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No. 553429-1

COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE COMPANY, Appellant,

v.

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

Respondents and Cross Appellants.

**REPLY BRIEF OF APPELLANT/CROSS RESPONDENT MUTUAL OF
ENUMCLAW INSURANCE COMPANY**

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I. REPLY ARGUMENT

A. AN APPELLANT NEED NOT ASSIGN ERROR TO FINDINGS OF FACT OR CONCLUSIONS OF LAW ENTERED REGARDING SUMMARY JUDGMENT RULINGS.

In its opening brief, MOE assigned error to the final Judgment Nunc Pro Tunc and the various summary judgment orders entered by the court which led to the entry of the Judgment Nunc Pro Tunc.

At multiple locations in their brief, the Martinellis contend that the failure of MOE to assign error to specific findings or conclusions set forth in the summary judgment orders precludes appellate review and that such findings/conclusion constitute the law of the case. Brief of Respondent, page 27, 32, 34, 45. As the following authorities indicate, the Martinellis are incorrect about the law.

Defendants contend that because the trial judge made certain findings and conclusions relative to this case in his dismissal order and plaintiffs did not assign error to them, they are the established facts and conclusions of the case and binding upon plaintiffs. Were this the case, there would be no need for us to proceed further since the trial judge's conclusions of law amply support his order. However, we have held on numerous occasions that findings of fact and conclusions of law are superfluous in both summary judgment and judgment on the pleadings proceedings. *E.g.*, *State ex rel. Carroll v. Simmons*, 61 Wash.2d 146, 377 P.2d 421 (1962); *State ex rel. Zempel v. Twitchell*, 59 Wash.2d 419, 367 P.2d 985 (1962). Thus, failure to assign error to any of them has no effect on plaintiffs' case.

Washington Optometric Association, Inc. v. County of Pierce, 73 Wn.2d 445, 448, 438 P.2d 861 (1968).

Furthermore, it is of no consequence that Landmark failed to assign error to the trial court's "finding" that the appeal provisions of § 10.20.035 were applicable. Findings of fact and conclusions of law are not necessary on summary judgment and, if made, are superfluous and will not be considered on appeal. *Donald v. Vancouver*, 43 Wash.App. 880, 883, 719 P.2d 966 (1986). A litigant need not assign error to superfluous findings. *Concerned Coupeville Citizens v. Town of Coupeville*, 62 Wn.App. 408, 413, 814 P.2d 243 (1991).

B. MOE'S CONTACT WITH THE ARBITRATOR DID NOT IMPAIR PAULSON'S DEFENSE OF THE MARTINELLI CLAIMS. THEREFORE, COVERAGE BY ESTOPPEL DOES NOT APPLY.

1. The Background

In its opening brief, MOE noted various facts and principals which are important to the issue of whether MOE's communications to the Arbitrator constituted bad faith. MOE noted, and the Martinellis did not disagree, that the following are relevant:

- There were multiple components to the Martinellis' claims, including alleged defects in the roof, exterior stone veneer, large columns, hardwood floors, windows, and alleged "stigma" damages from such defects that would exist after full repair. Each of these claims was in turn the subject of litigation of multiple issues including (a) whether there was actually any defect, (b) if a defect existed, (c) the nature and extent of damage caused, and (d) if a defect existed which caused damage, was Paulson or some subcontractor or the architect legally responsible for the damage.

- Prior to the Arbitration with Paulson, the Martinellis settled with their architect regarding the identical claims asserted by the Martinellis against Paulson. The AAA Arbitrator had ruled that Paulson would be permitted to present a defense that Martinellis had already recovered some or all of their damages from the architect regarding the defect and stigma claims asserted against Paulson. CP 341-42; 591.
- Though MOE was able to analyze the claims asserted by the Martinellis against Paulson sufficiently to permit a substantial settlement offer to the Martinellis, MOE could not determine beforehand the components of any award the Arbitrator might enter against Paulson. Paulson's personal coverage attorney appropriately noted that fact shortly before the Arbitration. CP 343-344.
- It would not have been appropriate for MOE to litigate to judgment a determination of which claims Paulson actually was or was not liable to the Martinellis. The complete litigation of any such declaratory judgment action before the AAA Arbitration would have definitely interfered with Paulson's defense of the claims in the Martinelli Arbitration.
- Being forced to wait until the completion of the Arbitration to determine the category of claims and damages upon which the Martinellis actually prevailed, MOE could have chosen to simply allow the Martinellis to execute against Paulson's assets and garnish the MOE/Paulson insurance contract, and in that

process litigate out what portions of the Arbitration award, if any, were insured. E.g., *Philadelphia Fire & Marine Ins. Co. v. City of Grandview*, 42 Wn.2d 357, 255 P.2d 540 (1953). Or, MOE could have then litigated a Declaratory Judgment Action. However, MOE did not want to put Paulsons' business in jeopardy while the coverage issues regarding the Arbitration award were litigated. Therefore, MOE attempted to exercise every feasible alternative to be in a position to promptly pay any insured aspects of the Arbitration award. MOE requested of Paulson the opportunity to intervene or simply attend the AAA Arbitration. Paulson would not consent.

- The claims asserted by the Martinellis against Paulson entailed some which were not insured by MOE, and also entailed some which would be insured by MOE. Until the Arbitrator reached his decision, regarding each individual claim, no one could know what sum, if any, was owed by MOE on Paulson's behalf.
- In light of Paulson's refusal to allow MOE to intervene, or have its coverage representatives attend the AAA Arbitration, MOE was concerned that at the conclusion of the Arbitration, MOE would not know how to segregate insured and uninsured claims actually awarded. MOE's concern was well founded, as is represented by the fact that Paulson and the Martinellis directed the Arbitrator to enter a lump sum award, as opposed to an award segregating each component of

claims (i.e. roof, exterior stone, columns, hardwood floors, and windows) and the corresponding amount of damages, if any, awarded for each component, plus stigma damages.

It is in this context that MOE communicated with the Arbitrator. The sole purpose of the communications was to attempt to allow MOE to acquire information that would assist in the segregation of the insured and uninsured aspects of the award which the Arbitrator was to enter. Such conduct did not constitute bad faith. CP 151; 82.

2. MOE's Conduct Did Not Constitute "Bad Faith."

To place the Martinellis arguments in the proper legal context, we must review the general law regarding bad faith in the context of defense of third party tort claims.

The relationship between Paulson and MOE arises from the fact that they mutually entered into an insurance contract. That contract creates certain duties which must be fulfilled by both Paulson and MOE. The two duties owed by MOE were (a) to investigate and defend potentially insured claims and (b) pay insured claims or judgments. *Truck Insurance Exchange v. Vanport Homes, Inc.*, 147 Wn.2d 751, 761, 58 P.3d 276 (2002).

The tort of bad faith recognizes that traditional contract damages do not provide an adequate remedy for a bad faith breach of the insurance contract

because an insurance contract is only an agreement to pay money for defense and indemnity, and recovery of damages under the contract would be thus limited to the amount due under the contract. *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 560, 951 P.2d 1124 (1998). However, in order to establish bad faith, an insured is required to show that the breach of some duty arising from the contract was unreasonable, frivolous, or unfounded. *Kirk v. Mt. Airy Ins. Co.*, *supra*, 134 Wn.2d at 560.

As established by *Tank v. State Farm Fire and Casualty Co.*, 105 Wn.2d 381, 715 P.2d 1133 (1986), the duties owed by an insurance company when defending its insured under a reservation of rights include (1) a thorough investigation, (2) retention of competent defense counsel, (3) keeping the insured informed of all developments, and (4) giving the insured's interests equal consideration with the insurance company's interests. *Tank, supra*, 105 Wn.2d at 388.

The Martinellis do not contend that MOE failed to retain competent defense counsel, or that the MOE defense team did not keep the Paulsons fully informed of all relevant developments. The MOE defense team thoroughly investigated, and made an offer of in excess of \$500,000 following its investigation. We note that the Martinellis do not argue that MOE's defense side

evaluation of the claims was unrealistic or an act of "bad faith." Thus, MOE fulfilled duties 1-3 regarding the defense of the claim.

The Martinellis hint that, the MOE coverage team failed to adequately investigate and determine the uninsured and insured claims. The facts are obviously to the contrary. On the coverage side, MOE had done everything possible to ascertain the range of possibly insured and uninsured claims. When the claims did not settle, all that was left to be done was to await an Arbitration award and then determine which components of that award were insured, and which components were uninsured. Until the Arbitration award was entered, obviously MOE could not proceed further.

Thus, the "bad faith" claim is parced down to the singular issue of whether MOE engaged in reasonable, frivolous or unfounded conduct that put its interests over the interests of Paulson. To answer that question, we must discern the interests of MOE and Paulson which were at issue.

One interest was a determination of the insured and uninsured claims. Paulson had the need and right to have those issues resolved, as did MOE. Having the Arbitrator delineate the basis of his award certainly would have advanced the joint interests of both Paulson and MOE, and the Martinellis do not suggest to the contrary. Thus, if the Arbitrator had answered the written

discovery issued by MOE in the declaratory judgment action, Paulson's interest would have been protected.

The second interest that Paulson had was undergoing an Arbitration without the trier of fact being prejudiced against his defense positions. The Martinellis fail to indicate, nor can we discern, any way in which the disclosure to the Arbitrator that insurance coverage issues existed caused the Arbitrator to be prejudiced against Paulson. To the contrary, it is unimaginable that an experienced construction Arbitrator would not be aware that certain claims against a contractor may be insured and certain claims may be uninsured. It is ironic that the Martinellis currently criticize MOE for not asking the Arbitrator for permission to intervene or attend the Arbitration. Brief of Respondent, page 6. Obviously, in pursuing either request, MOE would have to disclose the very interests and issue which the Martinellis currently contend should not have been disclosed to the Arbitrator. Further, during the initial flurry of objections to MOE's written communication with the Arbitrator, it was the Martinellis that claimed they were the ones prejudiced by such communication, which certainly would suggest that Paulson gained an advantage by the communication. CP 135.

The only potential harm from the communications pointed to by the Martinellis is the prospect that the Arbitrator might recuse himself, and thus the Arbitration might have been delayed, or the Arbitration may have proceeded and

then thereafter been invalidated as a result of the communications. Brief of Respondents, page 24. However, such matters are pure speculation, and did not occur. In fact, as discussed in further detail in the next section of this brief, the trial court correctly found that Paulson was in no way harmed in regard to his defense in the Arbitration by MOE's contact with the Arbitrator.

It may or may not be true that, if the issue of the right of MOE to issue the written questions to the Arbitrator was brought to head in a discovery motion in the declaratory judgment action, MOE's request for information may have been denied. However, that is not a basis for a finding of bad faith. In a similar situation, the court noted that the insurer Highland mistakenly withheld defense funding for the insured, while trying to resolve coverage issues. In holding that the mistake did not justify a finding of bad faith, the court stated:

Although Highland may have been mistaken, the extent of its responsibility was debatable, and the delay throughout which related to Highland's attempts – albeit clumsy – to resolve the coverage issues. Therefore, Highland's acts were not frivolous, nor was its position unfounded.

Insurance Co. of the State of Pennsylvania v. Highland's Insurance Co., 59 Wn.App. 782, 787, 801 P.2d 284 (1990).

We submit that the trial court was wrong in concluding that MOE's contact with the Arbitrator was an act of bad faith of putting MOE's interests above those of Paulson. Both MOE and Paulson had the concurrent interest of (1) Paulson prevailing, to the extent possible, in the Arbitration, and (2) determinig

what portions of the Arbitrator's award were insured and uninsured. No conduct by MOE interfered with Paulson's interests.

3. The Trial Court Ruled That MOE Established That Paulson Was Not Harmed Regarding Any Matter Relating To The Martinellis' Claims for Damages.

The Martinellis arguments require we review the law regarding the concept of coverage by estoppel.

