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No. 553429-I

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.

BRIEF OF APPELLANT

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2008 JUL 15 11 4: 45
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I. ASSIGNMENTS OF ERROR AND ISSUES

A. ASSIGNMENTS OF ERROR

Assignment Number 1: The trial court committed error entering the “Order Granting Mr. and Mrs. Martinellis’ Partial Motion for Reconsideration...” (CP 689-390), therein concluding in part that the conduct of Mutual of Enumclaw (MOE) estopped it from denying insurance coverage to Dan Paulson Construction, Inc. (Paulson) in regard to the construction defect claims asserted by Mr. and Mrs. Martinelli (Martinelli). Thereafter, the trial court committed further error by entering an “Order Denying Mutual of Enumclaw’s Motion for Reconsideration and Denying Mutual of Enumclaw’s Amended Motion for Reconsideration,” “Order Nunc Pro Tunc Granting Joseph and Karen Martinellis’ Motion for Partial Summary Judgment and Denying Mutual of Enumclaw’s Motion for Partial Summary Judgment.” and “Judgment Nunc Pro Tunc.” CP 958-959; 1002-1007; 979-983.

Assignment Number 2: The trial court committed error entering the “Order Granting Mr. and Mrs. Martinellis’ Partial Motion for Reconsideration.....” therein concluding that the Stipulated Arbitration Award entered into by Paulson and Martinelli was “reasonable.” CP 689-691. The Court committed further error by subsequently entering the “Order Denying Mutual of Enumclaw’s Motion for Reconsideration and Denying Mutual of Enumclaw’s Amended Motion for Reconsideration,” “Order Nunc Pro Tunc Granting Joseph

and Karen Martinellis' Motion for Partial Summary Judgment and Denying Mutual of Enumclaw's Motion for Partial Summary Judgment." and "Judgment Nunc Pro Tunc."

Assignment Number 3: The trial court committed error in refusing to rule upon the Subcontractor Exception to the "Damage to Your Work" exclusion contained in the MOE/Paulson insurance contract. CP 652-653.

Assignment Number 4: The trial court committed error when it specified that its judgment founded on tortious conduct bears interest at 12%.

B. ISSUES

Issue Number 1: When conduct by an insurance company in a Declaratory Judgment Action does not increase the insured's liability exposure to a claimant, should the company be estopped to assert valid insurance coverage exclusions?

Issue Number 2: When an insured and claimant enter into a stipulated settlement without the consent of the potentially affected insurance company, is the insurance company entitled to participate in a hearing in which a Court determines whether the stipulated settlement was "reasonable?"

Issue Number 3: Does the insured have the burden of establishing that a stipulated settlement with a claimant involves settlement of damage claims which fall within the Subcontractor Exception to the "Damage to Your Work" exclusion contained in an insurance contract?

Issue Number 4: Did the trial court have authority to apply the former 12% interest rate on the bad faith judgment against MOE by entering its judgment *Nunc Pro Tunc*?

II. STATEMENT OF THE CASE

A. STATEMENT OF FACTS

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

Dan Paulson is an experienced general contractor, having been in the business for approximately thirty (30) years. CP 531. In early 1998, Mr. Paulson's business, Dan Paulson Construction, Inc., (Paulson) entered into a written contract with Joseph and Karen Martinelli (Martinelli) to build a home in Friday Harbor, San Juan County. CP 49 – 53. The base construction price was \$1,365,000. CP 425. After certain changes, the final construction price was \$1,725,000. CP 427.

2. First Arbitration Between Paulson and Martinelli.

Unhappy with the ultimate billing from Paulson, which included change orders, the Martinellis refused to pay the final sum due. The construction contract required the parties to submit any dispute to AAA Arbitration. CP 52. During this first arbitration, Paulson was represented by his personal attorney, Griffith Flaherty. CP 434. During the course of that arbitration, the Martinellis also asserted certain defective construction claims. CP 434. Following arbitration,

Paulson was awarded \$100,000.00 against the Martinellis and the Martinelli defect claims were resolved. CP 430.

3. Martinellis' Claims Against Architect

Having generally lost their private arbitration against Paulson, the Martinellis then turned their attention to their architects, Olson Sundberg Kundig Allen (Architects). The Martinellis raised a variety of claims. The Martinellis claimed the Architects were liable for alleged defects in the roof, exterior stone veneer, large columns in the home, hardwood floors, and windows. CP 297. All told, the Martinellis claimed the architects were responsible for approximately \$1,400,000 in costs that they believed would be incurred to repair the alleged design/construction defects and \$800,000 for "stigma" damages that would allegedly exist even after repairs were performed. CP 299-300. The Martinellis sued the Architects for such damages in March, 2002. CP 401.

During the same period of mid-2002, the Martinellis made claim upon Paulson for the exact same alleged construction defects which were being asserted against the Architects. CP 401; 297-300. Initially, Paulson was represented by personal counsel Griffith Flaherty. CP 27. However, by mid-2002, Paulson had put his commercial liability insurance company on notice of the new Martinelli claims. The insurance company was Mutual of Enumclaw (MOE). MOE assigned defense counsel Greg Jones to represent Paulson. CP 28. The

assignment of defense counsel Jones was under a reservation of rights regarding various insurance coverage issues. CP 325 – 326.

In July, 2003, a mediation occurred in the Martinelli/Architect lawsuit. CP 290. Paulson and MOE assigned defense counsel Jones attended and participated, even though Paulson was not a party to the lawsuit. CP 28. No settlements were reached. CP 28; 290. The Architects offered \$250,000, but the Martinellis demanded approximately \$1,000,000.00. CP 290 – 291. Shortly after the mediation, the Architects and Martinellis settled and the Martinelli/Architect lawsuit was dismissed. CP 293 – 294. The terms of the Martinelli/Architect Settlement Agreement were confidential and not disclosed to Paulson or MOE. CP 403.

4. Second Arbitration Between Paulson and Martinellis And The MOE Defense

Having settled with the Architects, the Martinellis proceeded against Paulson with a second AAA Arbitration. After some delays, the arbitration hearing was ultimately scheduled to commence January 6, 2004. CP 109. The construction defect claims asserted by the Martinellis against Paulson were the same defects the Martinellis had asserted against the Architects. CP 295 – 307.

On more than one occasion, MOE advised Paulson's personal insurance coverage attorney of the scope of insurance coverage available regarding the Martinelli claims, and the limitations on such coverage. CP 325 – 326; 332 – 333. Specifically, the following was communicated:

- There were four annual policies of insurance issued by MOE to Paulson that were available to potentially cover the Martinellis' claims. That coverage totaled \$4,000,000. CP 325
- There were several potentially relevant insurance policy exclusions, three of which read:

This insurance does not apply to:

k. Damage to Your Product

“Property damage” to “your product” arising out of it or any part of it.

l. 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.

m. Damage to Impaired Property or Property Not Physically Injured.

“Property damage to “impaired property” or property that has not been physically injured, arising out of:

- (1) A defect, deficiency, inadequacy or dangerous condition in “your product” or “your work”; or
- (2) A delay or failure by you or anyone acting on your behalf to perform a contract or agreement in accordance with its terms.

This exclusion does not apply to the loss of use of other property arising out of sudden and accidental physical injury to “your product” or “your work” after it has been put to its intended use.

CP 336.

From the above-quoted insurance policy exclusions and exceptions, the starting point of determining insured and uninsured claims required that MOE know both (1) who performed what work on the home, and (2) what damage (construction defect) was caused by each entity that performed work on the home.

At MOE, there were two separate groups of personnel working on the Paulson matter. One group was responsible for the defense being provided to Paulson. The other group was responsible for the insurance coverage analysis and later the declaratory judgment lawsuit filed by MOE. CP 332. Following the failure of the July, 2003 mediation, both the defense and coverage teams' activity increased.

On the defense side, in October, 2003, Paulson's assigned defense counsel requested a large quantity of additional documents from the Martinellis. CP 410 – 411. The same month, the Martinellis made a \$1,000,000 settlement demand on Paulson. CP 217 – 218. In response to the demand, the individual at MOE responsible for the defense immediately reevaluated the claims which might be insured, and increased settlement authority to \$550,000. CP 97 – 100.

