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Court of Appeals
Division III
State of Washington

COURT OF APPEALS OF THE STATE OF WASHINGTON
DIVISION III

No. 31904-1-III

DOUG and DUSTY CANNON, Plaintiffs/Respondents

v.

COOK CUSTOM HOMES, a Washington corporation,

and

HOWES QUALITY DEVELOPMENT COMPANY, a Washington corporation, Defendants,

and

WESTERN HERITAGE INSURANCE COMPANY, Intervenor/Appellant.

REPLY BRIEF OF APPELLANT/INTERVENOR WESTERN HERITAGE INSURANCE COMPANY

Mark Thorsrud,WSBA #7951
Russell C. Love, WSBA #8941
Thorsrud Cane & Paulich
1325 Fourth Avenue, Suite 1300
Seattle, WA 98101
206-386-7755
mthorsrud@tcplaw.com
rlove@tcplaw.com

Attorneys for Western Heritage Insurance Co.

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I. Counterstatement of Facts

The Cannons' introductory and factual statements include material without record support or contrary to the facts.

The Cannons assert that they were "not at fault in any way."[1] But their contract with Cook stated that it was based on a report and verbal information from Greg Miller with Romer & Associates LLC indicating " . . . compacted fill building envelope, sufficient to build this home."[2]

In addition, the Cannons assert, without reference to the record, that the "engineers agreed that even after the repair work is performed, much of the damage can never be repaired."[3] However, the repair-cost proposal from Lewis Construction & Development included helical piles to be placed "in locations determined by our Structural Engineer to be used as a new foundational base for the portion of the home that is settling."[4] Further, the Cannons' counsel told the court that the Lewis

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[1] Cannon Brief at 6.

[2] CP 1154.

[3] Cannon Brief at 2.

[4] CP 736-737.

repair costs would "remedy the structural integrity of the lot under the house and . . . repair the Cannon residence."[5]

The Cannons claim that Western Heritage "denied coverage" for Cannons' claims against Cook,[6] when in fact Western Heritage did not. It agreed to defend Cook under a reservation of rights, stated its belief that it would not owe indemnity based on the information it had received, and asked Cook to provide any additional facts or evidence showing otherwise.[7] Western Heritage continued to defend Cook up through the covenant-judgment settlement.

II. Argument in Reply

The Cannons do not dispute the central point that a "settlement amount cannot be reasonable if it includes amounts beyond what the law allows the claimant to recover."[8] They disagree only on whether certain line items included in the

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[5] CP 558.

[6] Cannon Brief at 5.

[7] CP 1204.

[8] Brief of Appellant at 18.

settlement amount are recoverable. We turn therefore to those items after a brief discussion of the standard of review.

A. Contrary to the Cannons' claim, Western Heritage does not contend that the standard of review is de novo.

Even though Western Heritage stated clearly that the standard of review of the trial court's reasonableness determination is abuse of discretion and applied that standard,[9] the Cannons nevertheless insist that Western Heritage asks this court to engage in *de novo* review.

The Cannons misunderstand the abuse-of-discretion standard. A trial court abuses its discretion if it bases its ruling on an incorrect view of the law.[10] Therefore, in those instances where the trial court found damage components reasonable where the law does not permit recovery of those components, the trial court necessarily abused its discretion.

Under abuse-of-discretion review, the trial court also does not have "discretion" to rely on unsupported facts or to apply the

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[9] Brief of Appellant at 17, 23, 25, 27, 28, 30, 38.

[10] *Washington State Physicians Ins. Exch. v. Fisons Corp.*, 122 Wn.2d 299, 339, 858 P.2d 1054 (1993).

wrong legal standard.[11] Nor does the trial court have discretion to find facts without evidentiary support or to insulate its legal conclusions from review by characterizing them as findings of fact. Its legal conclusions, however denominated, are subject to *de novo* review because the trial court does not have discretion to misapply the law.[12]

More to the point, having claimed incorrectly that Western Heritage asks for *de novo* review, the Cannons fail to point to a single specific instance where Western Heritage applied the wrong legal standard to the record facts. Their brief refers to pages 22 and 39 of Western Heritage's brief as examples. On those pages, Western Heritage pointed out that the trial court's conclusions of law are subject to *de novo* review—which they are, even under an abuse-of-discretion standard of review.

