
IN THE SUPREME COURT OF THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE COMPANY,

Plaintiff/Respondent & Cross-Petitioner,

vs.

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

Defendants/Petitioners.

RECEIVED
SUPREME COURT
STATE OF WASHINGTON
2001 MAY 15 P 4:45
BY RONALD R. CARPENTER
CLERK

BRIEF OF AMICUS CURIAE
WASHINGTON STATE TRIAL LAWYERS ASSOCIATION
FOUNDATION

Bryan P. Harnetiaux
WSBA No. 5169
517 E. 17th Avenue
Spokane, WA 99203
(509) 624-3890

Gary N. Bloom
WSBA No. 6713
P.O. Box 1461
Spokane, WA 99210
(509) 624-4727

FILED
SUPREME COURT
STATE OF WASHINGTON
2001 MAY 22 P 4:14
BY RONALD R. CARPENTER
CLERK

On Behalf of
Washington State Trial Lawyers Association Foundation

TABLE OF CONTENTS

	Page
I. IDENTITY AND INTEREST OF AMICUS CURIAE	1
II. INTRODUCTION AND STATEMENT OF THE CASE	1
III. ISSUES PRESENTED	7
IV. SUMMARY OF ARGUMENT	7
V. ARGUMENT	10
A.) Overview Of Insurance Bad Faith, And The Obligations Of Liability Insurers Defending Under A Reservation Of Rights.	10
B.) MOE's Contact With The Arbitrator Was Bad Faith Conduct, Which Undermined The Insured's Right To Control The Underlying Litigation.	14
C.) If MOE's Contact With The Arbitrator Constituted Bad Faith, It Is Subject To The Rebuttable Presumption Of Harm And Coverage By Estoppel.	17
D.) If MOE Is Subject To Coverage By Estoppel Under <i>Butler</i> , It Should Be Bound By A Determination That The Covenant Judgment Is "Reasonable," Unless It Can Prove Fraud Or Collusion By The Insured.	19
VI. CONCLUSION	20

TABLE OF AUTHORITIES

<u>Cases</u>	<u>Page</u>
<u>Besel v. Viking Ins. Co.</u> , 146 Wn.2d 730, 49 P.3d 887 (2002)	11,13,17,19,20
<u>Chaussee v. Maryland Casualty Co.</u> , 60 Wn.App. 504, 803 P.2d 1339, 812 P.2d 487 (1991)	9,19
<u>Coventry v. American States Ins. Co.</u> , 136 Wn.2d 269, 961 P.2d 933 (1998)	10,13
<u>Ellwein v. Hartford Co.</u> , 142 Wn.2d 766, 15 P.3d 640 (2001), <i>overruled on other grounds</i> , <u>Smith v. Safeco Ins. Co.</u> , 150 Wn.2d 478, 73 P.3d 1274 (2003)	15
<u>Evans v. Continental Cas. Co.</u> , 40 Wn.2d 614, 245 P.2d 470 (1952)	14
<u>Fidelity Bankers Life Ins. Co. v. Wedco, Inc.</u> , 102 F.R.D. 41 (D. Nev. 1984)	16
<u>Hayden v. Mutual of Enumclaw</u> , 141 Wn.2d 55, 1 P.3d 1167 (2000)	11
<u>Holland America Ins. v. National Idemn.</u> , 75 Wn.2d 909, 454 P.2d 383 (1969)	14
<u>Kirk v. Mt. Airy Insurance Company</u> , 134 Wn.2d 558, 951 P.2d 1124 (1998)	10-12,17, 18
<u>Lenzi v. Redland Co.</u> , 140 Wn.2d 267, 996 P.2d 603 (2000)	17,20
<u>Mut. of Enumclaw v. Paulson Constr.</u> , 132 Wn.App. 803, 134 P.3d 240 (2006), <i>review granted</i> , 159 Wn.2d ___ (2007)	passim
<u>Safeco Insurance v. Butler</u> , 118 Wn.2d 383, 823 P.2d 499 (1992)	passim
<u>Tank v. State Farm</u> , 105 Wn.2d 381, 715 P.2d 1133 (1986)	10,13,15