In *Safeco Insurance Co. of America v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992), the court established the basic rules regarding the creation of insurance coverage for claims that would otherwise be uninsured. 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:

- 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.

After considering the substantial factual records submitted by the parties in the cross motions for summary judgment, the trial court specifically held that Paulson was in no way prejudiced or harmed regarding his defense against the Martinelli claims as a result of MOE's contact with the Arbitrator. Over the course of ten paragraphs, the trial court explained why and how MOE had rebutted the legal presumption that Paulson was harmed by MOE's contact with the Arbitrator. CP 650-651; Appendix A at pages 7-8. On appeal, the Martinellis do not dispute the accuracy of such conclusion by the trial court, and thus MOE's entitlement to summary judgment in that regard.

However, subsequent to the trial court's ruling discussed above, it was pointed out to the trial court that, **in the declaratory judgment action**, Paulson's attorney incurred attorney's fees to oppose MOE's subpoena duces tecum/written interrogatories addressed to the Arbitrator. The Martinellis argued, and the trial court agreed, that expenses incurred by the insured in the declaratory judgment action were sufficient harm/prejudice to justify invoking coverage by estoppel.

Such conclusion is clearly not supported by any of the cases analyzing coverage by estoppel.

In every Washington case in which courts have invoked coverage by estoppel, or remanded back to the trial court for further proceedings, the act or omission by the insurance company agreeably created harm/prejudice to the insured **regarding defense of the underlying tort lawsuit**. Stated differently, in none of the cases, was it 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 delaying 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 exposure to the Martinellis.

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 defense of the underlying tort claim, in which coverage by estoppel was invoked. All of the cases we have been able to locate in which coverage by estoppel was invoked involved some act or omission by the insurance company regarding the handling of the tort claim defense, which argueably increased the insurer's exposure to the tort claimant. *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 supplied).

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

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 to bad faith.

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

Attorney fees incurred in a declaratory judgment action are not owed to Paulson as a benefit of the insurance contract.

The recent decision in *Alaska National Insurance Co. v. Bryan*, 125 Wn. App. 24, 104 P.3d 1 (2004) supports the proposition that the fact that the insured had to incur fees in a declaratory judgment action commenced by the insurance company, during the pendency of the underlying tort lawsuit, does not constitute harm that would justify invoking coverage by estoppel. There, the insured was a Washington resident. While working in Alaska, the insured injured a third party. The injured party commenced a tort lawsuit in Alaska against the insured. The insurance company, Alaska National, retained legal counsel to defend the insured

in the tort lawsuit. Concurrently, Alaska National commenced a declaratory judgment action in Washington. The insured and the tort claimant then entered into a settlement and an assignment by the insured to the tort claimant of the insured's bad faith claims against Alaska National.

In the bad faith litigation, it was argued that the act of Alaska National filing the declaratory judgment action and requiring the insured to incur attorney's fees to defend against that action caused economic harm that would justify invoking coverage by estoppel. *Alaska National Insurance, supra*, 125 Wn. App. at 36-37. Though categorizing its response in terms of a conclusion that the filing of the declaratory judgment action did not constitute an act of bad faith (125 Wn. App. at 37), the implication of the holding is that the fees incurred by the insured in dealing with the issues in the declaratory judgment action are not a basis to invoke coverage by estoppel. See also, *Werlinger v. Warner*, 126 Wn.App. 342, 109 P.3d 22 (2005) (bad faith allegations that insurance company commenced a declaratory judgment action against the insured without providing him with legal counsel and allegations the insurance company failed to bring issue of coverage to a timely resolution).

In the present case, the trial court summarized its conclusion that Paulson did not suffer harm as follows:

Conclusion: Thus, the court finds that under the facts of this case, no reasonable person could reach conclusion that Paulson was prejudiced or

harmed by MOE's actions. MOE has rebutted the presumption of harm. The Martinellis' motion for partial summary judgment is denied. Even though the court found that MOE is guilty of bad faith, MOE has rebutted the presumption of harm. Therefore, MOE's motion for partial summary judgment that MOE is not liable to the Martinellis for bad faith on this issue is granted. CP 651; Appendix 1, page 8.

We submit that the law permits the invoking of coverage by estoppel only if the insured was harmed regarding the underlying tort lawsuit, and that coverage by estoppel may not be invoked if the sole "harm" to the insured was expenses incurred in the declaratory judgment action.¹

The Martinellis are correct that, if the insurance company engages in bad faith regarding the handling of the defense of the underlying tort claim, it is presumed that the insured was harmed, and that coverage by estoppel may be invoked. However, if the insurance company establishes that the insured was not harmed regarding the defense of the tort claim, coverage by estoppel is not invoked. Here, the trial court unequivocally held that Paulson was in no way harmed or prejudiced regarding the defense of the Martinelli tort claims. Therefore, coverage by estoppel does not apply. The trial court should be

¹ Such conclusion does not suggest that conduct by an insurance company in a declaratory judgment action could never harm the insured's position regarding defense of the underlying tort claim. For example, if MOE had commenced the declaratory judgment action long before it did, and before the Paulson/Martinelli Arbitration, litigated in that declaratory judgment action Paulson's liability to Martinellis, argument could be made that such action by MOE prejudiced Paulson's defense in the Martinelli claims. See, Brief of Appellant, page 20-21, and cases cited therein. MOE did not engage in such conduct. Interestingly, the Martinellis suggest MOE should have done so. Brief of Respondent, page 7, 8, 23.

directed to enter summary judgment for MOE on that issue and vacate the order granting the Martinellis summary judgment.

C. THE TRIAL COURT COMMITTED ERROR IN RULING THAT THE STIPULATED ARBITRATION AWARD AND SUBSEQUENT JUDGMENT WERE “REASONABLE”

The Martinellis argue that the trial court’s finding that the stipulated judgment between Paulson and the Martinellis was “reasonable,” and thus binding upon MOE, is sustainable on three grounds. Martinellis are wrong.

1. The Absence of “Fraud or Collusion” is Not Sufficient to Determine that the Stipulated Settlement was Reasonable.

The Martinellis argue that because MOE did not convince the trial court that the settlement was a product of “fraud or collusion” the settlement is per se reasonable, relying upon *Truck Insurance Exchange v. Vanport Homes, Inc.*, *supra*. That contention was specifically rejected by the court in *Werlinger v. Warner, supra*.

In *Werlinger*, insured Michael Warner had \$25,000 motor vehicle liability insurance limits. Driving his car, Mr. Warner caused the death of Mr. Werlinger. Shortly after the accident, counsel for Mr. Werlinger’s estate demanded the \$25,000 policy limits from Mr. Warner’s liability insurer, Clarendon National Insurance Company. Clarendon denied coverage on the basis that the vehicle driven by Mr. Warner was not listed on the insurance policy. After the accident,

Mr. Warner filed Chapter 7 bankruptcy and thus had no remaining personal liability regarding the *Werlinger* claims.

The Werlinger family then obtained permission to commence a lawsuit against Mr. Warner. Clarendon retained defense counsel to defend Mr. Warner under a reservation of rights. In the tort lawsuit, the Werlingers demanded \$25,000 policy limits. Clarendon did not tender the limits, but instead commenced a declaratory judgment action, seeking a declaration that it did not provide coverage to Mr. Warner. In the declaratory judgment action, trial court found that Warner was entitled to coverage through Clarendon. Thereafter, Clarendon tendered its policy limits, which were rejected by Werlinger claimants. Ultimately, the Werlinger claimants entered into a settlement with Mr. Warner for \$5 million, which included an assignment of Mr. Warner's bad faith claims against Clarendon.

In the tort action, Warner and Werlinger requested the court to determine the reasonableness of the settlement. Clarendon participated in the hearing. In the reasonableness hearing, the court weighed the various factors which must be examined in determining the reasonableness of a settlement. The trial court determined that the settlement was not reasonable, in light of the fact that Mr. Warner's liability regarding the Werlinger claims had been discharged in

bankruptcy. The trial court determined that the reasonable settlement was \$25,000. The Werlingers appealed.

On appeal, the Werlinger claimants argued that the \$5 million settlement was per se or presumptively reasonable, absent proof that it was the result of fraud or collusion. Citing *Truck Insurance Exchange v. Vanport Homes, Inc.*, *supra*. Holding that the settlement must be both reasonable and not the product of collusion or fraud, the court stated as follows:

Werlinger maintains the settlement was reasonable because she would certainly prevail at a trial on the issue of Warner's liability, and her claimed damages are within the expected range of a jury verdict in a wrongful death case where the beneficiaries are a widow with three dependant children. She contends that when the damages stipulated in a covenant judgment are reasonable, the judgment is presumptively valid and Clarendon cannot attack it except by showing fraud or collusion. For this proposition, she cites *Truck Ins. Exchange v. Vanport Homes, Inc.*, 147 Wn.2d 751, 58 P.3d 276 (2002).

The holding of *Truck Ins. Exchange*, an application of *Besel*, is not as broad as Werlinger represents. The insurer in that case refused to defend its insured, Vanport, a building construction-consulting firm, against lawsuits filed by the firm's customers. The customers claimed property damages amounting to nearly \$490,000. Vanport settled for that amount, and then successfully sued the insurer for coverage and bad faith in refusing to defend. Because of the insurer's wrongful refusal to defend, the trial court found the settlements to be per se reasonable without taking into consideration the *Glover/Chaussee* factors. The judgment entered by the trial court imposed the entire cost of the settlement upon the insurer along with Vanport's costs and attorney fees. The Supreme Court affirmed the determination that the settlements were reasonable per se:

An insurer faced with claims exceeding its policy limit should not be permitted to do nothing in the hope that the insured will go out of business and the claims will simply go away... We therefore hold that when an

insurer wrongfully refuses to defend, it has voluntarily forfeited its ability to protect itself against an unfavorable settlement, unless the settlement is the product of fraud or collusion.

Truck Ins. Exchange, supra, 147 Wn.2d at 765-66.

The court's discussion indicates that a covenant judgment can be reasonable per se only in a case where an insurer breaches its duty to defend or otherwise wrongfully "exposes its insured to business failure and bankruptcy." *Truck Ins. Exchange*, 147 Wash.2d at 765, 58 P.3d 276. The present case is not one in which the insurer refused to defend, nor did the insurer's allegedly wrongful conduct play any role in causing Warner's bankruptcy. Therefore, the trial court was obliged to measure the settlement for reasonableness using the *Glover/Chaussee* factors, as contemplated in *Besel*, and keeping in mind that the sole purpose of the covenant judgment was to serve as the presumptive measure of damages in a separate bad faith lawsuit.

Werlinger v. Warner, supra 109 P.3d at 26-27.

Here, MOE provided a defense to Paulson. The *Werlinger* decision makes it clear that a trial court, in some proceeding, was obligated to measure the settlement stipulated judgment between Paulson and the Martinellis for reasonableness using the *Glover/Chaussee* factors.

2. The Failure of the Trial Court to Enunciate its Analysis of the Glover/Chaussee Precludes this Court from Affirming the Finding that the Settlement was Reasonable.

Paulson and the Martinellis had the obligation and burden of proof to establish that the settlement was reasonable. *Chaussee v. Maryland Casualty Co.*, 60 Wn.App 504, 803 P.2d 1339, rev. den., 117 Wn.2d 1018 (1991). There, the court stated:

The Nodells urge this court to agree that unless the respondents can show unreasonableness, bad faith or collusion, the consent judgment is presumptively reasonable citing *Steil v. Florida Physicians' Ins. Reciprocal*, 448 So.2d 589, 628 (1984). We believe the rule adopted in

United Servs. Auto. Ass'n v. Morris, 154 Ariz. 113, 741 P.2d 246 (1987) should apply and hold that the plaintiff has the burden of proof on the issue of the reasonableness of the settlement. In *Morris*, the court held that a stipulated judgment with a covenant not to execute is not binding on the insurer unless the insured can show that the settlement was reasonable and prudent. *Morris*, 154 Ariz. at 120-21, 741 P.2d at 253-54. Other jurisdictions have also placed this burden of proof on the insured. See *Isaacson v. California Ins. Guar. Ass'n*, 44 Cal.3d 775, 750 P.2d 297, 309, 244 Cal.Rptr. 655 (1988) (where insurer has not denied coverage, the insured has the burden to prove that settlement was reasonable); accord *Miller v. Shugart*, 316 N.W.2d 729 (1982). These courts have reasoned that an insured may settle for an inflated amount to escape exposure and thus call into question the reasonableness of the settlement. We share this concern about consent judgments coupled with a covenant not to execute. *Chaussee, supra*, 60 Wn.App. at 510-511.