On the coverage side, in August, 2003, MOE's coverage attorney wrote Paulson's insurance coverage attorney, stating in part:

While Mutual of Enumclaw certainly hopes that the arbitration will end favorably to your client, it appears that at least some of the claims against DPCI [Paulson] are outside the scope of its commercial general liability policy. I am somewhat at a loss to know exactly what is being alleged by the Martinellis, as Mutual of

Enumclaw maintains separation between its coverage files and its defense files. Nevertheless, based on my limited knowledge, it appears that some of the policy's exclusions may become important from a coverage standpoint.

I would like to stress that Mutual of Enumclaw has very little information about the upcoming arbitration. In order to determine the existence and extent of coverage, we need DPCI to send this firm copies of the information relevant to the arbitration, including any analysis and reports of the damage to the Martinelli's home, and records of any subcontractor involvement in the arbitration proceedings.

CP 332 – 333.

Having not received response from Paulson's insurance coverage attorney, in mid-September, 2003, MOE's coverage attorney again wrote stating that it needed the information and that "Mutual of Enumclaw is trying to investigate this claim in order that it may provide the coverage owing under the Dan Paulson Construction policy." CP 334

In late September, 2003, Paulson's insurance coverage attorney responded, stating in part:

The enclosed documents are provided to you as a courtesy, since Mutual of Enumclaw does not have a right to the documentation that has been exchanged among the parties to the Martinelli/DPCI [Paulson] arbitration. DPCI hopes that the enclosed documentation will assist Mutual of Enumclaw's evaluation of an appropriate settlement offer that will resolve the Martinelli's claims.

Notwithstanding DPCI's cooperation in sharing documents related to the Martinelli arbitration, production of the documents should not be construed as a concession by DPCI that alleged defects and damages, as characterized by the Martinellis, are likely to be

awarded. Nor is DPCI conceding that the Martinelli's characterization of their claim will establish categories, or an appropriate segregation, of any [insured or uninsured] damages that arbitrator Dick Manning will award.

As you can from the enclosed documentation, the Martinelli's claims have been a moving target and DPCI hotly disputes the Martinelli's entitlement to recover any damages whatsoever.

CP 343 – 344 (Brackets added)

Since he was now in possession of expert's reports regarding the nature of the alleged home defects, repair cost estimates and information regarding who performed what work on the house (Paulson versus subcontractors), the MOE coverage attorney could begin analysis of potential insured and uninsured claims. However, as the above-quoted letter from Paulson's insurance coverage attorney correctly noted, the damage components actually awarded to the Martinellis in arbitration would be the true starting point for segregating any arbitration award between insured and uninsured losses.

Before the scheduled arbitration, Paulson's insurance coverage attorney made it clear to MOE that Paulson was a small construction company that would not be able to remain in business if the Martinellis received a substantial arbitration award and began collection efforts against Paulson. CP 221 – 222 (506). Further, even if the Martinellis did not immediately commence collection efforts against Paulson, it was asserted that the mere entry of the Arbitration Award as a Judgment against Paulson would have put it out of business because

Paulson would no longer be able to obtain construction financing or bonding necessary to operate as a contractor. CP 316.

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

With the Paulson/Martinelli arbitration scheduled to commence in early January, 2004, and having been rebuffed in its attempt to promptly learn the components of any award which might be entered by the arbitrator, MOE decided to try another alternative. MOE commenced a Declaratory Judgment Action. Paulson's insurance coverage attorney promptly objected to the commencement of that Action, contending it should not have been commenced until the arbitration was completed. CP 349.

Shortly before the scheduled Paulson/Martinelli private arbitration, MOE issued a subpoena duces tecum with written questions and cover letter to the

arbitrator which was returnable after the scheduled arbitration. CP 125 – 126; 133. As MOE explained to Paulson and the Martinellis, the purpose behind the written questions interposed to the arbitrator, was to allow MOE to segregate insured and uninsured damage elements and promptly pay the insured elements. CP 151; 82.

Paulson and the Martinellis objected to the written questions which had been interposed by MOE to the arbitrator in the Declaratory Judgment Action. CP 141 – 143; 145-147. After the matter before the arbitrator settled, MOE struck the subpoena. CP 161 – 163; 165.

MOE's attempt to timely learn of potentially insured and uninsured components of damages awarded to the Martinellis was further compromised. On several occasions, Paulson's insurance coverage attorney requested the Martinellis to agree to have the arbitrator enter a lump sum award, instead of following the usual practice of breaking the award into specific elements. CP 31 – 32; 156. The Martinellis ultimately agreed. CP 32. The Paulson's insurance coverage attorney candidly admitted that the reason he wanted the entry of a lump sum arbitration award was so that any damages awarded to the Martinellis would not be segregated into insured and uninsured elements, which in turn he hoped would force MOE to pay most, if not all, of the Martinelli's claims. CP 505 – 506.

Upon learning that Paulson had directed the entry of a lump sum arbitration award, the MOE coverage attorney objected stating:

In a recent letter I received from Brian Waid of Robert Gould's office, Mr. Waid indicated that both parties to the arbitration had specifically requested a "lump sum" award, which did not categorize the award. Mr. Manning has indicated to this firm that, as a matter of practice, he creates a very detailed award. From a coverage perspective, I am concerned that DPCI [Paulson] has chosen to affirmatively ask the arbitrator to deviate from his standard practice and issue an award that makes the proper application of policy coverages very nearly impossible. This implicates, once again, DPCI's duty to cooperate with Mutual of Enumclaw's investigation of the claim. It appears that DPCI, for whatever reason, has chosen to obscure, rather than help clarify, the only source of information that may elucidate the coverage question.

Mutual of Enumclaw will suffer considerable prejudice if Mr. Manning returns only a lump sum award on which the Martinellis begin execution. There may be only a matter of days in which Mutual of Enumclaw may be forced to choose (sic) between a gross overpayment on behalf of DPCI, and a bad faith claim from DPCI for failure to prevent the execution. We are asking for your client's help and cooperation in order that we can resolve the coverage questions based on the facts rather than guesses. Fortunately, there is still time for DPCI to make a request to Mr. Manning that he, as is his custom, make a detailed finding of facts and characterization of damages. It is Mutual of Enumclaw's sincere hope that DPCI do so, and avoid the issue of cooperation in the declaratory judgment action.

CP 156 – 157.

MOE's objection was to no avail.

On January 6, 2004, the private arbitration commenced. CP 178. On January 12, 2004, Paulson and the Martinellis orally agreed to a settlement containing the following elements:

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

CP 167 – 172; 188 – 209.

Based upon the Paulson/Martinelli Settlement Agreement, on January 20, 2004, the AAA arbitrator entered an Arbitration Award of \$1,300,000. CP 178 – 179. Thereafter, the Martinellis applied to the San Juan Island Superior Court for confirmation of the Arbitration Award and entry of a Judgment. Such Confirmation Order and Judgment were entered in San Juan County Superior Court, Cause Number 02-2-05152-0. CP 181-182.

B. STATEMENT OF PROCEEDINGS

1. Parties Claims and Counterclaims

MOE filed the present Declaratory Judgment Action on January 26, 2004, against Paulson and the Martinellis. In this Action, MOE requested the Court to determine which portions of the Arbitration Award and associated Superior Court Judgment were insured under the MOE/Paulson insurance contract, and which portions were not insured. CP 1 – 2.

As the Assignees of Paulson’s insurance contract and bad faith/Consumer Protection Act claims against MOE, the Martinellis filed an initial Answer and

Counterclaim, and a subsequent Amended Answer/Counterclaim. CP 3 – 10; 914 – 921.

Though a party to the Action, Paulson had no economic interest in the outcome because he was protected by the Paulson/Martinelli “Covenant to Not Execute.” Other than filing a Notice of Appearance through his insurance coverage attorney, Paulson did not file any pleadings.

2. Cross Motions for Partial Summary Judgment and Initial Trial Court Ruling

The parties filed cross-motions for Partial Summary Judgment. The Trial Court was requested to rule on essentially five issues. Each issue and the Court’s initial ruling are described below.

The first issue was whether MOE’s conduct through its insurance coverage attorney in issuing to the AAA Arbitrator the Subpoena Duces Tecum with written interrogatory questions, or two letters, constituted acts of bad faith which caused harm to Paulson. In its initial ruling, the Trial Court ruled that MOE’s written discovery request to the AAA arbitrator, and two letters, constituted improper discovery in the Action, but that Paulson had not been harmed by such discovery request. Therefore, the Trial Court ruled that MOE was not estopped from denying coverage for uninsured claims. CP 644 – 651.

