal to make the payment is not a violation of the WAC provisions and may not be the basis of a bad faith claim. *American Manufacturers Mutual Ins. Co. v. Osbourne*, 104 Wn.App. 686, 699-700, 17 P.3d 1229 (2001).

The Court of Appeals and trial court correctly held that the Martinellis have failed to establish that there is “clear liability” under the insurance contract for the Award, and thus no violation of the WAC provision has been established.

C. IF THIS COURT ACCEPTS REVIEW OF THE CASE, THEN IT MUST ALSO ACCEPT REVIEW OF THE ISSUE REGARDING WHETHER THE STIPULATED ARBITRATION AWARD ENTERED INTO BY PAULSON AND THE MARTINELLIS WAS “REASONABLE”.

In addition to finding coverage by estoppel, the trial court held that the settlement between the Martinellis and Paulson was “reasonable”. A finding that a settlement between a claimant and an insured was “reasonable” is significant, because it becomes the presumptive measure of harm if it is established that the insurance company acted in bad faith. *Besel v. Viking Insurance Co. of Wisconsin*, 146 Wn.2d 730, 738, 49 P.3d 887 (2002); *Werlinger v. Warner*, 126 Wn.App. 342, 349, 109 P.3d 22 (2005).

Any individual or entity who may be impacted by the settlement has a due process right to receive notice of the proposed settlement, and participate in a hearing before the tribunal which will determine whether the settlement was or was not reasonable. *Brewer v. Fibreboard Corp.*, 127 Wn.2d 512, 524-528, 531, 901 P.2d 297 (1995). *See, Howard v. Royal Specialty Underwriting, Inc.*, 121 Wn.App. 372, 379-380, 89 P.3d 265 (2004).

In the Court of Appeals, it was MOE’s position that the trial court in the present lawsuit relied upon the finding of “reasonableness” reached by either the private arbitrator and/or the Judge in the earlier Superior

Court proceeding in which the Arbitration Award was confirmed. Obviously, MOE was not a party to either of those proceedings, thus its right to challenge the reasonableness of the settlement has not been fulfilled.

Further, even though MOE was given notice of the prior Superior Court proceeding in which the Arbitration Award was confirmed, there was no valid basis for MOE to intervene, because the trial court in that proceeding could not overturn the Arbitrator's finding of reasonableness unless an error was apparent on the face of the Arbitration Award. *Barnett v. Hicks*, 119 Wn.2d 151, 153-154, 829 P.2d 1087 (1992); *Northern State Construction Co. v. Banchemo*, 63 Wn.2d 245, 249-250, 386 P.2d 625 (1964).

In its Opinion in this case, the Court of Appeals did not decide the merits of the "reasonableness" issue, because it concluded that the Paulsons had not established bad faith conduct by MOE or harm to Paulson. Therefore, the stipulated Arbitration Award, reasonable or unreasonable in amount, was not binding upon MOE. However, the Court did note in Footnote 29 that:

We agree, however, that MOE never had a meaningful opportunity to contest the arbitrator's reasonableness finding.

Court of Appeals, at p. 16.

If this Court accepts review and thereafter concludes that Martinellis have established coverage by estoppel, then this Court must concurrently examine the issue of whether there has yet been a proper determination that the settlement between the Martinellis and Paulsons was reasonable, and thus binding upon MOE.

IV. CONCLUSION

Under RAP 13.4(b), a Petition for Review will be granted only under limited circumstances. The Martinellis have failed to establish that the Court of Appeals decision conflicts with existing Washington law or involves other criteria which would justify Supreme Court review. Instead, what the Martinellis actually seek from this Court is an unwarranted and significant expansion of Washington bad faith law. The Martinellis' Petition for Review should be denied.

If the Martinellis' Petition for Review is granted in whole or in part, then MOE's Cross-Petition for Review should likewise be granted.

DATED this 16th day of August, 2006.

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