The Supreme Court has also stated that the trial court should enunciate its evaluation of the various *Glover/Chaussee* factors, so as to allow orderly appellate review, stating:

...we note that the finding of reasonableness necessarily involves factual determinations. Factual determinations will not be disturbed on appeal, when, as here, they are supported by substantial evidence. See *Peebles v. Port of Bellingham*, 93 W.2d 766, 771, 613 P.2d 1128 (1980). To aid an appellate review in the future, however, trial judges should enunciate those factors which lead them to conclude that a settlement is reasonable.

Glover v. Tacoma General Hospital, 98 Wn.2d 708, 718, 658 P.2d 1230 (1983). See, *Howard v. Royal Specialty Underwriting, Inc.*, 121 Wn.App. 372, 381, 89 P.3d 265 (2004) (“In its memorandum ruling, the trial court examined each of the *Chaussee/Glover* factors and specifically addressed each factor in its order.”)

As the one seeking an order determining the reasonableness of the settlement, it was Paulson/Martinelli that had the obligation to create the appropriate record. They failed to do so. Therefore, the trial court’s conclusionary determination that settlement was “reasonable” (CP 690) cannot

be sustained. *See, Crest Inc. v. Costco Wholesale Corp.*, _____ Wn.App. _____, 115 P.3d 349 (2005) (failure of trial court to articulate basis of attorney fee award required reversal and remand).²

3. MOE Does Have a Due Process Right to Participate in a Hearing Regarding Reasonableness.

Martinellis boldly state that “insurers have no specific right to participate in reasonableness hearings.” Brief of Respondents, page 38. 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.*, *supra*, 121 Wn.App. at 379-380. As explained in MOE’s opening brief, if the trial court did not specifically analyze the *Glover/Chaussee* factors in the present case, but instead was relying upon the finding of “reasonableness” by the Arbitrator, as thereafter affirmed in a separate Superior Court proceeding, then MOE’s due process right to contest reasonableness has not been protected. The Martinellis have not rebutted the

² As we noted in our opening brief, we do not know if the trial court even considered the *Glover/Chaussee* factors. That uncertainty arises from the fact that Paulson/Martinelli argued to the trial court that it could enter a finding of reasonableness either based solely on the fact that the AAA Arbitrator’s award stated that the settlement was reasonable, or alternatively, that the limited evidence presented to the trial court in the present case was sufficient to sustain a finding of reasonableness. CP 255-256.

argument that MOE did not have an opportunity to contest reasonableness in the Arbitration or the separate Superior Court proceeding in which the Arbitration award was confirmed and entered as a judgment. Brief of Appellant, page 38-43.

D. THE BURDENS OF PROOF UNDER EXCLUSION L

As noted in our opening brief, MOE asked the trial court to rule on the singular narrow legal issue. That issue was: Which party has the burden of proof regarding the exception contained in coverage exclusion L entitled “Damage to Your Work.” More specifically, exclusion L reads as follows:

This insurance does not apply to:
Damage To Your Work.

“Property damage” to “your work” arising out of it or any part of it and including in the “products-completed operations hazard”.

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

The trial court declined to rule on the burden of proof issue.

1. Trial Court Discretion.

We have acknowledged that the trial court had the discretion to not rule upon the question of who carries the burden of proof regarding the application of the exception to the coverage exclusion. However, as the Martinellis concede, it is an issue of first impression in this state. Assuming this court reverses the

finding of coverage by estoppel, then it would be appropriate for this court to resolve this pure question of law.

2. The Majority View is that the Insured Carries the Burden of Proof Regarding the Exception to a Coverage Exclusion.

Washington, like all states, holds that an insured carries the burden of proving a claim initially falls within the coverage terms of an insurance contract, and that the insurance company has the burden of proving facts that would bring the claim within a coverage exclusion. *Diamaco, Inc. v. Aetna Casualty and Surety Co.*, 97 Wn. App. 335, 337, 983 P.2d 707 (1999).

To date, no Washington case has addressed the legal question of which party carries the burden of proof regarding an exception to a coverage exclusion. We do note that in *American National Fire Insurance Co. v. B&L Trucking and Construction Co., Inc.*, 82 Wn.App. 646, 659, 920 P.2d 192 (1996), affirmed, 134 Wn.2d 413 (1998), the Court of Appeals noted that the trial court instructed the jury that the insured had the burden of proving that the claim fell within an exception to the pollution exclusion. As the Martinellis note in their brief, it appears to be the universal rule that the insured has the burden of proof regarding the “sudden and accidental” exception to the pollution exclusion. Brief of Respondents, footnote 22 at page 43. See, *Aydin Corp. v. First State Ins. Co.*, 18 Cal. 4th 1183, 959 P.2d 1213, 1215-1219 (1998).

The Martinellis' suggestion that the rule regarding burden of proof is or should be different outside the arena of pollution coverage is incorrect. As noted in insurance treatises, the majority rule places the burden of proving an exception to a coverage exclusion on the insured. 21 Appleman's Insurance Law, Section 12275 (1998 Supp); Couch on Insurance, Section 254 (Third Edition). It has been explained:

As a generality, the view that the insured bears the burden of showing that an exception to an exclusion applies, restoring coverage, is consistent with both the view that the burden should follow the benefit, and the view that the burden is to be placed on the party with the best access to the information that will be required to carry the burden.

Couch, supra.

This burden of proof rule has been applied to a variety of insurance contract clauses. *Traveler's Indemnity Co. v. Bloomington Steel and Supply Co.*, 695 N.W. 2d 408 (Minn. 2005) (exception to "expected or intended injury" exclusion); *Soo Line Railroad Co. v. Grounds Crew Car of Wyoming*, 694 NW 2d 109 (Minn. App. 2005); ("insured contract" exception to exclusion for liability assumed under any contract or agreement); *Duncan v. Cuna Mutual Insurance Society*, 614 SE 2d 592 (N.C. App. 2005) (exception to exclusion contained in life insurance policy); *State v. U.W. Marx Inc.*, 209 A.D. 2d 784, 618 NYS 2d 135 (1994) ("insured contract" exception to exclusion); *Modern Equipment Co. v. Continental Western Insurance Co., Inc.*, 355 F.3d 1125 (8th Cir. 2004) (exception

to “impaired property” exclusion); *Hartford Underwriters Insurance Co. v. Estate of Turks*, 206 F.Supp.2d 968 (E. D. MO 2002) (exception to exclusion in home owner’s policy). We see no reason Washington would not follow the commonly accepted rule that the insured has the burden of proof of establishing the application of an exception to an exclusion.

Martinellis note that a federal court in Missouri suggested that the insurance company would have the burden of proof of establishing the exception to the “Damage To Your Work” exclusion involved in this case. *National Union Fire Insurance Co. v. Structural Systems Technology, Inc.*, 756 F.Supp.1232 (E. D. MO 1991). There, the court did not actually discuss the burden of proof issue. Instead, the court simply noted that the insurance company had not established nor was there otherwise an indication in the record on appeal that the exception to the exclusion had not been triggered. When directly confronted with the application of the burden of proof rule, the Missouri courts have made it clear that the insured bears the burden of proof of establishing the triggering of an exception to an exclusion. *National Union Fire Insurance Co. v. Structural Systems Technology, Inc.*, 756 F.Supp. 1232 (E.D. MO 1991); *Hartford Underwriters Insurance Co. v. Estate of Turks, supra*.

MOE’s motion to the trial court was very simple. The court was requested to rule upon the issue of who has the burden of establishing the facts that would

determine whether the exception to the “Damage To Your Work” exclusion applied to the Martinellis’ various claims against Paulson. The answer to that question is a question of law which does not require any interpretation of the relevant language or the application of the language to a particular set of facts. Since the issue of the burden of proof is a matter of first impression in this state, we request the court to provide its guidance to the trial court.

3. The Martinellis’ Interpretation Of The “Damage To Your Work” Exclusion And Exception To The Exclusion.

Though they did not bring a motion requesting the trial court to interpret any aspect of the exclusion or exception, in their brief to this court the Martinellis offer two categories of comments.

First, Martinellis suggest that the interpretation and/or application of the insurance contract language at issue may be affected by matters such as “concurrent causation” and the concept of “efficient proximate cause.” Brief of Respondents, pages 41-42. In that vein, we note that the exclusion and exception to the exclusion use triggering words of “arising out of” “and arises.” Those terms, when used in an insurance contract, do not bring into play the efficient proximate cause or concurrent/joint causation legal concepts. *Kreml v. Unigard Security Insurance Co.*, 69 Wn.App. 703, 850 P.2d 533 (1993); *Mutual of Enumclaw Ins. Co. v. Patrick Archer Const., Inc.*, 123 Wn.App. 728, 97 P.3d 751 (2004). If this court accepts the Martinellis’ invitation to interpret the contract

language at issue, a portion of the court's analysis would need to be directed to this particular argument advanced by the Martinellis.

Second, the Martinellis provide a partial explanation of what they believe to be the scope of coverage provided in light of the exclusion and exception to the exclusion. Overall, we agree that the Martinellis' limited statement is accurate, as far as it goes. (Brief of Respondent, pages 42-43) However, the Martinellis' discussion does not take into account the definition of "your work" contained in the insurance contract, and appropriately avoids discussion of application of the coverage concept to particular factual scenarios.

The determination of the burden of proof issue invokes a simple question of law which should be ruled upon to assist the trial court on this matter of first impression. However, the Martinellis' own comments regarding the difficulty of actually interpreting the contract language in the abstract appear to be appropriate. Actual interpretation and application of the contract language is best left to the trial court, based upon the presentation of particular fact scenarios.

E. IF THE COURT REVERSES THE DETERMINATION OF BAD FAITH/COVERAGE BY ESTOPPEL, THEN THE ENTIRETY OF THE "JUDGMENT NUNC PRO TUNC," INCLUDING THE AWARD OF ATTORNEY FEES AND EXPENSES, MUST BE REVERSED

After the court entered summary judgment finding that MOE had engaged in bad faith, the Martinellis brought on a motion for summary judgment, requesting an award of attorney fees and expenses of litigation. CP 776-784, 785-

902. The court granted the Martinellis' summary judgment motion, and entered findings of fact and conclusions of law regarding attorney fees and expenses of litigation. CP 962-965. The attorney fees and expenses of litigation therein awarded, were ultimately part of the Judgment Nunc Pro Tunc entered by the court.

In its initial notice of appeal and amended notice of appeal, MOE appealed from the Judgment Nunc Pro Tunc, and each of the summary judgment orders, including those relating to attorney fees and expenses awarded to the Martinellis. CP 984-1001; 1041-1076.

In its opening brief, MOE assigned error to the Judgment Nunc Pro Tunc. In its brief, MOE noted that, if the appellate court reversed the finding that MOE engaged in bad faith, the monetary Judgment Nunc Pro Tunc, including that portion relating to attorney fees, must be reversed. Brief of Appellant, pages 44-45.

In response, the Martinellis make two arguments. First, the Martinellis contend that since MOE did not assign error to the summary judgment order and findings of fact/conclusions of law relating to attorney fees, the error has been waived. As we have noted at pages 1-2 of the present brief, parties need not assign error to superfluous findings of fact/conclusions of law entered in conjunction with a summary judgment motion.