The second issue presented to the Court was whether MOE engaged in bad faith in failing to settle within the \$4,000,000 of the Paulson/MOE insurance

contract limits. The Court ruled that the failure to reach settlement of the Martinelli claims against Paulson was not an act of bad faith by MOE. CP 651.

The third issue was whether MOE had acted in bad faith in failing to pay the insured aspects of the Arbitration Award and associated Judgment. The Trial Court ruled that the failure to pay any aspect of the Arbitration Award and associated Judgment was not an act of bad faith, because MOE still did not know what aspects of the settlement between Paulson and the Martinellis were insured and what aspects were not insured. CP 652.

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

The fifth issue presented by way of Motion for Partial Summary Judgment was which of the parties bears the burden of proof regarding the subcontractor exception to the “Damage To Your Work” exclusion in the insurance contract.¹ The Trial Court deferred ruling on this issue. CP 653.

The Martinellis then filed a Motion for Partial Reconsideration. CP 657 – 662. The Martinellis noted that Paulson’s personal attorney had objected to the Subpoena Duces Tecum/written interrogatories issued by MOE in the first

¹ That portion of the insurance contract reads:

This insurance does not apply to: Damage to your work. “Property damage” to “your work” arising out of any part of it and included in the “products – completed operations

Declaratory Judgment Action. The Martinellis argued that the attorney fees incurred by Paulson in opposing the Subpoena Duces Tecum/written interrogatories constituted sufficient “harm” to Paulson to justify the Court holding that MOE was estopped from denying insurance coverage for the entirety of the Arbitration Award. The Court orally ruled that such attorney fees constituted sufficient “harm” to estop MOE from denying coverage in regard to the entire Arbitration Award (RP I, pages 1 – 4). The Court then entered a written Order granting the Martinellis’ Motion for Partial Reconsideration, estopping MOE from denying coverage for uninsured claims. CP 689 – 691; 1002 – 1007.

MOE filed a Motion for Reconsideration and an Amended Motion for Reconsideration. CP 694 – 703; 903 – 913. MOE’s Motion for Reconsideration and Amended Motion for Reconsideration were denied. CP 958 – 959.

The Trial Court then considered the Martinelli’s Motion for Entry of Judgment and award of Olympic Steamship attorney fees. CP 762 – 775; 776 – 784; 785 – 902; 936 – 941; 942 – 945. On November 12, 2004, the Trial Court entered a “Judgment Nunc Pro Tunc” in the sum of \$1,300,000, plus *Olympic Steamship* attorney fees/expenses and interest. CP 966 – 970; 979 – 983. On the same date, the Trial Court entered Findings of Fact and Conclusions of Law regarding the award of *Olympic Steamship* attorney fees/expenses. CP 962-965.

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.

On November 24, 2004, Mutual of Enumclaw filed its first “Notice of Appeal.” CP 984 – 1001. Thereafter, the Trial Court entered an “Order Nunc Pro Tunc Granting Joseph and Karen Martinelli’s Motion for Partial Summary Judgment and Denying Mutual of Enumclaw’s Motion for Partial Summary Judgment.” CP 1002 – 1007.

Because the Court’s prior Orders and Judgment did not resolve all claims between the parties, the Trial Court decisions were not yet subject to appeal. On January 4, 2005, the Trial Court entered “Findings and Conclusions Upon Readiness Hearing, Motion to Compel Reference from Court of Appeals – Division I, and CR 54 (B) Certification” and “Order Re: CR 54 (B) Certification and Related Matters.” CP 1009-1010.

On January 19, 2005, Mutual of Enumclaw filed its “Amendment to Notice of Appeal to the Court of Appeals – Division I.” CP 1041 – 1076. On January 7, 2005, the Martinellis filed their Notice of “Cross Review” to the Court of Appeals. CP 1020 – 1040.

III. ARGUMENT

A. Summary of Arguments

The Trial Court’s decision that MOE was estopped from denying coverage for uninsured claims was based upon the erroneous conclusion that MOE engaged in “bad faith” conduct from which “coverage by estoppel” can arise. Further, the

alleged harm sustained by Paulson is not within the category from which “coverage by estoppel” can arise.

The Trial Court’s decision that the settlement between Paulson and the Martinellis was “reasonable” must be reversed because either the trial court record is inadequate to support such conclusion and/or MOE has not yet had the opportunity to litigate that issue.

The above noted errors by the Trial Court require reversal of the Judgment against MOE. However, if the Judgment is not reversed, then the Judgment must be amended to reflect the correct statutory interest rate.

Finally, assuming the Judgment is reversed, this Court should provide the Trial Court with guidance regarding the allocation of the burden of proof regarding the insurance contract coverage limitations.

B. The Trial Court Committed Error in Ruling the MOE Was Estopped From Denying Coverage for Uninsured Claims

1. The Trial Court Ruling

The trial court ruled that MOE’s conduct in the Declaratory Judgment Action of issuing a subpoena with written interrogatories to the AAA Arbitrator and advising the Arbitrator that insurance coverage issues existed between MOE and Paulson, constituted “bad faith” conduct which could have caused harm to Paulson. CP 647-650. However, in examining whether Paulson was actually harmed by the MOE communications with the Arbitrator, the trial court found that “under the facts of this case, no reasonable person could reach the conclusion

that Paulson was prejudiced or harmed by MOE's actions." CP 651. However, Paulson incurred attorney's fees in objecting to the discovery requests and letters that MOE's counsel sent to the Arbitrator. RP I 2-3. Having concluded that MOE's discovery request in the Declaratory Judgment Action was improper, and having found at least that fees were incurred by Paulson in the Declaratory Action to oppose MOE's discovery request, the Court held that MOE was estopped to deny coverage for uninsured claims. CP 689-690.

2. The Backdrop of Resolving Insurance Coverage Issues

To place the current issues in context, we must understand the relationship between the parties and the legal roadmap which exists to resolve coverage disputes between the parties.

Issues existed between Paulson and MOE regarding what Martinelli damages, if any, were insured under the insurance contracts. Thus, at the center of this lawsuit is the fact that insurance coverage issues existed. The law provides the parameters under which such issues are to be resolved.

The first and most significant principle of law is obvious. An insurance company should pay insured claims and should not pay uninsured claims.

Sometimes an insured and insurance company cannot agree as to whether the damages sustained by a third-party claimant are insured or uninsured. When the insured and insurance company cannot agree upon the coverage issues, the most common method of resolving the disagreement is through a Declaratory

Judgment Action as authorized by RCW 7.24.020.² Though the insured and insurer have available such Action to resolve their coverage disagreement, the timing of that litigation does not always intermesh efficiently with what is occurring regarding the underlying third-party damage claim. That deficiency can result from primarily two different reasons. First, the underlying damage claim may be in a settlement discussion or litigation mode that is resolved before a final judicial decision can be reached in the Declaratory Judgment Action. Harris, Washington Insurance Law, pages 14-3 through 14-6 (1995).

Second, in many instances it is inappropriate for an insurance company to institute a Declaratory Judgment Action and litigate the facts which will be determinative of insurance coverage before completion of the underlying lawsuit against the insured. As courts have explained, it would be inappropriate for an insurance company to use the Declaratory Judgment process to litigate factual issues that might establish its insured's damage liability to the third-party claimant. *Brohawn v. Transamerica Insurance Co.*, 276 Md. 396, 347 A.2d 842, 848 – 849 (1975); *Allstate Insurance Co. v. Atwood*, 319 Md. 247, 572 A.2d 154, 156 – 158 (1990). *Accord, Western National Assurance Co. v. Hecker*, 43 Wn.App. 816, 821 – 822, footnote 1, 719 P.2d 954 (1986); *Progressive Casualty*

² Rights and Status under written instruments, statutes, ordinances.

A person interested under a deed, will, written contract or other writings constituting a contract, or whose rights, status or other legal relations are affected by a statute, municipal ordinance, contract or franchise, may have determined any question of construction or validity under the instrument, statute, ordinance, contract or franchise and obtain a declaration of rights, status or other legal relations thereunder.