Thomas v. Henderson,
297 F.Supp. 2d 1311 (S.D. Ala. 2003) 16

Truck Ins. Exch. v. VanPort Homes,
147 Wn.2d 751, 58 P.3d 276 (2002) 10,14,19

Statutes, Rules & Regulations

Ch. 19.86 RCW 10

CR 54(b) 5

RCW 4.22.060 19

WAC 284-30-330(6) 6

Other Authorities

Thomas V. Harris, Washington Insurance Law
(2d ed. 2006) 14,15

A. Windt, Insurance Claims and Disputes: Representation
of Insurance Companies and Insureds,
(2d ed. 1988) 12

I. IDENTITY AND INTEREST OF AMICUS CURIAE

The Washington State Trial Lawyers Association Foundation (WSTLA Foundation) is a not-for-profit corporation organized under the laws of Washington, and a supporting organization of the Washington State Trial Lawyers Association (WSTLA). WSTLA Foundation, which operates the amicus curiae program formerly operated by WSTLA, has an interest in the rights of injured persons seeking legal redress under the civil justice system, including an interest in the rights of persons seeking to recover for the tort of insurance bad faith.

II. INTRODUCTION AND STATEMENT OF THE CASE

This appeal involves a claim of insurance bad faith arising out of an insurer's defense under a reservation of rights, in a construction claim dispute subject to arbitration. The underlying facts are drawn from the published opinion of the Court of Appeals, the briefing of the parties, and select Clerk's Papers. See Mut. of Enumclaw v. Paulson Constr., 132 Wn.App. 803, 134 P.3d 240 (2006), *review granted*, 159 Wn.2d ___ (2007); MOE Br. at 3-17; Martinelli Br. at 4-18; Martinelli Pet. for Rev. at 3-9; MOE Ans. to Pet. for Rev. at 2-7; Martinelli Reply on Cross-Pet. for Rev. at 1-4; CP 518-19 (pertinent insurance policy provisions); CP 644-56 (superior court letter opinion).

For purposes of this amicus curiae brief the following facts are relevant: Mutual of Enumclaw (MOE) insured Dan Paulson Construction,

Inc. (Paulson) under a commercial general liability policy.¹ Joseph and Karen Martinelli (Martinelli) contracted with Paulson to build a home. A dispute arose over alleged construction defects in the home, and Martinelli sought damages against Paulson in an arbitration proceeding.

Paulson tendered the defense of the arbitration to MOE, which agreed to defend Paulson under a reservation of rights, because MOE questioned whether some of the damages sought were covered under the insurance policy. MOE's assigned defense counsel was joined by private counsel retained by Paulson. MOE separately assembled a "coverage analysis team" to investigate the extent of coverage under the claim. Paulson Constr., 132 Wn.App. at 807. To this end, MOE's coverage team asked for and obtained information relevant to the underlying damage claims from Paulson's lawyer, who provided some documents as a courtesy.

In furtherance of its investigation, MOE also requested that Paulson and Martinelli allow it to intervene in the arbitration, or permit it to attend the arbitration proceeding as a third party observer, so that it could properly determine coverage issues. Both of these requests were

¹ The MOE policy provided in pertinent part:

1. **Insuring Agreement**

- a. We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend the insured against any "suit" seeking those damages. However, we will have no duty to defend the insured against any "suit" seeking damages for "bodily injury" or "property damage" to which this insurance does not apply. We will, at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result. (...)

denied. MOE made no formal attempt to intervene or appear in the arbitration proceeding. The governing arbitration rule gave the arbitrator discretion to allow MOE to attend, if it determined MOE had a “direct interest in the arbitration.” See Paulson Constr. at 812 n.11 (quoting arbitration rule).

While the coverage investigation was ongoing, Martinelli offered to settle the claim with Paulson for \$1 million. Paulson urged MOE to accept the offer, sharing concerns that a large arbitration award could ruin the company business. MOE’s counteroffer to settle for \$550,000 was declined.