Second, the Martinellis argue that MOE's opening brief did not present argument as to why the award of attorney fees must be reversed. However, as noted above, such argument was succinctly presented at pages 44-45 of MOE's opening brief. Admittedly, MOE's arguments were not lengthy. The simple fact of the matter is, it is automatic that an appellate court's reversal of the legal basis upon which attorney fees and expenses were awarded, necessarily results in a reversal of the judgment awarding those fees and expenses. *Stouffer & Knight v. Continental Casualty Co.*, 96 Wn.App. 741, 756, 982 P.2d 105 (1999).

F. CALCULATION OF INTEREST

The right to post-judgment interest is not contractual; it is a matter set by the legislature. *Puget Sound Nat'l Bank v. St. Paul Fire & Marine Ins. Co.*, 32 Wn. App. 32, 47, 645 P.2d 1122 (1982). The current Judgment Nunc Pro Tunc that the Martinellis have against MOE is not based upon the fact that the \$1.3 million judgment the Martinellis obtained against Paulson is actually insured under the MOE/Paulson insurance contracts. Instead, the Judgment Nunc Pro Tunc is based solely upon the Trial Court's conclusion that MOE engaged in the tort of bad faith. Thus, the tort post-judgment rate applies.

The post-judgment interest statute is simple. The legislature provides for post-judgment interest in three potentially relevant, distinct scenarios. First, it provides that a judgment on a contract with a "specified interest rate," "until paid"

will carry post-judgment interest at the rate specified in the contract. RCW 4.56.110(1).³ No contract involved in this case contains a specified interest rate; RCW 4.56.110(1) does not apply.

Conversely, RCW 4.56.110(3) applies to *all* judgments founded on tortious conduct. The Martinellis agree that their judgment against Mutual of Enumclaw is founded on the tort of bad faith. All judgments founded on tortious conduct “*shall* bear interest from the date of entry at two percentage points above the equivalent coupon issue yield, as published by the board of governors of the federal reserve system, of the average bill rate for twenty-six week treasury bills as determined at the first bill market auction conducted during the calendar month immediately preceding the date of entry.” *Id.* That rate, in this case, is 3.903 percent. This is the correct rate for post-judgment interest on the Judgment Nunc Pro Tunc.

The last statutory scenario is a catchall. RCW 4.56.110(4) applies only if sections (1) through (3) do not apply. Section (4) is irrelevant because section (3) applies to this case. The trial court erred when it awarded post-judgment interest at 12 percent, and should this Court sustain the remainder of the trial court’s

³ RCW 4.56.110 is set forth at Brief of Appellant, page 49.

Judgment Nunc Pro Tunc, it should reverse the award of post-judgment interest at the higher rate.⁴

II. REPLY TO MARTINELLIS' CROSS APPEAL

A. THE MARTINELLIS' CLAIM, THE TRIAL COURT PLEADINGS, AND THE TRIAL COURT RULINGS.

In their cross appeal, the Martinellis assert a Consumer Protection Act claim, alleging that MOE's failure to pay a portion of the stipulated judgment it obtained against Paulson violates WAC 284-30-330(6) and 284-30-370. Those regulations state:

WAC 284-30-330 Specific unfair claims settlement practices defined. (6) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear. In particular, this includes an obligation to effectuate prompt payment of property damage claims to innocent third parties in clear liability situations. If two or more insurers are involved, they should arrange to make such payment, leaving to themselves the burden of apportioning it.

WAC 284-30-370 Standards for prompt investigation of claims. Every insurer shall complete investigation of a claim within thirty days after notification of claim, unless such investigation cannot reasonably be completed within such time. All persons involved in the investigation of a claim shall provide reasonable assistance to the insurer in order to facilitate compliance with this provision.

⁴ If the Judgment Nunc Pro Tunc and conclusion that MOE engaged in the tort of bad faith, is vacated, and the Trial Court subsequently determines that the MOE/Paulson insurance contract provides coverage, then Martinellis present argument would make sense. Under that scenario, the Martinelli judgment against Paulson was based upon the construction contract, and under the MOE/Paulson insurance contract, MOE is obligated to pay for certain post-judgment interest awarded against Paulson.

In its Complaint For Declaratory Judgment, MOE asserted in relevant part of follows:

Some of the damage claimed [by Martinellis] against Dan Paulson Construction, Inc. is covered by the Mutual of Enumclaw policy, but much of it is subject to policy exclusions. The amount of the damage claimed against Dan Paulson Construction, Inc., which should come within these exclusions, is currently unknown. CP 2.

In their answer to this paragraph of MOE's Complaint, the Martinellis, as assignees of Paulson's rights, responded as follows:

With regard to paragraph 6, Martinellis admit that the Mutual of Enumclaw policy covered the damages claimed by the Martinellis against Paulson, in whole or in part, but deny the remainder of paragraph 6, and affirmatively believe that the majority of the damages against Paulson is subject to the policy; and, pursuant to Martinellis' counter claims, Mutual of Enumclaw is estopped as a matter of law to deny coverage. CP 915

From these pleadings, one can ascertain that even the Martinellis do not claim that all of the settlement between Paulson and the Martinellis are insured damages.

The Martinellis requested the Trial Court to enter a partial summary judgment that MOE violated the regulations by not paying to the Martinellis at

least a portion of the settlement reached between Paulson and the Martinellis.⁵

The trial court denied the Martinellis' request for partial summary judgment its initial memorandum decision stating as follows:

Even if MOE did not fail to settle "within policy limits," the Martinellis claim that MOE is guilty of bad faith because it has failed to pay any amount, even the undisputed amounts of property damage covered under its policy. According to the Martinellis, it is bad faith if an insurer refuses to pay, or does not timely pay, undisputed amounts of property damage covered under its policy. WAC 284-30-330(6), (7). By failing to pay undisputed amounts, the Martinellis argue that MOE left Paulson exposed to potentially substantial uninsured liability.

Whether an insurer's conduct satisfies its duty of good faith toward its insured depends upon whether the insurer's denial of coverage was based upon reasonable grounds. *Smith v. Safeco*, 150 Wash.2d at 486.

In this case, MOE has continually asserted that much of the liability is excluded under the subcontractor exception to the work exclusion. It is disputed that some, if not a large portion, of the work done in this case falls under the subcontractor exception to the work exclusion. Until MOE discovers what work is covered by the settlement, it is not in a position to determine what amounts are covered and what amounts are not covered. Since the parties did not contract to provide insurance for a noncovered event, MOE is not required to pay for amounts that are not covered under the policy.

⁵ As we have discerned, Martinellis do not argue on appeal that MOE should have paid some portion of the Martinellis' "claims" before or during the Arbitration. We so state, because their Brief on Appeal simply asserts that "the covenant judgment establishes a clear liability situation." Brief of Respondents, page 46. Logically, the Martinellis do not argue that the failure of MOE to pay to Martinellis some partial sum prior to or during the course of the Arbitration violates the regulation. This is particularly so, in light of the fact that there is no evidence that the insured Paulson requested such act. To hold that an insurer who is defending its insured against multiple disputed claim components must tender to the claimant some money, without obtaining for the insured a complete release of all claims, would clearly jeopardize the insured's negotiation position regarding an attempt to resolve all claims.

In any event, Paulson is not exposed to “potentially substantial uninsured liability” as the Martinellis claim because the stipulated agreement is \$1.3 million and the potential coverage is \$4 million.

Conclusion: Therefore, the court denies the Martinellis’ motion for partial summary judgment that it was bad faith for MOE to fail to pay undisputed property damage amounts. The court grants MOE’s motion for partial summary judgment that it did not act in bad faith for failure to settle within policy limits.

CP 652, Appendix 1 at page 9.

The memorandum decision was followed up by the court’s written order denying the Martinellis’ motion for partial summary judgment. CP 1005-1006.

Thereafter, the trial court concluded that its finding of coverage by estoppel against MOE made it unnecessary to then hold a trial regarding Martinellis’ claim regarding the WAC provisions. That claim by the Martinellis was stayed by the trial court. CP 1015. The court concurrently entered an order pursuant to CR 54(b) certifying to this court a singular matter. Specifically, the trial court certified to this court the November 12, 2004 “Judgment Nunc Pro Tunc” entered against MOE. The trial court did not certify to this court its order denying the Martinellis’ request for partial summary judgment.

For the reasons explained below, the Martinellis’ cross appeal is not well taken.

B. THE CROSS APPEAL ISSUE RAISED BY THE MARTINELLIS IS NOT PROCEDURALLY BEFORE THE COURT.

A non-final order, such as an order of summary judgment, or an order which has not been certified by the trial court as appealable under CR 54(b),⁶ is not appealable. *Glass v. Stahl Specialty Co.*, 97 Wn.2d 880, 652 P.2d 948 (1982). The appellate court may consider such order on appeal, if the trial court order falls within the criteria for discretionary review. *Id.* Here, the Martinellis requested

⁶ CR 54. JUDGMENTS AND COSTS

(b) Judgment Upon Multiple Claims or Involving Multiple Parties. When more than one claim for relief is presented in an action, whether as a claim, counterclaim, cross claim, or third party claim or when multiple parties are involved, the court may direct the entry of a final judgment as to one or more but fewer than all of the claims or parties only upon an express determination in the judgment, supported by written findings, that there is no just reason for delay and upon an express direction for the entry of judgment. The findings may be made at the time of entry of judgment or thereafter on the court's own motion or on motion of any party. In the absence of such findings, determination and direction, any order or other form of decision, however designated, which adjudicates fewer than all the claims or the rights and liabilities of fewer than all the parties shall not terminate the action as to any of the claims or parties, and the order or other form of decision is subject to revision at any time before the entry of judgment adjudicating all the claims and the rights and liabilities of all the parties.

review of the order denying their motion for partial summary judgment does not meet the criteria for discretionary review set forth in RAP 2.3(b).⁷ Therefore, it is not subject to review by this court.

Similarly, a denial of a motion for partial summary judgment is not an appealable order. *Anderson v. State Farm Mutual Insurance Co.*, 101 Wn.App. 323, 329, 2 P.3d 1029 (2000). An interlocutory appeal of an order denying summary judgment is not ordinarily granted unless it meets the criteria of RAP 2.3(b). *Caulfield v. Kitsap County*, 108 Wn.App. 242, 249, 29 P.3d 738 (2001). Additionally, the existence of a material fact precludes discretionary review of an order denying a motion for partial summary judgment. *Anderson v. State Farm Mutual Insurance Co.*, supra, 101 Wn.App. at 329.

⁷ RULE 2.3 DECISIONS OF THE TRIAL COURT WHICH MAY BE REVIEWED BY DISCRETIONARY REVIEW

(b) Considerations Governing Acceptance of Review.

Except as provided in section (d), discretionary review will be accepted only:

- (1) If the superior court has committed an obvious error which would render further proceedings useless;
- (2) If the superior court has committed probable error and the decision of the superior court substantially alters the status quo or substantially limits the freedom of a party to act; or
- (3) If the superior court has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by an inferior court or administrative agency, as to call for review by the appellate court.

The appellate court may consider that the superior court has certified, or that all parties to the litigation have stipulated, that the order involves a controlling question of law as to which there is substantial ground for a difference of opinion and that immediate review of the order may materially advance the ultimate termination of the litigation.

Here, the trial court was not asked, and did not certify to this court, the denial of the Martinellis' motion for partial summary judgment regarding their WAC claims. The Martinellis do not presently argue that the trial court was incorrect in its holding, quoted above, that "until MOE discovers what work is covered by the settlement, it is not in a position to determine what amounts are covered and what amounts are not covered." CP 652. As a result, it is unquestioned that there are material issues of fact regarding whether MOE has failed to pay to the Martinellis a sum which is undisputedly insured under the insurance contract.