Insurance Co. v. Cameron, 45 Wn.2d 272, 283, 724 P.2d 1096 (1986) (underlying negligence and proximate cause questions should be resolved in tort action and not in declaratory judgment proceeding).³

For example, let us assume that MOE had commenced a Declaratory Judgment Action and litigated to judgment the issue of coverage before the date set for the Paulson/Martinelli private arbitration. To prevail in such an Action, MOE would have been required to establish that (1) Paulson engaged in acts and/or omissions that caused damage to the Martinellis and (2) that such acts and/or omissions and resultant damage were not covered under the insurance contract. Such legal proceeding would have necessarily been harmful to Paulson's defense of the underlying Martinelli claims in the AAA Arbitration, and presumably would have resulted in Paulson asserting that MOE was acting in bad faith by proceeding with the Action. It is with this backdrop which we must now approach the facts of this case.

Based upon its initial investigation, it appeared to MOE's coverage representatives and coverage attorney that some of the claims of the Martinellis, if proven, may be insured and some may not be insured. After evaluating the

³ There are some instances in which litigation of the insurance coverage issues in the declaratory judgment action can proceed prior to or concurrent with litigation of the underlying damage lawsuit. In those instances in which the coverage issue involves questions which are independent and separate from the claims asserted in the underlying lawsuit, the declaratory judgment action can proceed. Examples of such issues which can be litigated without impacting the underlying damage lawsuit include matters as to whether the insured failed to comply with the notification provisions, failed to pay premiums or involve pure interpretations of law regarding coverage. *Allstate Insurance Co. v. Atwood*, *supra*, 572 A.2d at 156. See generally, Howard, Declaratory

claims, MOE authorized \$550,000.00 settlement authority. That offer did not resolve the Martinelli claims. Therefore, the AAA Arbitration was to proceed. Concurrently, MOE was aware that Paulson strenuously contended that (1) the Martinelli's claims were not valid, but, (2) if the Martinellis prevailed at arbitration and attempted to collect an Arbitration Award, Paulson may be put out of business.

It was in the above-described context in which MOE commenced the first Declaratory Judgment Action shortly before the scheduled AAA Arbitration. In that Action, MOE communicated with the Arbitrator and issued the written interrogatories, requesting that the arbitrator specify the components of any damages awarded by him to the Martinellis so that MOE could pay any insured damage award. It was that conduct which the Trial Court found constituted sufficient "bad faith" discovery to estop MOE from establishing that some of the damages awarded by the Martinellis were not insured under the MOE/Paulson insurance contract.

We submit that the bad faith determination and the coverage by estoppel conclusion by the Trial Court was incorrect. MOE did not act in bad faith, but even supposing that its actions rose to that level, it is only conduct which can increase the insured's exposure to the claimant that can estop an insurance company from otherwise asserting valid insurance coverage defenses. MOE's

Judgment Coverage Actions: A Multi-State Survey And Analysis And State v. Federal Law Comparison, 21 Ohio N.U. L. Rev. 13 (1994).

position that that it could direct special interrogatories to the AAA Arbitrator regarding his award does not justify estopping MOE from asserting appropriate insurance coverage defenses.

3. MOE Did Not Commit Bad Faith

The Martinellis alleged that it was bad faith for MOE to propose special interrogatories to the arbitrator. The trial court agreed with them, and held as a matter of law that MOE had committed bad faith. This holding is erroneous. Trial courts have discretion to allow insurers to intervene in underlying actions to propose special interrogatories to fact-finders.

a. When Facts Necessary to Determine Coverage are to be Resolved in an Underlying Action, Insurers May Intervene to Propose Special Interrogatories to Juries.

The difficulties in resolving the coverage aspects related to the Martinellis' underlying claim, as it headed toward arbitration, were neither novel nor unknown to the law. The procedural archetype is as follows:

- An insured tenders the defense of a third party claim under a liability insurance policy.
- The insurer recognizes that some elements of the third party's claim are covered by the policy, but others are not.
- The insurer accepts the tender of defense subject to a reservation of rights to dispute its obligation to indemnify the insured for liability outside of the policy's coverage.

- The insured and the third party claimant share an interest in maximizing the recovery from the insurance company. They therefore will make no attempt to identify the components or basis for any judgment, and will explicitly or implicitly attempt to obtain a generalized verdict.
- The insurer, knowing that a generalized verdict is a very likely result in the underlying litigation, and knowing that the jury in the underlying case is the *only* source of information about which of the claims inhere in the verdict, moves to intervene in the underlying action pursuant to CR 24 to propose a special interrogatory to the jury to obtain the necessary information.

Such was the situation in *Thomas v. Henderson*, 297 F.Supp.2d 1311 (S.D. Ala. 2003). In that case, the insured, Henderson, sold an airplane to a third party, Thomas. Shortly after taking possession of the plane, Thomas discovered that basic maintenance items that had been recorded in the plane's log had clearly not been performed. *Id.* at 1314. Thomas sued Henderson and Sky King, the inspection service, alleging sixteen causes of action mostly based on fraud, deceit, and conspiracy related claims. *Id.* Sky King tendered its defense of the claim to its insurer, Old Republic, under an Airport Liability policy. *Id.* at 1323. Old Republic defended Sky King under a reservation of rights to limit or deny liability coverage, claiming that "certain of Thomas's claims against its insureds may be covered while certain others may not." *Id.* The court summarized Old Republic's

position: “Based on these factors, Old Republic expresses concern that a general damages award in this action would effectively preclude it and its insureds from sorting out which components of that award against Sky King . . . were covered by the Policy and which were not.” *Id.*

Old Republic’s method of resolving this concern was to move to intervene under Rule 24(b), Fed. R. Civ. P., identical to Washington’s CR 24(b). *Id.* The insurer had no interest in being an active participant in the case, and only sought to intervene “for the limited purpose of submitting special jury interrogatories and/or a special verdict form for the Court’s consideration and requesting submission of the same to the jury.” *Id.* The purpose of the special interrogatories would be “to specify the claim or claims forming the basis for the verdict . . . and would also ask the jury to itemize any damage award in terms of compensatory damages for economic losses, mental anguish, and any other injury alleged, and punitive damages.” *Id.* Before conducting an analysis of the insurer’s motion to intervene, the court noted, “If . . . the declaratory judgment action yields a determination that certain elements of Thomas’s damages are covered and certain others are not, it would be impossible to allocate the parties’ respective responsibilities for those damages in the declaratory judgment action without itemization of the jury’s verdict.” *Id.* at fn. 14.

Ultimately, the *Thomas* court overruled the other parties’ objections, and allowed Old Republic to intervene, because, “Absent an itemized jury verdict in

this case, resolution of the coverage issues could be complicated considerably, as there would be *no way to distinguish among the types of claims and damages embraced by any damages award the jury might render.*” *Id.* at 1327 (emphasis added). Like the Martinellis, the objecting parties in *Thomas* claimed that the insurer should resolve all such issues in the declaratory judgment action, rather than “interfere” in the underlying litigation. The court rejected that suggestion outright.

[T]homas’s proposed solution that the Court “should ... allow Old Republic and its Insured to resolve the conflict between them in the declaratory judgment action” is facile, given the dimensions of Old Republic’s concern. Litigation of the coverage issue should be confined to the declaratory judgment action; however, without some specificity in the jury’s verdict in this case, those coverage issues *may not be amenable to effective resolution in the declaratory judgment action or anywhere else.*

Id. at fn. 20 (citations omitted).

Old Republic was thus allowed to intervene and propound special interrogatories to the jury, subject to the trial court’s supervision. *Id.* at 1327.

A similar fact pattern was presented to the court in the case of *Fidelity Bankers Life Ins. Co. v. Wedco, Inc.*, 102 F.R.D. 41 (D. Nev. 1984). In *Wedco*, an insurance agent was alleged to have been complicit with a life insurance client in deceiving life insurance companies regarding the health of the client. The client died, and the life insurance companies paid policy benefits, but sued the insurance agent for its role in the fraud. *Id.* at 42-43. The agent’s errors and omissions carriers provided a defense subject to a reservation of rights to deny coverage if

the liability was based on intentional acts. *Id.* The errors and omissions carriers moved to intervene pursuant to *Fed. R. Civ. P.* 24(b), in order to view discovery, and propose a special interrogatory to the jury regarding the agent's intention. As the court pointed out, "The purpose of knowing the jury's bases for any verdicts would be to make possible a division of the money damages between covered and non-covered acts of the insureds. The insurance companies must indemnify their insureds only for damages arising from covered acts." *Id.* at 43. The errors and omissions carriers were allowed to intervene in order to receive discovery and propose special interrogatories and verdict forms to the jury. *Id.* at 45.