Shortly before the arbitration was due to commence, MOE filed, but did not serve, a declaratory judgment action, and sought information regarding the disputed claims. MOE served the arbitrator with a subpoena duces tecum “designed to obtain information that would assist MOE in segregating insured and uninsured elements of the arbitration award, if any.” Paulson Constr. at 808. The subpoena was accompanied by a cover letter from MOE explaining why the information was requested.² MOE provided Paulson and Martinelli copies of the subpoena four days before the arbitration was scheduled to begin. However, the cover letter was not provided to Paulson and Martinelli at that time, and they first learned of it

² The cover letter and subpoena are appended to Martinelli’s opening brief in the Court of Appeals. See Martinelli Br. at Appendices A & B. The subpoena calls for the arbitrator to answer 17 questions regarding any arbitration award issued by him. For example, one question asks the arbitrator to “describe in detail each construction defect for which you awarded damages, and indicate the amount of damages you awarded for each.” See id. Appendix B, Question 14. The cover letter quotes the exclusion that primarily forms the basis for the coverage dispute. See id. at Appendix A.

when the arbitrator disclosed its existence when the arbitration began. See CP 645.

The arbitrator, Paulson and Martinelli opposed the subpoena and demanded its withdrawal. Over Martinelli's objection, MOE sent a second letter to the arbitrator abandoning some of its requests, but reaffirming its need for the information. Paulson incurred certain unspecified legal fees and expenses in opposing MOE's subpoena. See Martinelli Br. at 11.

Six days into the arbitration hearing Paulson, represented by private counsel and MOE's assigned defense counsel, entered into a covenant judgment with Martinelli for a lump sum arbitration award. A stipulated arbitration award of \$1,300,000 was approved by the arbitrator, and found to be "reasonable." See Martinelli Br. at 13. In conjunction with the settlement, Paulson assigned any claims it had against MOE, including for insurance bad faith, to Martinelli in exchange for a covenant that Martinelli would not execute on the judgment against Paulson.

The superior court confirmed the arbitration award, and found it reasonable. Martinelli Br. at 13. Thereafter, Martinelli, as assignee of Paulson, demanded MOE pay the undisputed insured portions of the damages. While MOE acknowledged some of the claims were covered under the policy, it declined to remit any payment until it ascertained which portions of the award were insured and which were not. After the settlement MOE struck its subpoena, dismissed the original (unserved)

declaratory judgment action, and filed this declaratory judgment action, requesting the court to determine which portions of the arbitration award were insured. Martinelli counterclaimed, as Paulson's assignee, seeking damages against MOE for, *inter alia*, insurance bad faith. See MOE Br. at 13-14.

On cross-motions for summary judgment the superior court determined that MOE had acted in bad faith by its contact with the arbitrator, and that Paulson had been harmed because of the legal fees and expenses incurred by it in opposing MOE's subpoena. The court then imposed coverage by estoppel as a matter of law, and entered judgment in favor of Martinelli for the full lump sum settlement, plus attorney fees, expenses and interest. The superior court deferred ruling on other issues, including those bearing upon coverage defenses, and entered a CR 54(b) order certifying the judgment as final and staying all further proceedings in the court.

On appeal, Division I reversed. First, the court found that while MOE's subpoena and cover letter were "somewhat clumsy," this contact "did not amount to bad faith." Paulson Constr. at 813. While the court found Paulson's "strategy" of a lump sum covenant judgment award was not improper, it concluded MOE was faced with "two unreasonable options" – either risking bad faith by litigating coverage issues in the declaratory judgment action before the arbitration, or being forced to pay the entire award regardless of whether it was based on covered claims. Id.

Second, in *dicta*, the Court of Appeals concluded that, while MOE had not acted in bad faith, the coverage by estoppel remedy under Safeco Insurance v. Butler, 118 Wn.2d 383, 823 P.2d 499 (1992), did not apply in any event. It did so for two reasons. First, it concluded that the “minor attorney fees incurred” were too insubstantial to support the coverage by estoppel remedy. Paulson Constr. at 816-17. It concluded:

If coverage by estoppel is imposed here, the remedy would grossly exceed the alleged harm. The amount of a covenant judgment is the presumptive measure of an insured’s harm caused by an insurer’s tortious bad faith if the covenant judgment is reasonable. Where the damages greatly outweigh the relatively minor economic harm, the remedy becomes more punitive than equitable.

Paulson Const. at 816-17 (footnote omitted). Second, the court found it significant that the alleged bad faith had occurred during “MOE’s attempt to determine coverage issues rather than from bad faith in defending the underlying tort lawsuit.” Id. at 816.