B. The Cannons may not recover stigma damages in addition to repair costs under the facts of this case.

The parties agree that in a breach-of-a-construction-

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[11] *Mayer v. Sto Indus., Inc.*, 156 Wn.2d 677, 684, 132 P.3d 115 (2006).

[12] *See* authorities cited in Brief of Appellant at 22.

contract case the plaintiff may recover the reasonable cost of repairs if that cost is not clearly disproportionate to the diminution in property value to the plaintiff.[13] Having recognized that legal point, however, the Cannons do not actually apply it.

As Western Heritage pointed out, the Cannons awarded themselves both repair costs ($396,478) and stigma (or diminution in value) damages ($292,500) for a total of $688,978. This amount is clearly disproportionate to the $475,000 value of the house. The Cannons do not refute this basic point.

Without addressing this "clearly disproportionate" issue, the Cannons claim, citing *Mayer* and *Pugel*, that they may recover stigma damages in addition to repair costs when even after the repairs there is a permanent loss. In *Mayer* the stigma remained because the house remained sided with EIFS, a known defective product.[14] And in *Pugel* the loss of lateral support

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[13] Cannon Brief at 13, Brief of Appellant at 20-21.

[14] *Mayer v. Sto Industries*, 156 Wn.2d 677, 695, 132 P.3d 115 (2006).

remained, causing a permanent loss in market value.[15] Thus, stigma damages may be awardable when there is no doubt that the harm affecting market value is from a remaining identifiable problem.

Here, however, the facts are different. As the Cannons told the court below, the $396,478 repair cost included structural engineering and geotechnical work to address the foundation problems and prevent future settlement. This amount would "remedy the structural integrity of the lot under the house and . . . repair the Cannon residence."[16] Because the repair costs address the foundation and settlement problems, no existing identifiable problem will remain as a basis for stigma damages.

Even if despite the full repair, the Cannons could show some identifiable permanent damage, the Cannons could still not recover stigma damages in addition to the repair costs because that would result in an award substantially in excess of

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[15] *Pugel v. Manheimer*, 83 Wn. App. 688, 693, 922 P.2d 1377 (1996), *review denied*, 131 Wn.2d 1024 (1997).

[16] CP 558, 736-739.

the fair market value of the house and the land and would be clearly disproportionate. They would be limited to fair market value. As a result, a settlement that includes nearly $300,000 of stigma damages cannot be reasonable.

C. The amounts awarded cannot be liquidated—and therefore cannot be the basis for prejudgment interest—before the court's determination of reasonableness.

The Cannons miss the point of *Coulter*.[17] Because the court in a reasonableness hearing must exercise its discretion to determine reasonableness, the damage amounts cannot be fixed and thus liquidated until after the court's reasonableness determination. It necessarily follows that the settlement amount cannot include prejudgment interest.

D. The settlement cannot be reasonable when it includes prejudgment interest on the stigma damages because the stigma damages were an "estimated" amount.

The parties agree that damages are liquidated only if the data in the evidence makes it possible to compute the amount with exactness, without reliance on opinion and discretion.[18] In

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[17] *Coulter v. Asten Group, Inc.*, 155 Wn. App. 1, 13, 230 P.3d 169 (2010).

[18] Brief of Appellant at 24; Cannon Brief at 17.

its opening brief, Western Heritage showed that the stigma damages, even if recoverable (which they are not), were an estimated amount (40% to 50%) of an opinion amount (the appraisal). Because the stigma-damages amount depends on opinion and discretion, it is, as a matter of law, not a liquidated amount.[19]

The Cannons fail to even respond on this point other than to say that the damages were calculated as 50% of the appraisal value.[20] The lack of a response concedes the issue.

E. The loss-of-use damages were also estimated and thus, as a matter of law, could not be liquidated.

In its opening brief Western Heritage pointed out that the loss-of-use claim was, like the stigma-damages claim, unliquidated. This was so because by the Cannons' own evidence it was an estimate ("We estimate that we have incurred [loss of use] damages [of] $74,299.16. . ."[21]) Moreover, it was based on incorrect factual and legal assumptions that 1) 49% was the

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[19] Brief of Appellant at 25-28.

[20] Cannon Brief at 19.