Thus, while there is no reported decision in Washington directly on point, insurers in this State can safely rely on the legal proposition that trial courts have the discretion to allow them to intervene under CR 24 for the limited purpose of proposing special interrogatories and verdict forms to juries in cases underlying coverage actions. In any event, there is absolutely no authority that even suggests that simply bringing a motion to intervene, regardless of how the court ultimately exercises its discretion, could constitute bad faith.

b. A Motion to Intervene, by Any Other Name, is Not Bad Faith.

The conflict between the Martinellis and Paulson was a variation on the above-described archetypal theme. MOE was defending Paulson under a reservation of rights because some of the Martinellis' allegations were covered but others were not. Mutual of Enumclaw was well aware of the danger of a

general, lump sum award, and the consequence that would have on parsing out covered versus non-covered elements⁴. But unlike the situation in *Thomas* and *Wedco*, the underlying dispute was in arbitration rather than court. The private arbitration was based on the consent of Paulson and the Martinellis, and there was no option to directly intervene against their will. Nevertheless, MOE requested permission to intervene. MOE was rebuffed. With few options remaining, MOE proposed its special interrogatories to the fact-finder (arbitrator) by way of a deposition on written questions issued from the Declaratory Judgment Action.

Proposing special interrogatories to an arbitrator, rather than a jury, is not bad faith. No case from any jurisdiction in the United States has ever held that an insurer that moves to intervene in an underlying action for the limited purpose of proposing special interrogatories to the fact finder acts in bad faith simply by filing the motion. Yet that is exactly what the Martinellis are asking this Court to find. The differences between the insurers' motions to intervene to propose a special interrogatory to the jury in the cases of *Thomas* and *Wedco* and Mutual of Enumclaw's issuance of written deposition questions to Arbitrator Manning are little more than a question of the caption on the pleadings.

Mutual of Enumclaw issued the special interrogatories to the arbitrator in advance of the arbitration, but not returnable until after the arbitration was complete; both Paulson and the Martinellis had an opportunity to move to quash

⁴ MOE's concern was certainly borne out. Paulson and the Martinellis had actually stipulated to altering the AAA rules to allow for a lump sum award, for the purpose of obscuring coverage.

the interrogatories just as they would have had the chance to oppose a motion to intervene for the purpose of proposing a special interrogatory to the fact finder. The trial court in this case could have quashed the discovery entirely (corresponding to a denial of the motion to intervene), or it could have reviewed MOE's proposed interrogatories to ensure no prejudice to the arbitrating parties, and allowed the limited inquiry. If the trial court had allowed the interrogatories to go forward, the mechanics of the arbitrator's responding to those interrogatories would have been indistinguishable from a jury turning its attention from a general verdict to the special interrogatories proposed by the insurer in a more standard intervention situation. The trial court's supervision of the process, invoked by a motion to quash, provided Paulson and the Martinellis with all the procedural safeguards to which they might have been entitled. To hold otherwise would elevate form over substance in the application of the court rules, a practice forbidden by our Supreme Court. "Thus, whenever possible, the rules of civil procedure should be applied in such a way that substance will prevail over form." *First Federal Sav. & Loan Assn. v. Ekanger*, 93 Wn.2d 777, 781, 613 P.2d 129 (1980).

The special interrogatories MOE proposed to the arbitrator were no more an impermissible inquiry into the arbitrator's decision than special interrogatories to the jurors are in impermissible inquiry into theirs. The trial court may have ultimately denied MOE's proposal to intervene, by quashing the discovery

request, but it was not bad faith to make that proposal⁵. The Court should reverse the trial court's ruling finding bad faith as a matter of law.

4. The Conduct of MOE in the Declaratory Judgment Action Cannot Create Estoppel to Deny Coverage for Insured Claims

It is the general rule that the concept of estoppel may not be used to provide coverage under an insurance policy regarding claims that are otherwise not insured. *Carew Shaw & Bernasconi, Inc. v. General Casualty Co. of America*, 189 Wash. 829, 336, 65 P.2d 689 (1937) (“... under no conditions can the coverage or restrictions on coverage be extended by the doctrine of waiver or estoppel”); *Estate of Hall v. HAPO Federal Credit Union*, 73 Wn. App. 359, 362-363, 869 P.2d 116 (1994). See, *Saunders v. Lloyd's of London*, 113 Wn.2d 330, 336, 779 P.2d 249 (1989). The rationale for the rule is that an insurance company should not pay for losses for which it did not contract to provide coverage and did not collect a premium. *Saunders, supra*, 113 Wn.2d at 336.

In *Safeco Insurance Co. of America v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992), the Court created a limited exception to the general rule that coverage cannot be created by estoppel. In *Butler*, the insured fired a handgun toward a group of young men in a truck. One of the shots struck one of the young men,

⁵ The special interrogatories sent to the arbitrator also contained a cover letter explaining why they were necessary. This letter contained no argument, and suggested no result in the arbitration. MOE inadvertently sent this cover letter only to the arbitrator, and not to counsel for the Martinellis or Paulson. The arbitrator provided all parties with a copy immediately thereafter. Nevertheless the Martinellis argued to the trial court that it was bad faith as a matter of law to send such an “ex-parte” letter. MOE did not stand to benefit from disrupting the arbitration proceedings, and no reasonable person could conclude that MOE was advancing its own interests

causing serious injury. Safeco asserted that coverage did not exist for the young man's injuries, contending that the injuries did not result from an "accident" and that the insurance policy excluded coverage for the insured's intentional conduct. *Butler*, 118 Wn.2d at 387. When the injured young man sued Mr. and Mrs. Butler, Safeco assumed the defense of the lawsuit under a reservation of rights.

The Butlers alleged that Safeco engaged in improper conduct regarding the acceptance of the defense and actual conduct of the defense of the underlying lawsuit by (a) failing to advise the Butlers for a period of time that the defense would be under reservation of rights, (b) causing the assigned defense counsel to delay his investigation, which resulted in evidence favorable to the Butlers being lost, (c) attempting to use assigned defense counsel to obtain statements from individuals that would assist Safeco in its coverage denial, and (d) co-mingling the Safeco defense and insurance coverage files at the claim office. *Butler, supra*, 118 Wn.2d at 395.

If the Butler's allegations were true, Safeco's conduct would necessarily increase the Butler's tort liability exposure to the injured claimant and/or constitute an improper manipulation of the defense being provided to the Butlers to enhance Safeco's coverage denial position. Either of those outcomes would increase the Butler's economic exposure to the tort claimant. To thwart such conduct, the *Butler* Court held that if the insured (or the insured's assignee)

at the expense of its insured through that letter. Nothing about the cover letter shows any kind of bad faith.

established such “bad faith” conduct by the insurance company, it would be estopped from relying upon otherwise valid insurance policy coverage limitations. *Butler, supra*, 118 Wash.2d at 392-394.⁶

The next coverage by estoppel case was *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 951 P.2d 1124 (1998). There, the Court applied the coverage estoppel rule when an insurance company refused in bad faith to provide its insured with a defense to a third party claim. Unlike the situation in which an insurance company has taken over control of the defense of the underlying claim, and has provided that defense in bad faith, a refusal to provide a defense leaves the insured in control of his defense and thus in control of his potential exposure to the third party claimant. On that basis, the *Kirk* Court could have held that the bad faith failure to provide a defense could not create coverage by estoppel. However, the *Kirk* Court noted that if it didn’t apply the *Butler* rule of coverage by estoppel, it would be encouraging insurance companies to avoid providing

⁶ In determining what conduct by an insurance company constitutes a “good faith” providing of the defense under a reservation of rights, the *Butler* court relied upon its previous holding in *Tank v. State Farm Fire and Casualty Co.*, 105 Wash.2d 381, 715 P.2d 1133 (1986). There, the court held that a good faith providing of a defense under reservation of rights required the insurance company to fulfill four criteria, stating:

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 relevant to his policy coverage and the progress of his lawsuit. 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.

Butler, supra, 118 Wash.2d at 388, quoting from *Tank, supra*, 105 Wash.2d at 388.

reservation of rights defenses to their insureds. *Kirk, supra*, 134 Wash.2d at 565.⁷ *Accord, Truck Insurance Exchange v Vanport Homes, Inc.*, 147 Wash.2d 751, 761, 58 P.3d 276 (2002).