In light of its disposition on the insurance bad faith claims, the Court of Appeals did not address MOE’s contention that the superior court erred in not allowing it to contest the determination of “reasonableness” of the covenant judgment award, made by the arbitrator and confirmed in the superior court. Id. at 818 & n.29.³ The Court of Appeals also rejected Martinelli’s cross-appeal urging that MOE had committed bad faith in its refusal to settle undisputed covered portions of the covenant judgment, in violation of its duty to settle and WAC 284-30-330(6), concluding that

³ Apparently the superior court in this action also determined the stipulated arbitration award was reasonable. See MOE Br. at 18; MOE Supp. Br. at 16-18.

“clear liability” had not been established under the administrative regulation. Id. at 817.

Martinelli sought review before this Court regarding whether MOE committed bad faith by its contact with the arbitrator, and whether coverage by estoppel applied under the circumstances. Martinelli also questioned whether MOE could delay payment on undisputed covered portions of the covenant judgment. MOE sought cross-review on whether it was wrongfully deprived of the right to challenge the reasonableness of the covenant judgment award.

This Court granted review on all issues.

III. ISSUES PRESENTED

1. Did MOE’s coverage analysis team act in bad faith in its contact with the arbitrator in the underlying litigation?
2. If MOE committed bad faith in its contact with the arbitrator, is it subject to the rebuttable presumption of harm and coverage by estoppel remedy under Safeco Insurance v. Butler, 118 Wn.2d 383, 823 P.2d 499 (1992)?
3. If MOE is found liable for the covenant judgment due to its bad faith, is it bound by the arbitrator’s and superior court’s determinations that the judgment amount is “reasonable”?

IV. SUMMARY OF ARGUMENT

Bad Faith Contact With The Arbitrator

MOE’s coverage analysis team’s contact with the arbitrator was unreasonable and constitutes insurance bad faith. MOE’s conduct undermined insured Paulson’s right to control the litigation, which in and of itself creates prejudice to the insured. In so doing, MOE placed its

interests ahead of the insured, in violation of the equal consideration rule. MOE's resort to this approach in an attempt to resolve which claims were covered under the policy also cannot be condoned because it did not attempt to formally intervene in a timely manner in the arbitration, and attempt to establish a legitimate "direct interest" justifying its involvement, as provided for in the governing arbitration rules.

Application Of Butler And Coverage by Estoppel

MOE's unjustified interference in the underlying litigation was the equivalent of mishandling a reservation of rights defense, and subjects it to the rebuttable presumption of harm under Safeco Insurance v. Butler and, if the presumption is not overcome, coverage by estoppel. Had Paulson's assigned defense counsel sought differentiation of the arbitration award on MOE's behalf, such conduct would unquestionably constitute bad faith, in favoring MOE's interests over the client-insured. MOE's attempt to achieve the same result through its contact with the arbitrator should be treated no differently. Where the insurer's conduct has the effect of undermining the insured's interest in the underlying litigation, and is inconsistent with its obligations in providing a defense, Butler applies. MOE's argument that the bad faith must specifically involve the conduct of the defense in the underlying litigation should be rejected.

Harm Is Harm Under Butler

The Court of Appeals below erred in weighing the degree of harm sustained by the insured against the insurer's judgment exposure, in

deciding whether to apply coverage by estoppel. By essentially balancing the consequences as between insured and insurer, the court disregarded the clear teaching of Butler, and subverted the stated policy for this remedy – to create a strong incentive for insurers to act in good faith. If an insurer cannot *fully* overcome the presumption of harm, coverage by estoppel applies. Otherwise insurers are invited, in determining how to conduct themselves, to weigh in advance the potential harm against the magnitude of their exposure, and base their conduct on the likelihood of any consequences for acting in bad faith. The Court of Appeals likewise erred in suggesting Butler is inapplicable because the bad faith conduct did not specifically involve the defense under a reservation of rights. As indicated above, MOE’s bad faith conduct here is tantamount to a breach occurring in the course of a reservation of rights defense. This is enough.

“Reasonableness” Finding Is Binding On Insurer Absent Fraud Or Collusion

An insurer subject to coverage by estoppel under Butler should be bound by a finding of “reasonableness” of the covenant judgment made under the “*Chaussee* criteria,” absent proof by the insurer that the judgment is the result of fraud or collusion. An insurer that in bad faith undermines the defense it is required to provide under the policy like the insurer who refuses to defend in bad faith, should be deemed to have forfeited its right to otherwise challenge the judgment amount.