[21] CP 784-785.

correct percentage, 2) the loss of use began in March 2006, and 3) the use of mortgage payments represented a proper measure of damages.[22]

The Cannons' responding brief does not even address these issues, other than to say that the loss-of-use amount was calculated.[23] The mere fact that they performed a calculation based on an estimate does not suffice to make the amount liquidated. The Cannons make no attempt to show how the calculation was factually and legally correct, nor do they offer any defense of the court's unsupported findings on the issue. As with the stigma damages, their lack of response concedes the issue.

F. The Cannons were not entitled to an award of attorney fees based on the indemnification clause; therefore, inclusion of the attorney fees in the settlement was unreasonable.

The Cannons' argument that they are entitled to attorneys' fees from Cook fails to come to grips with the

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[22] Brief of Appellant at 28-30.

[23] Cannon Brief at 18.

controlling language of the indemnification provision. In pertinent part, the provision states:

> ... [Cook] shall indemnify, defend and hold harmless Doug and Dusty Cannon ... from and against all claims, damages, losses and expenses, including but not limited to attorney's fees, arising out of or resulting from performance of the work ... or a breach of this agreement by the contractor....[24]

The contract can only be reasonably read to require Cook to defend and indemnify the Cannons from and against the claims from third parties. It does not state it will pay the Cannons' attorney fees in their action against Cook. Logically, Cook cannot "defend" them against their own claim, nor can Cook indemnify or protect them from their own claim. Cook can only "defend" the Cannons from claims against them by third parties arising from the work.

The court must construe the provision as a whole giving force and effect to all of the language. Interpreting the indemnity provision as requiring Cook to pay attorney's fees in the breach-of-contract action between the parties makes no sense because assumption of the Cannons' defense cannot apply

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[24] CP 1150 – 1151.

in a suit between the parties. Under the Cannons' reading, if they sued Cook they would be entitled to tender their "defense" (in fact offense) to Cook and Cook would be required to finance both their case and its own defense. Moreover, if the Cannons' reading were correct, it follows that Cook would also be required to defend the Cannons if Cook sued them for non-payment, if the Cannons contended that the non-payment resulted from "a breach of this agreement" by Cook. That is not even a plausible reading of the clause.

As Western Heritage pointed out in its opening brief, Washington law rejects interpreting an indemnification clause as a prevailing-party attorneys-fees provision.[25] Even the Cannons' cited foreign authorities do not support a contrary result. In *Chesapeake* for example, the court concluded—under different contract language (no requirement that the indemnitor "defend") and without any analysis—that one party could recover from the other.[26] And in *Transaction Network* not only

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[25] Brief of Appellant at 32-36.

[26] *Chesapeake and Potomac Tel. Co. v. Sisson*, 362 S.E. 2d 723 (Va. 1987).

did the case involve different language but the court was not presented with the claim that indemnity provision applied only to third-party claims.[27]

Prevailing-party clauses in contracts are quite common and well known. If Cook and the Cannons had genuinely intended to require payment of attorneys' fees to the prevailing party in their dispute, it is highly likely they would have included such an explicit provision in their contract. The absence of such an explicit provision speaks volumes and counsels against torturing the indemnification language as the Cannons wish.

Because the contract does not permit an award of fees, the trial court erred as a matter of law in finding reasonable a settlement that included over $200,000 in fees the Cannons could not have recovered at trial.

G. The Cannons fail to refute that the settlement was collusive.

The Cannons do not dispute that 1) Cook's defense counsel was prepared to contest liability and had estimated a

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[27] *Transaction Network Inc. v. Wellington Tech., Inc.*, 7 P.3d 409 (Mont. 2000).

50% - 60% chance of success at trial,[28] 2) Cook's defense counsel had estimated the amount of a reasonable settlement at $150,000 - $350,000,[29] 3) the Cannons had offered to settle for about $550,000 (approximately the value of the house and land),[30] and 4) yet, once granted a covenant not to execute, Cook settled for $1.3 million.[31] Further, that $1.3 million included large amounts the Cannons' brief does not justify. (In fact, if the approximately $800,000 in unrecoverable damages is subtracted, the difference is approximately the $550,000 amount of the earlier offer.)

Despite this evidence, the Cannons state "[t]here was no evidence of collusion between the Cannons and Cook."[32] This statement is meaningless without defining what collusion is. As Western Heritage pointed out in its opening brief, collusion "occurs when the insured [Cook] and the third-party claimant

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[28] CP 916; 1056-1064.