To summarize, in the cases involving the bad faith providing of a defense, the Court has focused upon the increased exposure of the insured to the tort claimant as a result of the improper providing of a defense, or the self-dealing by the insurance company by using the defense counsel in the underlying tort lawsuit to bolster the insurance company's denial of coverage. Both forms of conduct increase the insured's economic exposure to the tort claimant. In the context of failure to provide a defense, the Court concluded that the failure to apply the same estoppel rule would encourage insurance companies to avoid providing a reservation of rights defense, which may result in a less than well financed defense and thereby increase the likelihood of the insured losing to the claimant.

Turning to the next category of "coverage by estoppel" cases, we turn to the cases in which the Court precluded the insurance company from relying upon the stated monetary limits of the insurance policy. In a typical case, the insurance company controls the defense of the underlying claim. If it is highly probable that

⁷ Specifically, the *Kirk* Court stated as follows:

If we fail to apply the remedy acknowledged in *Butler* to this question, we would erode any incentive for an insurer to act in good faith. Without coverage by estoppel and the corresponding potential liability, an insurer would never choose to defend with a reservation of rights when a complete failure to defend, even in bad faith, has no greater economic consequences than if such refusal were in good faith. The requirement of acting in good faith cannot be rendered meaningless. *Accord, Trust Exchange Insurance Co. supra*, 134 Wash.2d at 565.

the underlying claim will result in a judgment against the insured that exceeds the stated insurance policy limits, the insurance company owes a good faith duty to its insured to attempt to settle that claim within the stated policy limits. A bad faith failure to effectuate a settlement within the monetary limits of an insurance policy estops the insurance company relying upon the stated monetary limits of the insurance contract. *Besel v. Viking Ins. Co. of Wisconsin*, 146 Wn.2d 730, 49 P.3d 887 (2002). The significant feature of such type of case, is that the insurance company bad faith conduct exposed the insured to personal financial liability to the claimant which would not have existed if the claim had been settled within insurance policy limits.

The conduct by MOE in this case does not have features of the conduct of the insurance companies which created a risk to the insured which the Courts in the above examples created coverage by estoppel. MOE provided a defense to Paulson. No one has suggested that assigned defense counsel and the MOE individuals responsible for conducting the defense and evaluating Martinellis' claims, fell short in their responsibilities. Likewise, it is undisputed that the MOE "defense side" did not attempt to gather evidence that would assist the MOE coverage position. Finally, the Trial Court found that MOE did not act in bad faith in refusing the Martinellis' settlement demand. CP 651-652, 1006. The facts of this case did not justify the application of coverage by estoppel rule adopted in *Butler*, *Kirk*, and *Besel*.

The conclusion that the coverage by estoppel rule is limited in scope, and does not apply in the present case, is made clear by *Coventry Associates v. American States Insurance Co.*, 136 Wn.2d 269, 961 P.2d 933 (1998).

Coventry involved a first party insurance claim. The insured's property was damaged by a landslide. Coventry submitted a claim to its insurer for damage to its property. After minimal investigation, the insurance company denied first party coverage. Coventry then sued its insurer, alleging bad faith failure to investigate and bad faith failure to disclose all applicable first party coverages. Trial court found that (a) no insurance coverage existed for the insurance loss, and (b) the insurance company had not acted in bad faith. *Coventry, supra*, 136 Wash.2d at 275.

On appeal, Coventry conceded that there was no coverage under its insurance policy for its loss. However, Coventry asserted that its insurance company had engaged in bad faith regarding its investigation of the loss. The insurance company, for purposes of appeal, conceded it "acted in bad faith" in the investigation of Coventry's first party claim. *Coventry, supra*, 136 Wash.2d at 275. Under *Butler*, that conduct would have resulted in coverage by estoppel. However, in holding that coverage by estoppel was not an appropriate remedy, the Court stated as follows:

We hold coverage by estoppel in the first party context is not the appropriate remedy because, unlike third party reservation of rights cases, the loss in the first party situation has been incurred before the insurance company is aware a claim exists. Furthermore, an insurer is not liable for

the policy benefits but, instead, liable for the consequential damages to the insured as a result of the insurer's breach of its contractual and statutory obligations. In third party reservation of rights cases, though, coverage by estoppel is an appropriate remedy because the insurer contributes to the insured's loss by failure to fulfill its obligation in some way. This contribution to loss is particularly true when acts of the insurer have led the insured to believe it is covered under the terms of the policy. See 1 Windt, *supra*, §§ 2.03, 2.05 (insurer's breach of its duty to investigate should not result in the insurer being estopped from denying coverage). This difference between third party cases and first party cases warrants different remedies.

Coventry, supra, 136 Wash.2d at 284-285 (Emphasis added)

The highlighted portion of the *Coventry* decision emphasizes the rationale for not applying the general rule that coverage cannot be created by estoppel, and using of the "coverage by estoppel" exception in some third party liability situations. In the third party liability situation, if the insurance company acting in bad faith contributes to the insured's exposure to the third party claimant, coverage by estoppel is an approved remedy. For example, in *Safeco v. Butler*, it was alleged in part that the insurance company inappropriately delayed assigned defense counsel from beginning the investigation of the shooting, resulting in a loss of evidence that may have been favorable to the Butler's defense of the tort lawsuit. In *Besel v. Viking Insurance Co. of Wisconsin*, the insured's personal economic exposure to the third party claimant was increased by the failure of the insurance company to accept a policy's limits demand (\$25,000) from the claimant. In each instance, the conduct of the insurance company exposed the insured to a greater likelihood of personal financial liability to the third party claimant.

In the present case, the Trial Court found that no such increased liability exposure occurred as a result of MOE's communications with the AAA Arbitrator. CP 650-651. After careful analysis, the Trial Court held that the sole harm suffered by Paulson was the fact that its personal insurance coverage attorney had to perform legal research and object to the actions which MOE took in the Declaratory Judgment Action of communicating with the AAA Arbitrator. (RP I pages 1-2.) To apply the rule of coverage by estoppel under those circumstances would be a significant expansion of Washington law which is not justified. In fact, we have not found any appellate decision from any jurisdiction which allows such expansion.

The Trial Court conclusion that MOE is estopped to deny coverage should be reversed. The Trial Court should be directed to enter Summary Judgment for MOE.

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

1. Trial Court Ruling

As part of its Summary Judgment ruling, the Trial Court ruled that the settlement between Paulson and the Martine!lis was "reasonable." CP 690.

The basis for the Trial Court's finding of "reasonableness" is unclear. Paulson/Martinelli argued that the Court could find the Stipulated Arbitration Award was reasonable on two alternative grounds. First, they argued that the

Arbitrator in the private Arbitration stated in his Award that the settlement was “reasonable.” They then argued that, in a separate lawsuit, they obtained court confirmation of the Arbitration Award and MOE was prohibited from litigating “reasonableness” in the present Declaratory Judgment Action. CP 255-256. Alternatively, Paulson/Martinelli argued that the evidence before the Trial Court in the Summary Judgment proceeding was sufficient to allow the Court to find “reasonableness” under the parameters set forth in *Chaussee v. Maryland Casualty Co.*, 60 Wn.App 504, 803 P.2d 1339, rev. den., 117 Wn.2d 1018 (1991). CP 254-257.

The basis of the Trial Court’s ruling that the settlement was “reasonable” does not exist in Trial Court record. As we explain next, that ruling must be vacated.

2. MOE’s Due Process Right to Litigate the Issue of “Reasonableness” was Infringed.

If the Trial Court’s ruling that the settlement was “reasonable” was based upon either the private Arbitrator’s statement in that regard, or the confirmation of the Arbitration Award in the subsequent Trial Court proceeding, then MOE’s due process right to test the “reasonableness” was infringed. Specifically, MOE did not have the right to contest “reasonableness” in either of those proceedings which preceded the present Action.

When an insurance company is defending a claim against its insured under a reservation of rights, the insured may negotiate a settlement on its own, over

the objection of the insurance company. *Tank v. State Farm Fire and Casualty Co.*, 105 Wn.2d 381, 389, 715 P.2d 1133 (1986); *Chaussee, supra*, 60 Wn.App. at 509-510. The most common method by which an insured settles a claim over the objection of his insurer is by a Stipulated Judgment and Covenant Not to Execute the Judgment against the insured's personal assets. Settled in that manner, an inherent conflict of interest exists between the insured and its insurer. As our Court's and commentators have noted, when an insured settles a claim, and receives protection against his personal assets being subject to satisfying the settlement, it has no incentive to minimize the settlement sum. *Besel, supra*, 146 Wn.2d at 737-738; *Werlinger v. Warner*, 126 Wn.App. 342, 109 P.3d 22, 27 (2005); Harris, Judicial Approaches to Stipulated Judgments, Assignments of Right, and Covenants Not to Execute in Insurance Litigation, 47 Drake L. Rev. 853 (1999).