RECEIVED
SUPREME COURT
STATE OF WASHINGTON
MAY 22 A 9:53
BY RONALD R. CARPENTER
CLERK

V. ARGUMENT

A.) Overview Of Insurance Bad Faith, And The Obligations Of Liability Insurers Defending Under A Reservation Of Rights.

An insurer commits the tort of bad faith if its acts or omissions are unreasonable, frivolous, or unfounded. Kirk v. Mt. Airy Insurance Company, 134 Wn.2d 558, 560, 951 P.2d 1124 (1998). As noted in Tank v. State Farm, 105 Wn.2d 381, 385, 715 P.2d 1133 (1986), “[t]he duty to act in good faith or liability for acting in bad faith generally refers to the same obligation.” The duty is fiduciary in nature, but involves “something less than a true fiduciary relationship.” Safeco Insurance v. Butler, 118 Wn.2d at 389. As explained in Tank:

[A]n 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.

105 Wn.2d at 386.

An insurer may be liable in tort for both special and general damages for bad faith conduct. See generally Coventry v. American States Ins. Co., 136 Wn.2d 269, 285, 961 P.2d 933 (1998).⁴

Special rules have developed with regard to liability insurers fulfilling their duty of good faith, when providing a defense for insureds in litigation brought by third-party claimants. See generally Truck Ins. Exch. v. VanPort Homes, 147 Wn.2d 751, 58 P.3d 276 (2002). Entitlement to a

⁴ An insurer’s bad faith conduct may also give rise to liability under Washington’s Consumer Protection Act, Ch. 19.86 RCW, if the additional requirements of that act are met. See Coventry, 136 Wn.2d at 275-85.

defense is one of the essential features of a liability policy, and the duty to defend is broader than the duty to indemnify. Id., 147 Wn.2d at 760. The duty to defend is triggered by allegations in the underlying complaint that conceivably render the insurer liable under the policy. Hayden v. Mutual of Enumclaw, 141 Wn.2d 55, 64, 1 P.3d 1167 (2000).

When a liability insurer in bad faith either fails to defend or mishandles the defense, this Court has recognized the unique problems an insured encounters in proving he or she is demonstrably worse off because of the insurer's conduct. More particularly, the Court has sanctioned the "covenant judgment" mechanism by which insureds may extricate themselves when insurers have, in one way or another, committed bad faith relating to the duty to defend. See Besel v. Viking Ins. Co., 146 Wn.2d 730, 734, 49 P.3d 887 (2002). Under the covenant judgment mechanism, the insured enters into a good faith settlement with the plaintiff in the underlying litigation for a stipulated judgment, and in turn assigns any bad faith claim against the insurer to the plaintiff, while also obtaining a covenant from the plaintiff not to execute against the insured, but to seek recovery on the assigned claim from the insurer. See e.g. Butler, 118 Wn.2d at 390-400 (involving mishandling of duty to defend); Kirk, 134 Wn.2d at 561-65 (involving failure to defend); Besel, 146 Wn.2d at 733-36 (involving failure to settle claim during course of defense).

In upholding an insured's right to use the covenant judgment mechanism to extricate himself or herself from the underlying claim, this Court has approved of the remedy of coverage by estoppel for the insured's assignee. Under this remedy, there is a rebuttable presumption of harm to the insured. Butler at 390. Imposition of this presumption relieves the insured of the "almost impossible burden of proving that he or she is demonstrably worse off because of [the insurer's actions]." Id. (quoting A. Windt, Insurance Claims and Disputes: Representation of Insurance Companies and Insureds, §2.09 at 40-41 (2d ed. 1988)). This presumption may be overcome if the insurer proves the insured suffered no harm as a result of its bad faith conduct. Id. at 392. Imposing the presumption of harm furthers both the compensatory and deterrent functions of tort law:

Presuming prejudice once the insured establishes bad faith shifts the burden to the insurer to prove its acts did not prejudice the insured. The shifting of the burden ameliorates the difficulty insureds have in showing that a particular act resulted in prejudice. It also recognizes the fact that loss of control of the case is in itself prejudicial to the insured. Finally, imposing a presumption of prejudice only after the insured shows bad faith adequately protects the competing societal interests involved. It provides a meaningful disincentive to insurers' bad faith conduct while protecting insurers from frivolous claims.