Finally, Martinellis do not argue, and we do not discern any basis for concluding, that the issue presented by the Martinellis falls within any other criteria under RAP 2.3(b) which would permit discretionary review.

The purported cross appeal issue raised by the Martinellis remains pending before the trial court and will be litigated by the parties if this court vacates the Judgment which was entered against MOE and which is the sole subject of the present appellant proceeding.⁸

⁸ We acknowledge that a respondent may argue for the affirmation of a judgment on a ground other than the basis of the trial court's entry of the judgment. However, as explained later in this brief, even if this court were to determine that MOE violated the WAC provision relied upon by the Martinellis, the remedy would not be coverage by estoppel for the \$1.3 million Paulson/Martinelli settlement, but instead would be limited to actual damages sustained by Paulson as a result of the fact of nonpayment by MOE after the settlement was reached.

C. THE MARTINELLIS DID NOT ESTABLISH THEIR RIGHT TO SUMMARY JUDGMENT

An unreasonable violation of one of the insurance claim practices regulations does create a cause of action for the tort of bad faith and/or a CPA claim. *American Manufacturers Mutual Insurance Co. v. Osbourne*, 104 Wn.App. 686, 17 P.3d 1229 (2001). There, the court set forth the elements and parameters of such claim, stating:

Good Faith and Consumer Protection Act Causes of Action

The fiduciary relationship between the insurer and the insured is the source of the duty of good faith. *Tank v. State Farm Fire and Cas. Co.*, 105 Wash.2d 381, 385, 715 P.2d 1133 (1986). “[A]n insurer must deal fairly with an insured, giving equal consideration in all matters to the insured’s interests.” *Tank*, 105 Wash.2d at 386, 715 P.2d 1133 (emphasis omitted). The duty to act in good faith is broad and conduct that does not amount to intentional bad faith or fraud may be a breach of duty. *Indus. Indem. Co. of the Northwest, Inc. v. Kallevig*, 114 Wash.2d 907, 916-17, 792 P.2d 520 (1990). This duty is both legislatively and judicially imposed. See RCW 48.01.030; *Tank*, 105 Wash.2d at 386, 715 P.2d 1133.

The Insurance Commissioner has promulgated regulations that define specific acts and practices that constitute a breach of an insurer’s duty of good faith. RCW 48.30.010; see WAC 284-30-300 to -800; *Tank*, 105 Wash.2d at 386, 715 P.2d 1133. Generally, “[a]n action for bad faith handling of an insurance claim sounds in tort.” *Safeco*, 118 Wash.2d at 389, 823 P.2d 499; *Anderson v. State Farm Mut. Ins. Co.*, 101 Wash.App. 323, 333, 2 P.3d 1029 (2000). But a breach of these regulations also constitutes a per se unfair trade practice violation and “insured’s may bring a private action against their insurers for breach of duty of good faith under the CPA[.]” based on such breaches. *Tank*, 105 Wash.2d at 386, 394, 715 P.2d 1133.

To prevail on a CPA claim, one must show (1) an unfair or deceptive act or practice in trade or commerce that impacts the public interest, and (2) resulting injury to the claimant's business or property. *Indus. Indem.*, 114 Wash.2d at 920-21, 792 P.2d 520; *Hangman Ridge Training Stables, Inc. v. Safeco Title Ins. Co.*, 105 Wash.2d 778, 784-85, 719 P.2d 531 (1986). The insured may establish the first element by showing a violation of any subsection of WAC 284-30-330. *See Indus. Indem.*, 114 Wash.2d at 923, 792 P.2d 520; *Hangman Ridge*, 105 Wash.2d at 786, 719 P.2d 531; *Anderson*, 101 Wash.App. at 330, 2 P.3d 1029.

The elements of a non-CPA bad-faith claim are similar. The violation of a WAC 284-30-330 subsection establishes a breach of duty. *Anderson*, 101 Wash.App. at 333, 2 P.3d 1029. But, unlike the injury in the CPA claim, the injury alleged need not be economic and may include emotional distress or personal injury. *Coventry Assocs. v. Am. States Ins. Co.*, 136 Wash.2d 269, 284, 961 P.2d 933 (1998) ("Coventry II").

Thus, to prevail on a summary judgment motion on either the CPA or non-CPA bad-faith claims, AMMI must show there is no question of fact as to (1) whether it violated any subsection of WAC 284-30-330, or (2) whether such violation caused a recognized injury. *Indus. Indem.*, 114 Wash.2d at 920-21, 792 P.2d 520; *Hangman Ridge*, 105 Wash.2d at 784-85, 719 P.2d 531. *American Manufacturers Mutual Insurance Co. v. Osbourne*, supra, 104 Wn.App. at 696-698 (footnote omitted).⁹

There are two other limiting components of such claims. First, such claims exist solely in regard to harm caused to the insured and harm to the tort claimant, such as the Martinellis, are not cognizable. *Tank v. State Farm Fire & Casualty Co.*, 105 Wn.2d 381, 714 P.2d 1133 (1986); *Nigel v. Harrell*, 82 Wn.App. 782, 919 P.2d 630 (1996) (tort claimant does not have a cause of action

for alleged violation of WAC 284-30-330(6) by tort defendants insurer). Second, if the insurance company had a reasonable basis to withhold payment, its refusal to make the payment is not a violation of the WAC provision and may not be the basis of either a CPA or a bad faith claim. *America Manufactures Mutual Insurance Co. v. Osbourne*, *supra*, 104 Wn.App. at 699-700, and cases cited therein; (reasonable basis of not complying with WAC precludes CPA claim); *Kirk v. Mt. Airy Insurance Co.*, *supra*, 134 Wn.2d at 560 (the tort of bad faith requires a showing that the insurance company's conduct was unreasonable, frivolous, or unfounded); *Capelou v. Valley Forge Ins. Co.*, 98 Wn.App. 7, 22, 990 P.2d 414 (1999) (No bad faith/CPA claim when there is a debatable question of coverage). Here, the Martinellis have failed to carry their burden of proof, establishing that they were entitled to summary judgment regarding any alleged violation of the regulation.

It has not been clearly established what liability, if any, MOE has for the settlement entered into by Paulson and the Martinellis. Not only has there been a failure to determine whether that settlement met the reasonableness standards discussed earlier in the party's briefs, but there is absolutely no way to presently

⁹ The American Manufacturing court was a first party insured bad faith/CPA claim. We submit that the regulations relied upon by the Martinellis do not apply in the context of failing to pay a third party claim which is being defended. We are unable to locate any case law on the subject.

ascertain what components of the settlement were actually insured, as opposed to uninsured.

Anticipating this response from MOE, the Martinellis brief points to the fact that, prior to Arbitration, MOE evaluated the Martinellis' claims, and ascertained that some of them were insured under the MOE/Paulson insurance contract. On that basis, MOE made a \$550,000 settlement offer. However, in an analogous situation, the court noted that pre-litigation settlement offers do not determine what in fact was the sum actually owed to the claimant. As noted by the court, the amount offered in settlement does not set the floor in regard to what is an undisputed sum owed. *Voland v. Farmers Insurance Co. of Arizona*, 189 AZ 448, 943 P.2d 808 (AZ.App. 1997). There the court stated:

Contrary to plaintiff's contention, that the carriers considered her claim's "fair value" to be \$30,000 and therefore offered to settle for that amount does not mean they acknowledged that was "the minimal amount the insurers own adjuster had evaluated as being owed to the insured." Rather, the settlement offer was simply a proposal to compromise and resolve the claim, nothing more and nothing less. It represented the carriers' evaluation or best estimate, at that point in time, of what the trier (here, the arbitrators) might award.

The carriers' settlement offer did not bind them if, as it turned out, the claim could not be settled and had to be arbitrated. Nor did it set a "floor" on what the arbitrators had to award or what the carriers ultimately would have to pay. As State Farm correctly notes, "an unaccepted settlement offer does not liquidate the amount of damages or constitute an admission of 'undisputed amounts' owed."

As the trial court correctly held here, it has not been established what sum, if any, MOE undisputedly provides in coverage regarding the settlement between Paulson and the Martinellis.

The second reason that the trial court's denial of summary judgment must be sustained, is that the Martinellis failed to establish how Paulson had been damaged as a result of the failure of MOE to pay after the settlement was reached. Absent any proof of actual damage to the insured, and a method to calculate that damage, neither a CPA nor a bad faith claim can be awarded. *American Manufactures Mutual Insurance Co., supra*. Again, anticipating MOE's response, Martinellis appear to suggest that there should be a presumption of harm if the WAC provision was violated. That contention has been specifically rejected. *American Manufacturers Mutual Insurance Co. v. Osbourne, supra*, 104 Wn.App. at 702, citing *Coventry Associates, LP v. American States Insurance Co.*, 86 Wn.App. 845, 939 P.2d 1245 (1997), reversed on other grounds, 136 Wn.2d 269 (1998).

In summary, the Martinellis have failed to prove a violation of a regulation or any damage to Paulson from any alleged violation.

D. A VIOLATION OF A WAC PROVISION DOES NOT CREATE COVERAGE BY ESTOPPEL

Without directly stating so, the Martinellis infer a violation of a WAC provision, after settlement by the tort claimant and the insured, can be a basis to

invoke coverage by estoppel and require the insurance company to pay the entirety of the settlement, both insured and uninsured aspects. However, the Martinellis do not argue or offer citation to authority for this extraordinary proposition. The failure of a party present argument or any citation to authority in their opening brief regarding an issue precludes review. *In re the Marriage of Wallace*, 111 Wn.App. 697, 704, 45 P.3d 1131 (2002).

In fact, it has already been conclusively held that a violation of one of the insurance regulations does not create coverage by estoppel. *Hayden v. Mutual of Enumclaw Ins. Co.*, 141 Wn.2d 55, 61-63, 1 P.3d 1167 (2000).

The Martinellis cross-appeal is procedurally deficient, lacks a legal argument or citation to relevant authority, and is in part directly contrary to binding authority. Though sanctions are not requested, the cross-appeal should emphatically be denied.

III. CONCLUSION

Paulson built a home for the Martinellis for \$1,725,000. After being sued, and to protect himself from uninsured claims, Paulson entered into a lump sum settlement with the Martinellis. We do not know how much the architects paid for the identical claims, and we do not know how much of the Martinelli/Paulson settlement is for insured or uninsured claims. The Martinellis' Brief does not enlighten us on any of these issues.

In the hope of sweeping these critical issues from sight, the Martinellis convinced the Trial Court that conduct of MOE, which resulted in Paulson incurring attorney fees in a Declaratory Judgment Action, preclude MOE from litigating these issues via the current Declaratory Judgment insurance coverage proceeding and a reasonableness hearing regarding the Paulson/Martinelli settlement.

The Trial Court was mistaken in the following respects:

- Concluding that MOE was estopped from denying insurance coverage due to its initiating discovery directed to the Arbitrator.
- Failing to conclude that MOE was not estopped from denying coverage based upon its initiating discovery directed to the Arbitrator.
- Concluding that the Paulson/Martinelli settlement was reasonable based upon the record before the Court.
- Entering the Judgment Nunc Pro Tunc, including \$1.3 million principal, interests, attorney fees and costs.
- Applying a post-judgment interest rate of 12% to the principal judgment amount.

In addition to resolving the above issues, MOE requests the court to address the issue regarding the burden of proof of an exception to a coverage exclusion.

Dated this 8th day of September, 2005.

A handwritten signature in black ink, appearing to read "K. C. Webster", written over a horizontal line.