Because of the inherent conflict between an insured and its insurance company in this setting, the insured (or his assignee) has the responsibility to prove that the settlement was reasonable before it may become potentially binding upon the insurance company. *Chaussee, supra*, 60 Wn.App. at 510-511. If the settlement is found to be "reasonable", it becomes the presumptive measure of an insured's harm in a subsequent bad faith action against the insurance company. *Besel, supra*, 146 Wn.2d at 738; *Werlinger, supra*, 109 P.3d at 26.

In determining the “reasonableness” of a settlement agreement in a tort lawsuit wherein one defendant settles, and there are remaining defendants, a trial court is required to weigh the factors set forth in *Glover v. Tacoma General Hospital*, 98 Wn.2d 708, 658 P.2d 1230 (1983), overruled on other grounds, *Ground Controls, Inc. v. Smiley*, 110 Wn.2d 695, 756 P.2d 717 (1988). Our courts have determined that the *Glover* factors are also the elements which must be examined in determining the “reasonableness” of a settlement by an insured which was not approved by its insurer. *Besel, supra*, 146 Wn.2d at 738; *Chaussee, supra*, 60 Wn.App. At 511-512. The elements consist of the following:

- The claimant’s damages.
- The merits of the defendant’s defense theories, and fault of nonparties or parties that have already settled.
- The claimant’s comparative fault.
- The risks and expenses of continued litigation.
- The defendant’s ability to pay.
- Any evidence of bad faith, collusion, or fraud between the claimant and the defendant in arriving at the settlement.
- The extent of the claimant’s preparation of the case.
- The interests of the insurance company that may be impacted by the settlement.

Besel, supra, 146 Wn.2d at 738; *Werlinger, supra*, 109 P.3d at 27 (“... the interest of the insurer, as a third party affected by the settlement, was another *Glover* factor weighing against a determination that the amount was reasonable.”)

Any individual or entity who may be impacted by the settlement has a due process right to receive notice of the proposed settlement, and participate in a hearing before the tribunal which will determine whether the settlement was or was not reasonable. *Brewer v. Fibreboard Corp.*, 127 Wn.2d 512, 524-528, 531,

901 P.2d 297 (1995). See, *Howard v. Royal Specialty Underwriting, Inc.*, 121 Wn.App. 372, 379-380, 89 P.3d 265 (2004).

If the Trial Court relied upon the finding of the “reasonableness” by the private Arbitrator, then MOE’s rights were violated. MOE was not a party to the private AAA Arbitration. MOE was not advised of the proposed settlement and did not have an opportunity to litigate the issue of “reasonableness” before the Arbitrator entered his conclusion in the Paulson/Martinelli Arbitration.

Similarly, subsequent application to the Superior Court for confirmation of the Arbitration Award did not afford MOE an opportunity to litigate the question of the “reasonableness” of the Paulson/Martinelli settlement. A Superior Court proceeding seeking to affirm a private Arbitration Award is very limited in scope. When Paulson/Martinelli applied to the Superior Court in a separate action to have the Arbitration Award affirmed, that Trial Court’s did not have authority to reject the Arbitrator’s finding of “reasonableness.”

A trial court’s review of an Arbitration Award is limited to the grounds contained in RCW 7.04.160 and .170.⁸ *Barnett v. Hicks*, 119 Wn.2d 151, 153-

⁸ RCW 7.04.160 Vacation of award -- Rehearing. In any of the following cases the court shall after notice and hearing make an order vacating the award, upon the application of any party to the arbitration:

- (1) Where the award was procured by corruption, fraud or other undue means.
- (2) Where there was evident partiality or corruption in the arbitrators or any of them.
- (3) Where the arbitrators were guilty of misconduct, in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence, pertinent and material to the controversy; or of any other misbehavior, by which the rights of any party have been prejudiced.

154, 829 P.2d 1087 (1992). The Superior Court may only affirm, vacate, modify, or correct an Arbitration Award according to the statutory grounds. *Barnett, supra*, 119 Wn.2d at 156.

The Superior Court in which Paulson and Martinelli sought to have the Arbitration Award affirmed, could not overturn the Arbitrator's finding of "reasonableness" unless an error by the Arbitrator in reaching that decision was apparent from the face of the Arbitration Award. *Northern State Construction Co. v. Banhero*, 63 Wn.2d 245, 249-250, 386 P.2d 625 (1964). Additionally, the

(4) Where the arbitrators exceeded their powers, or so imperfectly executed them that a final and definite award upon the subject matter submitted was not made.

(5) If there was no valid submission or arbitration agreement and the proceeding was instituted without either serving a notice of intention to arbitrate, as provided in RCW 7.04.060, or without serving a motion to compel arbitration, as provided in RCW 7.04.040(1).

An award shall not be vacated upon any of the grounds set forth under subdivisions (1) to (4), inclusive, unless the court is satisfied that substantial rights of the parties were prejudiced thereby.

Where an award is vacated, the court may, in its discretion, direct a rehearing either before the same arbitrators or before new arbitrators to be chosen in the manner provided in the agreement for the selection of the original arbitrators and any provision limiting the time in which the arbitrators may make a decision shall be deemed applicable to the new arbitration and to commence from the date of the court's order.

RCW 7.04.170 Modification or correction of award by court. In any of the following cases, the court shall, after notice and hearing, make an order modifying or correcting the award, upon the application of any party to the arbitration:

(1) Where there was an evident miscalculation of figures, or an evident mistake in the description of any person, thing or property, referred to in the award.

(2) Where the arbitrators have awarded upon a matter not submitted to them.

(3) Where the award is imperfect in a matter of form, not affecting the merits of the controversy. The order must modify and correct the award, as to effect the intent thereof.

Superior Court which was requested to confirm the Arbitration Award, was not entitled to hear any evidence that MOE might have wanted to present contesting the Arbitrator's finding of reasonableness. *Hatch v. Cole*, 128 Wash. 107, 222 P. 463, affirmed, 130 Wash. 706 (1924).

In summary, MOE was not a party to the private Arbitration, and did not receive notice of any hearing in which the private Arbitrator might decide the question of "reasonableness." Therefore, the Arbitrator's finding of "reasonableness" of the settlement could not be binding upon MOE. Similarly, the subsequent Superior Court proceeding in which Paulson/Martinelli sought confirmation of the Arbitration Award, was not a forum in which MOE could exercise its due process right to litigate the "reasonableness" of the Paulson/Martinelli settlement. If the Trial Court in the present Declaratory Judgment Action determined that the Stipulated Arbitration Award and subsequent Superior Court Judgment affirming that Award were adequate grounds to presently find "reasonableness," the Court committed error.

3. If the Trial Court Purported to Find the Stipulated Arbitration Award was "Reasonable" Based Upon Evidence Presented by the Parties in the Present Declaratory Judgment Action, the Record in This Proceeding is Insufficient to Uphold Such Conclusion.

As noted above, in determining whether a Stipulated Settlement between an insured and a third party claimant is presumptively binding upon the insurance company, a Court is required to hold a hearing in which the insurance company and other interested parties can participate, and weigh the various factors set forth

in *Chaussee/Glover*. Though no statute or case law requires that the trial court enter formal Findings of Fact and Conclusions of Law regarding the issue of “reasonableness,” the factors relied upon by the Trial Court must be enunciated. *Glover, supra*, 98 Wn.2d at 718. The reason the basis for a trial court’s finding of “reasonableness” must be enunciated, is that an Appellate Court is entitled to review the Trial Court’s decision to determine whether the finding of “reasonableness” was supported by substantial evidence. *Howard v. Royal Specialty Underwriting, Inc., supra*, 121 Wn.App. at 380.

In the present Declaratory Judgment proceeding, the Trial Court did not enunciate verbally or in writing any analysis of the *Chaussee/Glover* elements or indicate what evidence, if any, the Court was relying on in reaching the conclusion that the Stipulated Arbitration Award was “reasonable.” The failure of the Trial Court to enunciate the basis of its conclusion precludes this Court from affirming the finding of “reasonableness.” See *Crest Inc. v. Costco Wholesale Corp.*, (No. 53364-I, July 7, 2005) (2005 WL 1560194) (Failure of trial court to articulate basis of attorney fee award requires reversal and remand).