Id. (citations omitted); see also Kirk at 564.

If the insurer cannot overcome the rebuttable presumption of harm, then coverage by estoppel results, and the insurer acting in bad faith is liable for the amount of the covenant judgment, including any excess over policy limits. Butler at 394.

The court has placed some limitations on the coverage by estoppel remedy. It is confined to the third-party bad faith context. Coventry, 136 Wn.2d at 281. Further, the underlying stipulated judgment must be “reasonable,” and not the product of fraud or collusion. See Besel at 738-40; Truck Exch. at 764-66; see also §C., *infra*.

The coverage by estoppel remedy has been applied and is particularly apt when an insurer commits bad faith during the course of defending under a reservation of rights. See Butler at 392-400. In this instance, the insurer provides a defense while expressly reserving the right to question coverage. In this unique, conflict-ridden circumstance, the Court has imposed a heightened duty upon the insurer:

We find ... that the potential conflicts of interest between insurer and insured inherent in this type of defense mandate an even higher standard: an insurance company must fulfill an enhanced obligation to its insured as part of its duty of good faith. Failure to satisfy this enhanced obligation may result in liability of the company, or retained defense counsel, or both.

This enhanced obligation is fulfilled by meeting specific criteria. First, the company must thoroughly investigate the cause of the insured’s accident and the nature and severity of the plaintiff’s injuries. Second, it must retain competent defense counsel for the insured. Both retained defense counsel and the insurer must understand that only the *insured* is the client. Third, the company has the responsibility for fully informing the insured not only of the reservation of rights defense itself, but of *all* developments relative to his policy coverage and the progress of his lawsuit. This information regarding progress of the lawsuit includes disclosure of all settlement offers made by the company. Finally, an insurance company must refrain from engaging in any action which would demonstrate a greater concern for the insurer’s monetary interest than for the insured’s financial risk.

Tank, 105 Wn.2d at 387-88.

An insurer defending under a reservation of rights has the right to commence a separate declaratory judgment action to determine whether it has a duty to defend. Truck Ins. Exch. at 761. However, this action must be timely, and does not otherwise relieve the insurer of its enhanced obligations in providing the reservation of rights defense. Id. at 763-64. There are limitations on what can be achieved by the declaratory judgment action. For example, an insurer cannot use the declaratory judgment action to decide duty to defend questions that will necessarily be resolved in the underlying litigation. See Holland America Ins. v. National Idemn., 75 Wn.2d 909, 912-15, 454 P.2d 383 (1969). Also, it is generally understood that an insurer cannot accelerate the declaratory judgment action disposition so as to extinguish its duty to defend in the underlying litigation if, in doing so, it would prejudice the insured's position in the underlying litigation. See Paulson Constr., 132 Wn.App. at 813; see also Thomas V. Harris, Washington Insurance Law §14.2 at 14-4, 14-6 (2d ed. 2006).⁵

B.) MOE's Contact With The Arbitrator Was Bad Faith Conduct, Which Undermined The Insured's Right To Control The Underlying Litigation.

MOE's contact with the arbitrator constitutes insurance bad faith. It unreasonably undermined Paulson's control over the litigation. See

⁵ An insurer defending under a reservation of rights has a duty to attempt settlement of the underlying claim. See Evans v. Continental Cas. Co., 40 Wn.2d 614, 627-30, 245 P.2d 470 (1952); Thomas V. Harris, supra, § 17.7. Martinelli urges that this duty to settle was breached in this case. See Martinelli Supp. Br. at 14-18. This issue is fact-intensive, and is not addressed in this amicus curiae brief.

Butler, 118 Wn.2d at 392. This right of control includes the insured's prerogative on whether to propose a breakdown of damages in the verdict or arbitration award. See Thomas V. Harris, supra, §17.8, at 17-17. As Mr. Harris notes:

As a tactical, coverage-oriented decision, an insured may instruct his attorney to propose a verdict form that calls for an undifferentiated verdict. Because he must represent his client with undivided loyalty, defense counsel, when so instructed by his client, would necessarily seek such an undifferentiated judgment even if it would be more economical to seek a tort determination which would also resolve the coverage issues.

Id.