K. C. Webster, WSBA #7198
Attorney for Mutual of Enumclaw
Insurance Company, Appellant

APPENDIX

SUPERIOR COURT OF THE STATE OF WASHINGTON

FOR THE JUDICIAL DISTRICT OF ISLAND AND SAN JUAN COUNTIES

August 19, 2004

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Re: Mutual of MOE Insurance Co. v. Dan Paulson Construction, Inc.,
and Karen and Joseph Martinelli; San Juan County Superior Court, No. 04-2-05012-1

Dear Counsel:

This matter came before the court on the following motions:

1. Counterclaimants Joseph and Karen Martinelli's Motion for Partial Summary Judgment;
2. Plaintiff's Motion for Partial Summary Judgment; and
3. Martinelli's Motion to Remedy Mutual of Enumclaw's Abuse of Privilege and to Compel Discovery.

The two motions for partial summary judgment have similar issues, although they are worded somewhat differently. Karen and Joseph Martinelli (the Martinellis) ask the court to find that Mutual of Enumclaw (MOE) breached its duty of good faith to its insured, Dan Paulson Construction, Inc. (Paulson) by issuing a subpoena and sending an *ex parte* letter to the arbitrator in mediation and by failing to pay undisputed amounts due under its insurance contract.

The motion by MOE asks the court to find that MOE is not liable to the Martinellis for bad faith on the issues above and to find that the burden of proving that there is insurance coverage for the work of the subcontractors is on the Martinellis.

Court's Letter Opinion – August 19, 2004

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HACKETT BEECHER & HART

ALAN R. HANCOCK
Judge

VICKIE I. CHURCHILL
Judge

DONALD E. EATON
Court Commissioner

KAREN A. LERNER
Court Commissioner

SHERRY L. CAMERON
Court Administrator

The Martinellis' motion asks the court to find that MOE waived the attorney-client privilege and to enter an order *in limine* prohibiting MOE from offering evidence and argument concerning whether MOE had a reasonable basis for issuing the subpoena to the arbitrator, for initiating *ex parte* correspondence to the arbitrator, and for interjecting evidence of insurance coverage into the arbitration proceedings. The Martinellis' motion also asks the court to compel discovery for matters which MOE claims are privileged.

The parties agree that the facts are undisputed.

FACTS

The Martinellis entered into a contract with Dan Paulson Construction, Inc. (Paulson) to build a home on San Juan Island. Both parties initiated arbitration proceedings; Paulson's proceeding is not relevant to this case. The Martinellis initiated arbitration proceedings for breach of contract against Paulson for construction defects. The arbitration proceeding was limited to \$1 million recovery.

Paulson, who had a comprehensive general liability insurance policy with MOE, was assigned counsel by MOE in the arbitration proceedings under a reservation of rights. Under the reservation of rights, MOE agreed to defend Paulson but pointed out in the reservation letter that there was no coverage for defective work performed by Paulson, just for defective work performed by Paulson's subcontractors. MOE has admitted that some of the Martinellis' damages fall within the policy coverage; i.e., work performed by Paulson's subcontractors and a "stigma" claim.

The arbitration between Paulson and the Martinellis was scheduled to start on January 6, 2004. In October 2003, Paulson, with the Martinellis' agreement, requested that the arbitrator make a single, lump sum arbitration award, rather than itemize his damage findings.

On November 21, 2003, MOE filed a declaratory judgment action in San Juan Superior Court against both the Martinellis and Paulson. On December 30, 2003, MOE sent a subpoena duces tecum to the arbitrator for a deposition on written interrogatories with a response date on January 23, 2004. Paulson and the Martinellis received a copy of the subpoena of January 2, 2004, four days prior to the date for the scheduled arbitration.

In addition to documentation and requests for production, the subpoena also sought information from the arbitrator as to which witnesses he found credible, itemization of the arbitration award, and analysis of which elements of the award involved work performed by subcontractors.

MOE's attorneys also sent the arbitrator a cover letter dated December 30, 2003, which explained MOE's interpretation of Paulson's insurance coverage. MOE's attorney explained that MOE was defending under a "reservation of rights" and that MOE "needs more information about the basis of your [future] award." MOE and its attorneys did not send a copy of that letter to either Paulson's counsel or the Martinellis' counsel. The parties to the arbitration first learned of MOE's correspondence to the arbitrator when the arbitrator disclosed it to them at commencement of the arbitration on January 6, 2004.

AAA Arbitration and the parties to the arbitration promptly asked MOE to withdraw its subpoena to the arbitrator. The arbitrator telephoned MOE's attorney to voice his objection. When MOE's attorney disclosed that he intended to send a second letter to the arbitrator, the Martinellis protested and urged MOE to not engage in any more direct communications with the arbitrator pending AAA Arbitration's retention of counsel to represent the arbitrator. However, MOE sent a second letter to the arbitrator dated January 7, 2004, abandoning Interrogatories Nos. 8-9 and 12-13. MOE informed the arbitrator in the letter that "the policy at issue is not first party coverage; it is a liability policy and any obligation that MOE of MOE may eventually have (other than defense) is based entirely on the award."

Attorneys for Paulson and the Martinellis complained to MOE's attorney that MOE's actions prejudiced the arbitration proceeding. MOE dismissed the Martinellis from the Superior Court declaratory action on January 9, 2004, after the Martinellis indicated they would seek a protective order against MOE's subpoena to the arbitrator. MOE thereafter struck the arbitrator's deposition before dismissing the Superior Court cause (No. 03-2-05168-4) in its entirety. MOE refiled the complaint in this instant proceeding.

On January 12, 2004, during the sixth day of the arbitration trial, Paulson and the Martinellis entered into a Stipulated Arbitration Award in the amount of \$1,300,000, plus certain additional, specific relief. The parties submitted the stipulated arbitration award to the arbitrator who found that it was a reasonable award based on the testimony of the witnesses, the exhibits and all the materials submitted to him during the course of the hearings.

The Martinellis moved this court to confirm the arbitration award, which the court did by order and judgment dated February 2, 2004, in Case No. 02-2-05152-0. MOE knew of those proceedings but did not to intervene. Paulson assigned its contract and bad faith causes of action against MOE, in consideration of which the Martinellis executed a covenant not to execute against Paulson.

On February 4, 2004, the Martinellis as assignees of Paulson made demand upon MOE to pay the undisputed, insured portions of damages due under the policy. MOE has made no payments to the Martinellis.

Other facts necessary to this opinion are included below.

LAW

Summary Judgment

A party moving for summary judgment bears the initial burden of showing the absence of an issue of material fact. *Young v. Key Pharmaceuticals*, 112 Wash.2d 216, 225, 770 P.2d 182 (1989). This "showing may consist of merely pointing out that there is 'an absence of evidence to support the nonmoving parties' case.'" *Young*, 112 Wash.2d at 225 n.1, quoting, *Celotex Corp. v. Catrett*, 477 U.S. 317, 325, 91 L.Ed. 2d 265, 106 S.Ct. 2548 (1986). Once this showing occurs, "the inquiry shifts to the party with the burden of proof at trial" to respond with competent evidence. *Young*, 112 Wash.2d at 225. The evidence must be admissible. CR 56(e). If the party with the burden of proof on the issue fails to "establish the existence of an element essential to that party's case, and on which the party will bear the burden of proof at trial," the trial court should grant the motion for summary judgment. *Young*, 112 Wash.2d at 225, quoting *Celotex*.

Duty to Act in Good Faith

An insurer has a duty of good faith to its policyholder and violation of that duty may give rise to a tort action for bad faith. *Truck Ins. Exch. V. Vanport Homes, Inc.*, 147 Wash.2d 751, 765, 58 P.3d 276 (2002). To succeed on a bad faith claim, the policyholder must show the insurer's breach of the insurance contract was unreasonable, frivolous, or unfounded. *Overton v. Consol. Ins. Co.*, 145 Wash.2d 417, 433, 38 P.3d 322 (2002). Whether an insurer acted in bad faith is a question of fact. *Van Noy v. State Farm Mut. Auto. Ins. Co.*, 142 Wash.2d 784, 796, 16 P.3d 574 (2001). Questions of fact may be determined on summary judgment as a matter of law where reasonable minds could reach but one conclusion. *Ruff v. County of King*, 125 Wash.2d 697, 703-04, 887 P.2d 886 (1995).

When defending under a reservation of rights, an insurer owes its insured an *enhanced duty of fairness* and may not demonstrate greater concern for its own monetary interests than for the insured's financial risk. *Tank v. State Farm Fire & Cas. Co.*, 105 Wash.2d 381, 385-86, 715 P.2d 1133 (1986). While the insurer does not have to place the insured's interests above its own, it is required to give "equal consideration" to the insured's interests. *Id.* Thus, an insurance company's duty of good faith rises to an even higher level than that of honesty and lawfulness of purpose toward its policyholders: an insurer must deal fairly with an insured, giving equal consideration *in all matters* to the insured's interests. *Id.*

DISCUSSION

I. Motions for Partial Summary Judgment

Both motions for partial summary judgment address two specific areas of MOE's alleged bad faith: (1) interference with the insured's arbitration proceeding, and (2) MOE's alleged refusal to pay undisputed property damage amounts due under its policy. MOE words the second issue as whether MOE breached its duty of good faith by failing to settle the Martinellis' claims against Paulson for \$1 million. MOE's motion for partial summary judgment also asks the court to find that the burden is on the insured for proving there is insurance coverage for the work of the subcontractors.

A. Did MOE Breach Its Duty of Good Faith by Engaging in Discovery with the Arbitrator in the Insured's Arbitration Proceeding?

The Martinellis contend that MOE breached its duty of good faith by interfering with the insured's arbitration proceeding when MOE sent a subpoena to the arbitrator and informed the arbitrator in a cover letter of the reservation of rights with Paulson.

Arbitration is described by the courts as "a substitute for judicial action," in which arbitrators "become the judges of both the law and the facts." *Int'l Assoc. of Fire Fighters Local 46 v. City of Everett*, 146 Wash.2d 29, 37-38, 42 P.3d 1265 (2002). A judge should be called as a witness "[o]nly in the rarest of cases" to testify concerning matters "upon which he has acted in a judicial capacity, and these occasions...should be limited to instances in which there is no other reasonably available way to prove the facts sought to be established." *State ex rel Carroll v. Junker*, 79 Wash.2d 12, 21, 482 P.2d 775 (1971).

It is undisputed that MOE issued a subpoena to the arbitrator prior to the arbitration trial that was scheduled for January 6, 2004. MOE sent a cover letter with the subpoena, informing the

arbitrator that the questions were intended to determine what portions of the overall liability were based on Paulson's faulty work. The discovery was served on the parties to the declaratory judgment action, but the cover letter was sent only to the arbitrator.

MOE first argues that a deposition is proper with respect to an arbitrator's prejudgment of the dispute. *Hoelt v. MVL*, 343 F.3d. at 66 (the District Court acted within its discretion in permitting counsel to depose the arbitrator regarding the allegation of prejudgment). MOE is wrong. The question in *Hoelt* was whether arbitrator had prejudged the dispute; i.e., to events that occurred *before* the dispute resolution mechanism had been triggered. No similar issue is involved in this action. MOE advances no reason that it believed the arbitrator had prejudged the issues in the proceeding.

Second, MOE maintains that its contact with the arbitrator was not improper since it was not a party to the arbitration.¹ This argument overlooks the fact that the Rules of Professional Conduct prohibit a lawyer from *ex parte* contact with a judge.² The Martinellis allege that the cover letter informing the arbitrator of disputed insurance matters was *ex parte* contact. The court agrees.