D. The Monetary Judgment Against MOE Must Be Reversed.

Based upon its determination that MOE was estopped to deny insurance coverage for the settlement between Paulson and the Martinellis and that such settlement was “reasonable,” the Trial Court entered Judgment against MOE for the amount of the settlement and interest. Because MOE is not estopped to deny

insurance coverage for uninsured claims and/or the issue of the “unreasonableness” of the settlement has not yet been litigated, the monetary Judgment against MOE must be reversed.

Based upon its conclusion that MOE engaged in “bad faith” in communicating with the Arbitrator, the Trial Court awarded the Martinellis all the attorneys’ fees and expenses incurred in the present Action. However, reversal of the finding of coverage estoppel requires that the award of attorney fees and expenses incurred in the present Action must be reversed.

E. The Burden of Proving that Some or All of Paulson’s Liability Arose from the Work of Subcontractors is on the Martinellis.⁹

When an insured alleges coverage and the insurer asserts an exclusion, each party is required to prove the facts essential to its own claim. Determining coverage is a two-step process where the insured must first establish that the loss falls within the scope of the policy. *Diamaco, Inc. v. Aetna Casualty and Surety Co.*, 97 Wn. App. 335, 337, 983 P.2d 707 (1999). The insurer then has the burden of showing that the loss is excluded by specific language in the policy. *Id.* MOE certainly concedes that Paulson has met his burden of showing that the Martinellis’ claim comes within the policy’s grant of coverage. The burden thus

⁹ The trial court elected to not rule upon this issue even though it was argued and briefed by the parties. Having ruled that coverage existed due solely because of application of “coverage by estoppel,” the resolution of the burden of proof issue became moot. Since the burden of proof issue is purely a question of law and is a matter not firmly resolved under Washington law, it is appropriate for this court to presently resolve the issue.

shifts to Mutual of Enumclaw to prove that the loss falls within the specific language of an exclusion. Here is that exclusion:

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”.

The definition of “your work” is:

- a. Work or operations performed by you **or on your behalf**; and
- b. Materials, parts or equipment furnished in connection with such work or operations.

(Emphasis added).

The work performed by Dan Paulson and all of its subcontractors and materialmen thus falls squarely within the definition of “your work.” Since Paulson’s policy does not apply to “your work”, liability for any damage to the entire project of the Martinellis’ residence is excluded from coverage. There is no dispute that the house was Paulson’s “work.” MOE easily met its burden of proving that the loss falls within the specific terms of the exclusion.

The exclusion is not, however, the end of the question. The same exclusion (1) also contains an exception:

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

The insured has the burden of proving that the loss comes within the policy’s coverage. The insurer then has the burden of proving the applicability of

an exclusion. At that point, the burden shifts back to the insured 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). In *Aydin*, the court was faced with an insured claiming liability coverage for pollution damages. The parties agreed that the loss came within the scope of the policy, and that the policy's pollution exclusion applied. The pollution exclusion, however, had an exception for "sudden and accidental" discharges. The court noted the dearth of law in California addressing the question of which party had the burden of proving the applicability of an exception to an exclusion. *Id.* at 1190. After a survey of the positions taken by other jurisdictions, California adopted the majority holding that the burden of proving an exclusion rests strictly on the insured. As was noted in *Aeroquip Corp. v. Aetna Casualty and Surety, Inc.*, 26 F.3d 893, 895 (9th Cir. 1994), "This allocation aligns the burden with the benefit and is consistent with the general principle under California law that "while the burden is on the insurer to prove a claim covered falls within an exclusion, the burden is on the insured initially to prove that an event is a claim within the scope of the basic coverage." Montana agrees. After reaffirming that the insured must prove the loss to be within the grant, and the insurer must prove the exclusion, the court addressed the burden of proving an exception to an exclusion in *Travelers Cas. & Sur. Co. v. Ribi Immunochem Research*, 108 P.3d 469, 476 (Mont. 2005). "We now turn to the third and final step in the process. Although courts remain split on the issue,

the majority return the burden of proving an exception to an exclusion to the insured. . . This allocation appropriately aligns the burden with the benefit as the party seeking the benefit of a particular policy provision bears the burden of proving its application.”

Courts in Washington have allocated the burden in the same way, although without significant analysis. In *B&L Trucking & Construction Co., Inc. v. Northern Ins. Co. of New York*, 32 Wn. App. 646, 920 P.2d 192 (1996), aff'd, 134 Wn. 2d 413 (1998), the court was faced with the application of the same “sudden and accidental” exception to the pollution exclusion that was addressed in *Aydin*. In discussing the instructions given to the jury, the court approved of the instruction that the insured had the burden of proving the application of the exception. *Id.* at 660. In this case, the exception is for damage arising out of the work of subcontractors. The insured has the burden of proving the application of this exception. For these reasons, the Court should have ruled as a matter of law that Paulson, via the Martinellis, had the burden of proving that some part of Paulson’s liability is exempted from the Work exclusion by the subcontractor exception, and which part that is

F. The 12% Interest Rate Specified In The Judgment Exceeds The Amount Set By Statute

The Judgment entered by the Trial Court on November 12, 2004, specified that its principal amount bears interest at the rate of 12%. CP 967. If this Court

does not vacate the Judgment, then MOE requests that this Court revise the interest component of the Judgment.

The legislature substantially reduced the interest rate on judgments “founded on tortious conduct, effective June 10, 2004.” RCW 4.56.110.¹⁰ The Martintellis’ judgment against MOE is founded on alleged tortious conduct of “bad faith.” Butler, supra, 118 Wn. at 389 (An action for bad faith handling of an insurance claim sounds in tort). To support interest at the higher rate, the court entered its judgment *Nunc Pro Tunc* to an earlier date before the legislature

¹⁰ RCW 4.56.110
Interest on judgments.

Interest on judgments shall accrue as follows:

(1) Judgments founded on written contracts, providing for the payment of interest until paid at a specified rate, shall bear interest at the rate specified in the contracts: PROVIDED, That said interest rate is set forth in the judgment.

(2) All judgments for unpaid child support that have accrued under a superior court order or an order entered under the administrative procedure act shall bear interest at the rate of twelve percent.

(3) Judgments founded on the tortious conduct of individuals or other entities, whether acting in their personal or representative capacities, 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. In any case where a court is directed on review to enter judgment on a verdict or in any case where a judgment entered on a verdict is wholly or partly affirmed on review, interest on the judgment or on that portion of the judgment affirmed shall date back to and shall accrue from the date the verdict was rendered.

(4) Except as provided under subsections (1), (2), and (3) of this section, judgments shall bear interest from the date of entry at the maximum rate permitted under RCW 19.52.020 on the date of entry thereof. In any case where a court is directed on review to enter judgment on a verdict or in any case where a judgment entered on a verdict is wholly or partly affirmed on review, interest on the judgment or on that portion of the judgment affirmed shall date back to and shall accrue from the date the verdict was rendered. The method for determining an interest rate prescribed by this subsection is also the method for determining the “rate applicable to civil judgments” for purposes of RCW 10.82.090.

[2004 c 185 § 2; 1989 c 360 § 19; 1983 c 147 § 1; 1982 c 198 § 1; 1980 c 94 § 5; 1969 c 46 § 1; 1899 c 80 § 6; 1895 c 136 § 4; RRS § 457.]

eliminated the 12% rate for judgments founded on tortuous conduct. This was error.

IV. CONCLUSION

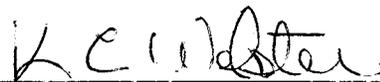
MOE's actions in the Declaratory Judgment Action neither constituted "bad faith" nor was the type of conduct which estops an insurance company from denying claims which are not insured. The trial should be directed to enter Summary Judgment that MOE is not estopped from denying coverage for the uninsured claim asserted by the Martinellis against Paulson. Correspondingly, the Judgment entered against MOE for the entire monetary sum awarded the Martinellis against Paulson must be vacated.

The Trial Court should be directed to revisit its finding that the Paulson/Martinelli settlement was reasonable.

To assist the Trial Court upon remand, this Court should rule that the insured (or its assignee) has the burden of proving that a claim falls within the exception to an insurance contract coverage exclusion.

Finally, if the Judgment against MOE is not reversed, the correct statutory interest rate should be applied.

Dated this 15th day of July, 2005.



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Attorney for Mutual of Enumclaw
Insurance Company, Appellant