MOE's attempt to influence the arbitrator's deliberative process by suggesting he will later be accountable for "showing his math" is no different than if MOE had directly sought to influence assigned counsel. MOE impermissibly wrested control of the underlying litigation from the insured, and placed its interests over those of the insured in violation of the equal consideration rule. See Tank, 105 Wn.2d at 388 (requiring that "defense counsel and the insurer must understand that only the *insured* is the client"); Butler at 395 (finding genuine issue of fact requiring trial on insurance bad faith claim, based upon insurer's attempt to use insured's lawyer to obtain statements to use in the coverage action); cf. Ellwein v. Hartford Co., 142 Wn.2d 766, 781-82, 15 P.3d 640 (2001) (relying on Tank in condemning UIM insurer's attempt to convert insured's defense expert in underlying subrogation dispute to UIM insurer's expert), *overruled on other grounds*, Smith v. Safeco Ins. Co., 150 Wn.2d 478, 73

P.3d 1274 (2003). The Court of Appeals was wrong in concluding MOE did not act in bad faith.

The Court of Appeals' willingness to view MOE's "last resort" subpoena sympathetically, because it was faced with "two unreasonable options" (risk bad faith by litigating coverage issues first, or paying the entire arbitration award), is also misguided. See Paulson Constr., 132 Wn.App. at 813. While MOE unsuccessfully sought permission from Paulson and Martinelli to intervene in the arbitration or attend the hearing, it never made a formal motion to intervene or appear as a person with a "direct interest" in the arbitration by virtue of the unresolved coverage issues. See id. at 812 & n.11 (describing arbitration rule permitting request to appear). Although Washington law is unclear on the right of an insurer to intervene under such circumstances, courts have allowed an insurer to do so in analogous proceedings, when the insured's interests are not prejudiced. See Fidelity Bankers Life Ins. Co. v. Wedco, Inc., 102 F.R.D. 41, 44 (D. Nev. 1984) (allowing permissive intervention by insurers in underlying litigation involving the validity of life insurance policies); Thomas v. Henderson, 297 F.Supp. 2d 1311, 1324 (S.D. Ala. 2003) (allowing insurer to intervene in underlying litigation regarding sale of defective aircraft). Having not availed itself of the opportunity to formally intervene or appear, and convince the arbitrator of its direct interest in the outcome and the manner in which the case is determined, MOE should not be heard to say that its subpoena and *ex parte* cover letter

were reasonably justified and consistent with its duty to give equal consideration to its insured. Cf. Lenzi v. Redland Co., 140 Wn.2d 267, 276-78, 996 P.2d 603 (2000) (noting UIM insurer could have avoided adverse consequences of default judgment in underlying proceeding by seeking intervention or appearance in that proceeding). MOE's "last resort" was of its own making.⁶

C.) If MOE's Contact With The Arbitrator Constituted Bad Faith, It Is Subject To The Rebuttable Presumption Of Harm And Coverage By Estoppel.

If MOE's contact with the arbitrator constituted bad faith, it is subject to the presumption of harm and the coverage by estoppel remedy sanctioned in Butler, and subsequent cases. See 118 Wn.2d at 392-94; see also Kirk, 134 Wn.2d at 562-65; Besel, 146 Wn.2d at 737-38. The Court of Appeals *dicta* to the contrary must be rejected. As developed in §B.), supra, MOE's conduct was the equivalent of mishandling a reservation of rights defense. Intermeddling by MOE impacted the insured's strategic choices in the underlying litigation and disserved the integrity of the reservation of rights defense. This conduct should expose MOE to liability under Butler. The Court of Appeals conclusion that Butler did not apply because "the alleged harm stemmed from MOE's attempt to determine coverage issues rather than from bad faith in defending the

⁶ There may be instances where the mere making of a motion to intervene is prejudicial to the insured, and violative of the equal consideration rule. Whether a motion for intervention or the like should be granted necessarily requires a case-by-case inquiry, guided by notions of reasonableness and the equal consideration rule. However, because MOE did not seek to intervene or appear, it should not be for it to contend its effort would have been unsuccessful.

underlying tort lawsuit,” miscasts the nature of MOE’s conduct. Paulson Constr. at 816.