A judge, or an arbitrator in this case, is prohibited from having *ex parte* contact from lawyers, law teachers, and other persons who are not participants in the proceeding.³ A lawyer or other persons not participants in the proceeding cannot have *ex parte* contact with an arbitrator. See, *Int'l Assoc. of Fire Fighters Local 46*, 146 Wash.2d 29, 37-38 (2002); *Valrose Maui, Inc. v. Maclyn Morris, Inc.*, 105 F. Supp. 1118, 1123-24 (D. Haw. 2002). It is immaterial that MOE was not a party to the arbitration. Other persons not participants in the proceeding, such as MOE, cannot have *ex parte* contact with an arbitrator. *Id.*

Next, MOE contends that it has the right to discovery of a non-party witness, the arbitrator, in the Superior Court declaratory judgment action. This contention ignores the well-established rule that arbitrators may not be deposed absent "clear evidence of impropriety." *Hoelt v. MVL Group, Inc.*, 343 F.3d 57, 66-7 (2nd Cir. 2003). The use of post-award affidavits from arbitrators is also discouraged. See, e.g., *Woods v. Saturn Distrib. Corp.*, 78 F.3d 424 (9th Cir. 1996), *cert. dismissed*, 518 U.S. 1051 (1996) (noting that "deposition of arbitrators are 'repeatedly condemned' by courts"). Additional case law protects arbitrators from being required to give evidence reflecting their deliberative processes. *Container Technology Corp. v. J. Gadsden Pty. Ltd.*, 781 P.2d 119, 121 (Colo.App. 1989) (holding that party may not depose arbitrators for the purpose of inquiring into the arbitrator's thought process).

MOE argues that there was "clear evidence of impropriety," pointing to the stipulation between Paulson and the Martinellis that the arbitrator provide a lump sum award. MOE argues that Paulson and the Martinellis deliberately tried to obscure the award by stipulating to a lump sum. However, there is no competent evidence, only speculation that the Martinellis entered into the stipulation with Paulson in an attempt to keep such information from MOE. The nonmoving party may not rely on speculation or argumentative assertions that unresolved factual matters

¹ "No party and no one acting on behalf of any party shall communicate *ex parte* with an arbitrator or candidate for arbitrator concerning the arbitration..." Rule 19 of the American Arbitration Association (AAA) Rules and procedures.

² "A lawyer shall not (a) seek to influence a judge, juror, prospective juror or other official by means prohibited by law; (b) communicate *ex parte* with such a person except as permitted by law; or (c) engage in conduct intended to disrupt a tribunal." RPC 3.5.

³ Comment to Canon of Judicial Conduct 3(A)(4).

remain. *Meyer v. University of Washington*, 105 Wash.2d 847, 852, 719 P.2d 98 (1986); *Zobrist v. Culp*, 18 Wash.App. 622, 570 P.2d 147 (1977). Instead, the nonmoving party must set forth specific facts that sufficiently rebut the moving party's contention and disclose that a genuine issue of material fact exists. *Deicomes v. State*, 113 Wash.2d 612, 631, 782 P.2d 1002 (1989). MOE's argument that there was "clear evidence of impropriety" fails.

In another argument, MOE asserts that discovery of the arbitrator's "arithmetic supporting the award" was not improper. Without such discovery, MOE maintains that Paulson and the Martinellis, who had stipulated to a lump sum arbitration award, increased the likelihood that MOE would be forced to pay a claim that was outside Paulson's coverage. This argument is suspect, however, because MOE's coverage counsel admitted at deposition that he did not learn of the lump sum stipulation between Paulson and the Martinellis until he learned of that fact in a letter dated January 8, 2004, from one of the attorneys representing the Martinellis. The subpoena to the arbitrator is dated December 30, 2003.

The discovery to the arbitrator was simply an attempt to learn the "arithmetic" supporting the lump sum, MOE maintains. Yet, the "arithmetic" is part of the arbitrator's reasoning and mental impressions, which is improper. Washington law is clear and unequivocal that the arbitrator may not explain his award. *Lent's, Inc. v. Santa Fe Engineering*, 29 Wash.App. 257 (1981)(an explanation for an arbitration award "would have the effect of encouraging disappointed parties in attempts to impeach adverse awards"); *accord, Lester v. Mills*, 117 Wash.502, 505-06, 201 P. 752 (1921).

MOE contends that the discovery to the arbitrator as to the covered and uncovered claims was not reasonably available through other means. This argument ignores the fact that both Paulson and the Martinellis cooperated with MOE's requests for information. Paulson provided the claims representative at MOE with requested information in July 2002. In August 2003, MOE requested documents from Paulson, which Paulson provided in September 2003. MOE's coverage attorney admitted at his deposition that MOE never asked for anything more.

Even if Paulson and the Martinellis refused to provide discovery, MOE could have sought discovery through the declaratory judgment action, which was filed in the Superior Court. However, MOE does not indicate what discovery it did not have, with the exception of the arbitrator's explanation of his award. Additionally, MOE admits that it could bring a declaratory judgment action, which it did, and litigate the issue of what Paulson's policy covered. Thus, much of the information sought by MOE was reasonably available from other sources, with the exception of the arbitrator's mental impressions.

It is clear to the court that MOE was representing its own interests, not Paulson's, when it subpoenaed the arbitrator and when it sent the arbitrator its cover letter. However, the question remains, did MOE's actions in contacting the arbitrator "demonstrate greater concern for the insurer's monetary risk than for the insured's financial risk"? *Tank*, 105 Wash.2d at 388. If MOE's actions did, then MOE did not meet its enhanced duty of fairness under a reservation of rights defense, and there is bad faith. *Id.*

By sending the cover letter to the arbitrator, MOE interjected insurance questions and reservations of rights into the arbitration that potentially could have prejudiced the parties to the arbitration, and more specifically, MOE's own insured, Paulson. The fact that an arbitrator is presumed to consider only the relevant evidence in coming to a decision does not excuse MOE's

actions. *Ex parte* communications with arbitrators pose a grave risk of invalidating an arbitration decision under RCW 7.04.160(1), (2) and (3). The court agrees with the Martinellis that, potentially, such *ex parte* communications create uncertainty as to whether an award will withstand judicial scrutiny or require recusal from the arbitrator.

Conclusion: Thus, the court finds that reasonable minds could reach but one conclusion: MOE's actions in initiating discovery of the arbitrator, prior to the arbitration trial, and sending an *ex parte* letter to the arbitrator informing the arbitrator of the reservation of rights was bad faith.

B. Did MOE Rebut the Presumption of Harm?

Once there has been a finding of bad faith, a rebuttable presumption of harm arises. *Safeco v. Butler*, 118 Wash.2d 383, 823 P.2d 499 (1992). The insurer can rebut the presumption of harm by showing by a preponderance of evidence its acts did not harm or prejudice the insured. *Safeco v. Butler*, 118 Wash.2d at 394. Thus, the next question before the court is whether there are material facts in dispute that Paulson was harmed or prejudiced by MOE's actions.

MOE argues that Paulson was not harmed by their contact with the arbitrator because the arbitrator never made any ruling since the parties settled. The Martinellis respond that the fact that the parties entered into a stipulated arbitration award with a covenant not to execute does not rebut the presumption of harm. *Safeco v. Butler*, 118 Wash.2d at 397 (an insured's assignment of their rights under the policy does not relieve the insured from liability, nor does it preclude a showing of harm). The Martinellis are correct. The fact that the parties entered into a stipulated arbitration award, thus eliminating any need for the arbitrator to come to a decision, is not determinative of whether the presumption of harm has been rebutted.

However, MOE argues that even assuming that its actions in contacting the arbitrator were improper, their actions did not cause the arbitrator to be prejudiced against either the Martinellis or Paulson. First, the parties to the arbitration had the right to rely on the arbitrator's ability to rule on issues of liability and damages independently of any insurance issues. The parties to the arbitration apparently agreed, argues MOE, because after discussing the subpoena and the *ex parte* letter with the arbitrator, both parties to the arbitration agreed to use the arbitrator, continued with the arbitration hearing, and went through several days of the arbitration trial. Thus, any objection to the arbitrator hearing the issues was waived by both parties. Finally, argues MOE, Paulson was not prejudiced because the difference between a lump sum award and a differentiated award did not lead to a different financial outcome for Paulson.

The Martinellis argue that Paulson's stipulated award could be invalidated under RCW 7.04.160(1) and (2). Since the parties to the arbitration waived any objection they had to the arbitrator continuing with the case, that argument has no merit as it bears on the issue now being considered by the court. Further, Paulson's stipulated award of \$1.3 million was well within the policy limits, so he did not suffer any harm in that regard.

The Martinellis argue that Paulson also suffered harm because of the potential effect on his credit rating and damage to reputation and loss of business opportunities, as did the insured in *Safeco v. Butler. Id.*

In *Safeco v. Butler*, the Butlers asserted that the insurer decided to defend under a reservation of rights over two months prior to notifying the Butlers of its intent to do so, thus causing the

Butlers to lose evidence by delaying the investigation. The Butlers entered into a stipulated agreement with the third party for \$3,000,000 and assigned their rights under the policy in return for a covenant from the third parties not to execute against the Butlers. The Court in *Safeco v. Butler* noted that even though the agreement insulated the insured from liability, it still constituted a real harm because of the potential effect on the insured's credit rating and damage to reputation and loss of business opportunities. *Safeco v. Butler*, 118 Wash.2d at 399. The Martinellis argue that the same is true for Paulson in this case.

This court does not agree. The facts in *Safeco v. Butler* are dissimilar. In that case, the insurer defended under a reservation of rights, but did not notify the insured for two months. During that period, evidence was lost because of the insurer's failure to investigate.

In this case, it is undisputed that Paulson is covered for some of the damages contained within the \$1.3 million stipulated agreement and is excluded from coverage for other damages. Thus, any effect on Paulson's credit rating and damage to reputation and loss of business opportunities would have occurred whether Paulson entered into a stipulated agreement or not. Further, the court agrees that Paulson's stipulated award of \$1.3 million was well within the policy limits, so he did not suffer any harm in that regard. Finally, the court also finds that Paulson was not prejudiced because the difference between a lump sum award and a differentiated award did not lead to a different financial outcome for Paulson.

Conclusion: Thus, the court finds that under the facts of this case, no reasonable person could reach the conclusion that Paulson was prejudiced or harmed by MOE's actions. MOE has rebutted the presumption of harm. The Martinellis' motion for partial summary judgment is denied. Even though the court has found that MOE is guilty of bad faith, MOE has rebutted the presumption of harm. Therefore, MOE's motion for partial summary judgment that MOE is not liable to the Martinellis for bad faith on this issue is granted.

C. Has MOE Provided a Reasonable Justification for Its Failure to Pay Undisputed Property Damage Amounts? Alternatively, Did MOE Breach its Duty of Good Faith by Failing to Settle the Martinellis' Claims Against Paulson for \$1 Million?

An insurer is liable when it fails to settle a claim within the policy limits if that failure is attributable to either bad faith or negligence. *Hamilton v. State Farm Ins. Co.*, 83 Wash.2d 787, 523 P.2d 193 (1974). If the insured claims that the insurer denied coverage unreasonably in bad faith, then the insured must come forward with evidence that the insurer acted unreasonably. The policyholder has the burden of proof. *Smith v. Safeco Ins. Co.*, 150 Wash.2d 478, 486, 78 P.3d 1274 (2003).

MOE argues that Paulson was never exposed to a judgment outside MOE's policy limits because Paulson's aggregate policy limit was \$4 million, well within the settlement amount of \$1.3 million. The Martinellis concede in their opposition to MOE's motion for partial summary judgment that MOE's policy limits exceed the judgment against Paulson and that MOE's failure to settle the Martinellis' claims "within policy limits" was not bad faith. Thus, MOE is granted partial summary judgment on this issue.

However, the Martinellis argue that does not absolve MOE of liability for bad faith in its settlement analysis and negotiations on behalf of Paulson. Moreover, the Martinellis assert that

MOE breached its duty of good faith by not disclosing that it had more than \$1 million of coverage, while it now admits the aggregate policy limit was \$4 million.

There is no counterclaim against MOE for bad faith for allegedly misstating coverage. Further, the insurance coverage information has been available to Paulson. The court notes that MOE provided the declaration page for each of the annual policies since 1999 for the four years in question.⁴ Presumably, Paulson had available the insurance coverage information. In any event, that issue is not properly before the court.