[29] CP 916.

[30] CP 835, 861, 797, 558, 757.

[31] CP 784, 787-793.

[32] Cannon Brief at 24.

[the Cannons] work together . . . to inflate the third party's [the Cannons'] recovery to artificially increase damages flowing from the insurer's [Western Heritage's alleged] breach."[33] That describes precisely what occurred here: Cook and the Cannons worked together to artificially increase the supposed damages by including vast sums—over $800,000 according to Western Heritage's argument—not recoverable against Cook as a matter of law.[34]

Indeed, the Cannons' brief admits that that is what occurred:

> The settlement with Cook merely guaranteed another lawsuit with Western Heritage and the expense of future litigation had to be considered in determining what the Cannons would accept as a covenant judgment.[35]

In other words, according to the Cannons, they had to artificially inflate the amount of the covenant judgment beyond

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[33] *Safeco Ins. Co. of America v. Parks*, 170 Cal. App. 4th 992, 88 Cal. Rptr.2d 730, 748 (2009); Brief of Appellant at 41.

[34] *See also Indep. Sch. Dist. No. 197 v. Accident & Cas. Ins. of Winterthur*, 525 N.W.2d 600, 607 (Minn. App. 1995) (Collusion is the lack of opposition between plaintiff and insured that otherwise would assure settlement is result of hard bargaining.)

[35] Cannon Brief at 25.

what they could have recovered against Cook to compensate themselves for their anticipated collection expenses—even though the *Glover* factors do not permit it. The Cannons' description of their motivation establishes that the settlement amount was the product of collusion.

The Cannons' diversionary arguments change none of this. Mr. Cannon's cancer[36] is indeed unfortunate but cannot justify an increase in the settlement amount because his illness is not a *Glover* factor.[37] Mr. Cook's cancer may have made a settlement desirable, but it cannot make an unreasonable settlement reasonable. Their claim that Cook was exposed to a claim for Western Heritage's defense costs is also incorrect. While Western Heritage did reserve its right to seek reimbursement from Cook of defense costs,[38] by the time of the settlement our Supreme Court had determined that an insurer

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[36] *See* Cannon Brief at 25, 29-30.

[37] *See Mutual of Enumclaw Ins. Co. v. T&G Construction*, 165 Wn.2d 255, 264, 199 P.3d 376 (2008) (listing the *Glover* factors).

[38] CP 564.

may not do so.[39] Therefore, this presented no risk to Cook. And their suggestion that Western Heritage relies on "innuendo and speculation"[40] is equally misguided; Western Heritage has pointed to specific evidence—the inclusion in the settlement amount of vast sums not recoverable as a matter of law, among other things—showing why the settlement is collusive as a matter of law.

H. The trial court abused its discretion in denying Western Heritage's request for discovery.

Despite the compelling evidence indicating collusion and bad faith, the Cannons claim that "no smoking gun" implied bad faith or collusion to justify discovery.[41] Western Heritage disagrees. The evidence discussed above and in Western Heritage's opening brief is just such a "smoking gun." Further, a showing of a "smoking gun" is not required as a condition precedent to discovery. Discovery is, after all, a search for facts and evidence a party does not already have. For that reason

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[39] *See National Sur. Corp. v. Immunex Corp.*, 176 Wn.2d 872, 887, 297 P.3d 688 (2013).

[40] Cannon Brief at 24.

[41] Cannon Brief at 28.

discovery may not be properly denied based on the opposing party's claim that "you won't find anything."[42]

The Cannons seek to justify the court's denial of discovery not on the record in this case but on decisions in other cases. And with good reason. The record in this case shows that the trial court's reasoning in denying the requested discovery was untenable. That Western Heritage was "not a stranger to the case" was irrelevant because none of the Cannons' cited cases sought the narrowly-focused discovery requested here. Even though Western Heritage sought discovery tightly focused on the settlement process,[43] something not the subject of discovery before, the court in its ruling failed to focus on the relevant issues:

> The Court: And thank you counsel. Counsel, I do recall the general chronology of motions and items that have come before the court through the pendency of this particular matter, and as stated by counsel, Mr. Roberts, I do recall that there was an issue of illness that put a lot of pressure on all the parties to try to work this matter through. And

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[42] *See* Cannon Brief at 33-34 (claiming that Western Heritage "would not have uncovered any non-privileged information that had not already been discovered").