Further, the Court of Appeals attempt to inject a balancing test into the presumption of harm analysis under Butler is similarly misguided. See id. at 816-17 (finding that, in any event, harm is not shown “[w]here the damages greatly outweigh the relatively minor economic harm,” and concluding “the remedy becomes more punitive than equitable”).⁷ This approach has the effect of dismantling the Butler formulation and injects a burdensome case-by-case weighing of particular facts in its stead. It also disregards the fundamental twin precepts of Butler –a presumption of harm is required because of the almost impossible proof problems visited on the insured, and an extraordinary remedy is necessary in order to provide a strong disincentive for insurers acting in bad faith. See 118 Wn.2d at 390-92; see also Kirk at 564, 565. If an insurer cannot fully overcome the presumption of harm, then coverage by estoppel applies. Period. Neither Butler nor its progeny suggest the insurer may escape bad faith in this context under a *de minimus* analysis.⁸

⁷ In forwarding this analysis, the Court of Appeals appears to disregard the underpinnings of the majority opinion in Butler, referencing the *dissent* instead. See Paulson Constr., 132 Wn.App. at 816-17 & accompanying notes.

⁸ The Court of Appeals is also incorrect in suggesting that Paulson incurred no harm in responding to the subpoena and *ex parte* cover letter because it would have incurred similar fees and expenses if MOE had formally sought to intervene. See Paulson Constr. at 816. A mere motion to intervene does not constitute bad faith, if it does not prejudice the insured’s interests. In this instance, no cognizable “harm” would follow. The fees and expenses incurred would present normal transactional costs for the insured. MOE’s unorthodox and unjustified contact with the arbitrator was much different, leading to unnecessary fees and expenses, in order for the insured to retain control of the litigation.

D.) If MOE Is Subject To Coverage By Estoppel Under *Butler*, It Should Be Bound By A Determination That The Covenant Judgment Is “Reasonable,” Unless It Can Prove Fraud Or Collusion By The Insured.

In a bad faith action involving the duty to defend, a covenant judgment is the presumed measure of the insured’s harm, if the judgment is found to be “reasonable” under the so-called “*Chaussee* criteria.” See Besel, 146 Wn.2d at 738; Chaussee v. Maryland Casualty Co., 60 Wn.App. 504, 803 P.2d 1339, 812 P.2d 487 (1991) (adopting “reasonableness hearing” criteria applicable to RCW 4.22.060 for determining reasonableness of stipulated judgment). This reasonableness finding may occur in the underlying litigation, or related declaratory judgment action. See Besel at 734; Truck Ins. Exch., 147 Wn.2d at 759.

In Truck Ins. Exch., this Court concluded 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.” 147 Wn.2d at 765-66 (citation omitted). Assuming reasonableness was appropriately established in either the underlying litigation or this declaratory judgment action, MOE should only be able to challenge the covenant judgment amount upon proof of fraud or collusion. An insurer that in bad faith undermines the defense of its insured should, like an insurer who refuses to defend, be deemed to have forfeited the right to otherwise challenge the settlement amount. The

fact that the insurer is not present at the reasonableness determination is not dispositive. Besel at 734, 739-40.⁹

Lastly, reasonableness determinations are made under the supervision and control of a court of law or the equivalent, such as an arbitrator. The Court should hesitate to assume this function is not performed fully and competently in the insurer's absence. Cf. Lenzi v. Redland Co., 140 Wn.2d at 281 (rejecting UIM insurer's argument that default judgment should not be given effect because of concern for collusive judgments, concluding judges and commissioners are not mere bystanders blindly accepting the parties' submissions).

VI. CONCLUSION

The Court should adopt the reasoning advanced in this brief and resolve this appeal accordingly.

DATED this 15th day of May, 2007.
FILED AS ATTACHMENT
TO E-MAIL *

BRYAN P. HARNETIAUX

GARY N. BLOOM

On Behalf of WSTLA Foundation

*Brief transmitted for filing by e-mail; signed original retained by counsel.

⁹ Apparently, MOE was given notice of the reasonableness hearing in the arbitration confirmation proceeding, but did not seek to appear. Martinelli Br. at 13. MOE contends any attempt to appear at that juncture would have been futile. See MOE Supp. Br. at 17. Also, Martinelli contends MOE did not seek to fully challenge the reasonableness hearing in the superior court in this case. See Martinelli Supp. Br. at 18-19.