Even if MOE did not fail to settle “within policy limits,” the Martinellis claim that MOE is guilty of bad faith because it has failed to pay any amount, even the undisputed amounts of property damage covered under its policy. According to the Martinellis, it is bad faith if an insurer refuses to pay, or does not timely pay, undisputed amounts of property damage covered under its policy. WAC 284-30-330(6), (7). By failing to pay undisputed amounts, the Martinellis argue that MOE left Paulson exposed to potentially substantial uninsured liability.

Whether an insurer’s conduct satisfies its duty of good faith toward its insured depends upon whether the insurer’s denial of coverage was based upon reasonable grounds. *Smith v. Safeco*, 150 Wash.2d at 486.

In this case, MOE has continually asserted that much of the liability is excluded under the subcontractor exception to the work exclusion.⁵ It is disputed that some, if not a large portion, of the work done in this case falls under the subcontractor exception to the work exclusion. Until MOE discovers what work is covered by the settlement, it is not in a position to determine what amounts are covered and what amounts are not covered. Since the parties did not contract to provide insurance for a noncovered event, MOE is not required to pay for amounts that are not covered under the policy.

In any event, Paulson is not exposed to “potentially substantial uninsured liability” as the Martinellis claim because the stipulated agreement is \$1.3 million and the potential coverage is \$4 million.

Conclusion: Therefore, the court denies the Martinellis’ motion for partial summary judgment that it was bad faith for MOE to fail to pay undisputed property damage amounts. The court grants MOE’s motion for partial summary judgment that it did not act in bad faith for failure to settle within policy limits.

D. Who Bears the Burden of Proving Liability Coverage under the Subcontractor Exception to the Work Exclusion?

⁴ ...”So that you will have an understanding of the Mutual of MOE liability coverage available to your client, I am enclosing copies of the Declaration for each of the annual policies since 1999 when the Martinelli home was completed....” Reservation of Rights Letter from Mutual to Paulson’s attorney, dated July 22, 2002; Exhibit C, Gould Declaration of 4-27-04.

⁵ See discussion on Subsection C: “Who Bears the Burden of Proving Liability Coverage under the Subcontractor Exception to the Work Exclusion?”

MOE requests that the court find that the insured has the burden of proving that there is insurance coverage for the work of the subcontractors under the subcontract exception, Exclusion (1). The Martinellis respond that the court should defer ruling on this issue until the parties have conducted discovery on the contract claim issues.

The insurance policy language at issue is as follows:

This insurance does not apply to:

- ...
1. **Damage to Your Work**
“Property damage” to “your work” arising out of it or any part of it and included in the “products-completed operations hazard”.

This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor.

Subcontractor Exception, Exclusion (1), Commercial General Liability Coverage Form, Exhibit K, Declaration of Brent W. Beecher, dated 5-4-04.

The burden of proof in determining whether insurance coverage exists is a two-step process. First, the insured must prove that the policy covers his loss. Thereafter, to avoid coverage the insurer must prove that specific policy language excludes the insured’s loss. *Truck Ins. Exch. V. BRE Properties, Inc.*, 119 Wash.App. 582, 588 (2003). MOE concedes that Paulson met his burden of showing that the Martinellis’ claim comes within the policy’s grant of coverage.

The burden then shifts to MOE to prove that the loss falls within the specific language of a policy exclusion. According to MOE, liability for any damage to the entire project at the Martinellis’ residence is excluded from coverage because the work was performed by Paulson or by subcontractors and materialmen on Paulson’s behalf. Thus, MOE argues that it has met its burden of showing that an exclusion applies, and the burden should then shift to the Martinellis to prove that an exception to the exclusion restores coverage. *Aydin Corp. v. First State Ins. Co.*, 18 Cal. 4th 1183, 959 P.2d 1213 (1998).

Conclusion: The Martinellis urge the court to defer its ruling on this issue until the parties have conducted discovery on the contract claim issues, which they have not yet done. The court agrees and will defer its ruling until the parties have conducted discovery on the contract claim issues.

III. Martinellis’ Motion to Remedy MOE of MOE’s Abuse of Privilege and to Compel Discovery

A. Has MOE Improperly Raised Issues and Made Arguments Concerning Facts Shielded from Discovery by the Attorney-Client Privilege?

The attorney-client privilege protects confidential communications given in the course of professional employment from discovery or public disclosure so that clients will not hesitate to speak freely and fully inform their attorneys of all relevant facts. *Escalante v. Sentry Ins. Co.*, 49

Wash.App. 375, 393-97, 743 P.2d 732 (1987); RCW 5.60.060(2). The privilege is subject to exceptions and “must be strictly limited to the purpose for which it exists.” *Id.*

The Martinellis argue that MOE has waived the attorney-client privilege because MOE used privilege as a shield in the deposition of the coverage counsel, Brent Beecher, but used privilege as a sword in its brief. A party may not prevent discovery of privileged documents and information “if to do so would in effect enable them to use as a sword the protection which the Legislature awarded them as a shield.” *Pappas v. Holloway*, 114 Wash.2d 198, 208 (1990).

This approach to resolution of privilege claims applies to insurance bad faith litigation. *Escalante*, 49 Wash.App. at 393-97. Under CR 26(b)(4), an attorney’s mental impressions, conclusions, opinions, or legal theories concerning the litigation are protected against disclosure. In bad faith actions, however, courts have held that mental impressions are discoverable if they are directly in issue and if the discovering party makes a stronger showing of necessity and hardship than is normally required under CR 26. *Escalante*, 49 Wash.App. at 397. The showing of necessity and hardship in CR 26(b)(4) is whether “the party seeking discovery has substantial need of the materials in the preparation of his case and ...he is unable without undue hardship to obtain the substantial equivalent of the materials by other means.” CR 26(b)(4).

In this case, the Martinellis argue that the reasonableness of MOE’s conduct is at issue and that the mental impressions of MOE’s attorney should be discoverable. *Smith v. Safeco Ins. Co.*, 150 Wash.2d 478, 486 (2003)(whether the insurer’s conduct satisfies its duty of good faith toward its insured depends upon whether the insurer “acted unreasonably, ... whether the insurer’s alleged reasonable basis was not the actual basis for its actions, or that other factors outweighed the alleged reasonable basis”).

The Martinellis provide several examples of how they believe MOE used the attorney-client privilege as both a sword and a shield. For example, by arguing that its subpoena to the arbitrator was reasonable, the Martinellis assert that MOE waived the attorney-client privilege as to whether its attorney had a reasonable basis for that belief and, if so, the basis for that belief.

As another example, the Martinellis argue that MOE said that it filed its declaratory judgment action to determine the extent of its coverage obligations and that the arbitrator was the only person who could provide that information. However, when asked at deposition why the declaratory judgment action was not served on the parties or disclosed to opposing counsel until the *ex parte* letter sent to the arbitrator, MOE invoked privilege.

Finally, the Martinellis argue that MOE’s assertion that its *ex parte* letter to the arbitrator did not have the potential to damage any interest of Paulson opened the door for the Martinellis to inquire whether Mr. Beecher discussed his plan to send the *ex parte* cover letter to the arbitrator with other lawyers, whether it was improper for him to insert insurance into the arbitration, whether ER 411 prohibited what he did, and why he did not immediately withdraw the subpoena upon being informed of adverse authority.

As sanctions, the Martinellis urge the court to (1) strike the hearing on MOE’s summary judgment motion; (2) enter an order *in limine* prohibiting MOE from offering evidence and argument concerning (a) whether MOE had a reasonable basis for issuing the subpoena to the arbitrator; (b) whether MOE had a reasonable basis for initiating *ex parte* correspondence to the arbitrator, and; (c) whether MOE had a reasonable basis for interjecting evidence of insurance

coverage into the arbitration proceedings in respect to both parties' motions for summary judgment.

Conclusion: The court denies the above requests from the Martinellis'. The court has already ruled that MOE's action in subpoenaing the arbitrator, sending an *ex parte* letter to the arbitrator and interjecting evidence of insurance coverage into the arbitration proceeding was bad faith, although MOE has rebutted the presumption of harm. The issue of reasonableness as it pertains to MOE's contact with the arbitrator is moot.

B. Should the Court Require MOE to Admit or Deny the Reasonableness of the Stipulated Arbitration Award

Martinellis' Request for Admission No. 12 asked MOE to admit that the stipulated Arbitration Award was "reasonable." MOE objected that the request was "outside the scope of CR 36." A party is not required to concede legal conclusions. *Brust v. Newton*, 70 Wash.App. 286, 295, 852 P.2d 1092 (1993).

MOE issued both an objection and a denial to the Request for Admission No. 12. A party is not required to concede legal conclusions. *Id.* The court denies the Martinellis' motion above.

C. Should the Court Require MOE to Answer Interrogatories Concerning its Knowledge of the AAA Code of Ethics for Arbitrators?

Civil Rule 26(b)(1) allows discovery of "any matter, not privileged, which is relevant...[or] reasonably calculated to lead to the discovery of admissible evidence." The Martinellis proposed interrogatories to MOE as to whether MOE and its coverage counsel knew of the Code of Ethics for Arbitrators during the period between November 2003 and January 2004 and, if so, the source of their knowledge. MOE refused to testify on the grounds that the interrogatories were "not reasonably calculated to lead to the discovery of admissible evidence."

The court finds that the interrogatories in question are not reasonably calculated to reveal admissible evidence. Further, inquiring into opposing counsel's knowledge of any rules or procedures is an invasion of the work product rule.

D. Should MOE Be Required to Disclose its Liability Insurance Coverage

This issue is moot. MOE has disclosed that there is no such insurance, as attested by the Declaration of Larry A. Beck.

E. Should the Court Require MOE to Either Produce Certain Documents Claimed as Privileged, or Should the Court Examine the Documents In Camera?

The court has examined *in camera* the seven documents for which the Martinellis seek production or *in camera* inspection. The court's conclusions are contained below:

1. December 10, 2002, IntraOffice Communication from Sheryl Caulfield to Debbi Sellers:
The court agrees that the document contains legal advice provided by JD to SC. Redacting

such legal advice, the remainder is "As you know we are defending the insured....My initial investigation is that we insured 5 of the subs."

2. July 9, 2003, IntraOffice Communication from Debbi Sellers to Lana Bunning: The legal advice given by JB to L.Bu. was properly redacted.
3. October 17, 2003, Letter from Brent Beecher to Lana Bunning: The court believes the document is privileged, with the exception of the following: "I am assuming that you were assigned this file; it was originally Sheryl's. If I am mistaken, I would appreciate it if you would forward this letter to the appropriate person. Thanks. ..."
4. October 24, 2003, Email from Debbi Sellers to Brent Beecher: MOE is correct; this communication concerns the "date of arbitration."
5. January 2, 2004, Letter from Brent Beecher to Larry Beck: The letter is privileged.
6. January 7, 2004, Activity Log Entry by Larry Beck: This activity log is privileged.
7. January 7, 2004, Letter from Brent Beecher to Larry Beck: This letter is privileged.

As directed by the *Escalante* court, this court has conducted an *in camera* inspection of the requested documents to determine whether the attorney-client privilege applies. The court finds that it does. However, the court does not find that the Martinellis have overcome that privilege by showing a foundation in fact for the charge of civil fraud.

Conclusion: For the reasons set forth above, the Martinellis' motion to compel discovery is denied.

CONCLUSION

The court believes that it has considered and ruled on all the issues properly before it. Upon proper presentation, the court will enter orders reflecting the above rulings.

Sincerely,



VICKIE I. CHURCHILL
Judge

No. 553429-I

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COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE COMPANY, Appellant,

v.

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

Respondents and Cross Appellants.

CERTIFICATE OF SERVICE

I, Sherida M. Warner, declare that on the date noted below, caused
to be delivered via legal messenger, a copy of the Reply Brief of Appellant
to:

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DATED this 9th day of September, 2005.

A handwritten signature in black ink, appearing to read "Sherida M. Warner", is written over a horizontal line.

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