[43] CP 813-820.

> so that was a key aspect of the totality of facts and circumstances leading up to the resolution. I am troubled by the difficulty that is, to me, going to be manifest should there be depositions taken of counsel at this stage of the proceedings and particularly when it appears there has been due provision of notice of developments to all concerned parties throughout. This is not a new case. It goes back quite some time, as we know, and has involved a lot of expert involvement as well.
>
> And, counsel, I would deny the motion to permit further discovery at this juncture.[44]

With respect, reasoning that does not address the issues before the court is untenable and an abuse of discretion.

The Cannons do not refute that Western Heritage was prejudiced by the denial of discovery. After all, the court later faulted Western Heritage for failing to produce evidence that the court wouldn't let it discover.[45] Nor can they justify the trial court's denial of discovery on their claim that the discovery sought protected information. As Western Heritage explained both to the trial court and in its opening brief here, it was not

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[44] RP (6/21/2013) at 13.

[45] CP 1421-1422 (stating in ruling that "there really is no evidence of [bad faith, collusion or fraud]); CP 1433 (written finding that "[t]here was no evidence or suggestion that the settlement arose from bad faith, collusion or fraud").

seeking privileged information, but only information about communications between the parties.[46] And, in any event their argument about privilege cannot apply to the sought-after deposition of Michael Cook.

Because the trial court abused its discretion in denying discovery, and Western Heritage was prejudiced by the denial, this court should reverse.

I. The Cannons are not entitled to an award of attorney fees on appeal.

As Western Heritage pointed out in section F above, the indemnification provision does not require Cook to finance the Cannons' litigation. More importantly, it says nothing requiring Western Heritage to pay their fees. For both reasons, they cannot recover fees on this appeal. Because the indemnification clause is the only basis on which they seek fees, the court should deny their request.

III. Conclusion

As requested in Western Heritage's opening brief, this court should reverse the trial court's order finding the

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[46] Brief of Appellant at 43-44, 46; CP 813-820.

settlement reasonable and remand to the trial court with directions to find the settlement unreasonable and collusive as a matter of law. This court should direct the trial court that the total value of a reasonable settlement cannot include those amounts identified above as unrecoverable. In the alternative, if the court does not find the settlement collusive as a matter of law, the court should reverse the trial court's denial of discovery and remand for discovery on collusion.

The court should award Western Heritage its costs and deny the Cannons' request for attorney fees.

Dated 19 April, 2014.

Mark Thorsrud, WSBA #7951
Russell C. Love, WSBA #8941
Thorsrud Cane & Paulich
Attorneys for Appellant/ Intervenor
Western Heritage Ins. Co.

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CERTIFICATE OF SERVICE
RE BRIEF OF APPELLANT/INTERVENOR WESTERN HERITAGE INSURANCE COMPANY

Mark Thorsrud,WSBA #7951
Russell C. Love, WSBA #8941
Thorsrud Cane & Paulich
1325 Fourth Avenue, Suite 1300
Seattle, WA 98101
206-386-7755
mthorsrud@tcplaw.com
rlove@tcplaw.com

Attorneys for Western Heritage Insurance Co.

Certificate of Service

I hereby certify that on the 21st day of April, 2014 I caused to be served REPLY BRIEF OF APPELLANT/INTERVENOR WESTERN HERITAGE INSURANCE COMPANY, and this Certificate of Service on the following counsel of record in the manner described below:

Counsel for Cannons:

John C. Black
Kevin W. Roberts
Maximilian Held
Dunn Black & Roberts, P.S.
Banner Bank Building
111 North Post, Suite 300
Spokane, WA 99201-0705
Email: jblack@dunnandblack.com
kroberts@dunnandblack.com
mheld@dunnandblack.com
spowell@dunnandblack.com
mobrien@dunnandblack.com
Via U.S. Mail and email

Counsel for Howes Quality Development Company:

Andrew Bohrnsen
Bohrnsen, Stocker, Smith, Luciani & Staub, PLLC
The Morgan Building
312 W. Sprague Avenue
Spokane, WA 99201
Email: abohrnsen@comcast.net
Via U.S. Mail and email

Executed at Seattle, Washington this 21st day of April, 2014.

Mary Lou Hanshaw