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No. _____

IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

Court of Appeals No. 55342-9-I

MUTUAL OF ENUMCLAW INSURANCE COMPANY,

Respondent,

v.

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

Petitioners.

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PETITION FOR REVIEW

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ORIGINAL

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I. IDENTITY OF PETITIONERS AND INTRODUCTION

Mr. and Mrs. Joseph Martinelli (“the Martinellis”), defendants/counterclaimants in the trial court and respondents in the Court of Appeals, file this Petition for Review. Respondent Mutual of Enumclaw Insurance Company (“MOE”) filed, but did not serve, a declaratory judgment complaint against the Martinellis and MOE’s insured, Dan Paulson Construction, Inc. (“Paulson”). Arbitration proceedings were then pending between the Martinellis and Paulson. After MOE interfered in the underlying arbitration, the Martinellis and Paulson agreed to a covenant judgment including Paulson’s assignment of its contract and bad faith claims against MOE. The Martinellis then counterclaimed against MOE as assignees of Paulson.

Reversing the trial court summary judgment in favor of the Martinellis, the Court of Appeals held: (1) MOE did not act in bad faith when it subpoenaed the Arbitrator in the insured’s underlying arbitration and sent him *ex parte* communications; and (2) MOE successfully rebutted the *Butler* presumption of harm because MOE’s potential liability due to coverage by estoppel “greatly outweigh[s] the relatively minor economic harm” suffered by the insured. Appendix A, pp. 8, 10.

Petitioners attach the Court of Appeals published opinion, 132 Wn. App. 803, 134 P.3d 240 (2006), and Order denying rehearing as Appendices A and B, and the trial court's Letter Opinion and Summary Judgment Order as Appendix D and E.

II. ISSUES PRESENTED FOR REVIEW

1. Does an insurer breach its duty of good faith under *Tank v. State Farm Fire & Casualty Co.*, 105 Wn.2d 381, 715 P.2d 1133 (1986) when it unreasonably interferes in the insured's assigned defense?

2. Was MOE's interference in the insured's underlying defense "unreasonable, frivolous, or unfounded," within *Smith v. Safeco Ins. Co.*, 150 Wn.2d 478, 78 P.3d 1274 (2003), considering that well-established law prohibited MOE's subpoena and *ex parte* communications to the Arbitrator and the parties had months earlier provided MOE with *all* the information it needed to adjust the claim?

3. May an insurer successfully rebut *Butler's* presumption of harm by showing that the insurer's potential liability "greatly *outweighs* the [insured's] relatively minor economic harm"?

4. When liability has been established, may Washington insurers delay payment of undisputed, covered claims until all disputes concerning all claims are resolved, without violating WAC 284-30-370 and 330(6)?

III. STATEMENT OF THE CASE

The Martinellis contracted with Paulson to build a new home. CP 1 ¶2, CP 49. MOE had issued a Comprehensive General Liability (CGL) insurance policy to Paulson. CP 1 ¶1, 215-6. The Martinellis filed a demand for arbitration against Paulson with the American Arbitration Association (“AAA”). CP 1 ¶3, CP 44-5, CP 52. MOE assigned counsel to defend Paulson in the arbitration proceeding under a reservation of rights. CP 1 ¶4, 55-6. Thereafter, both Paulson and the Martinellis *fully cooperated* with MOE, by providing MOE with *all* of the information and documentation it requested. Appendix D, p. 6. For example, in late July and August 2002, MOE requested information which Paulson and the Martinellis promptly provided and made available to MOE. CP 56, 441-2, 448-450 ¶¶3-8, 452. Concerned about duplication of copying costs, MOE chose not to follow through beyond what Paulson provided it. CP 395 ¶4, 448-50 ¶¶4-8. In August 2003, MOE again requested documents from Paulson. CP 333-4. MOE’s coverage counsel confirmed that Paulson gave him the documents he

requested, in September 2003, and that **MOE never asked for anything more**. Appendix D, p. 6. In short, by September 2003, MOE had *all* of the information needed to adjust this claim and, by October 2003, MOE's adjusters had substantially completed their work. CP 97-8, 100-03.

More than a year later, in November 2003, MOE filed *but did not serve* a separate declaratory judgment action against Paulson and the Martinellis. CP 121. MOE's complaint admitted that "**some of the damage** claimed against [Paulson] **is covered by the Mutual of Enumclaw policy,**" but alleged that some of those damages were not covered. CP 2 ¶6 (emphasis added), CP 86. MOE waited until December 15, 2003, before informally notifying its insured that it had filed the complaint. CP 36 ¶4, 121, 123.

The Martinelli/Paulson arbitration was scheduled to start on January 6, 2004, before AAA Arbitrator J. Richard Manning, Esq. CP 108. MOE did not move to intervene, and did not ask the Arbitrator for permission to attend. CP 75, 445. On January 2, 2004, *four days prior to the start of the arbitration trial*, counsel for Paulson and the Martinellis received a copy of a subpoena issued to Arbitrator Richard J. Manning in MOE's declaratory judgment action, scheduling the Arbitrator's deposition on written interrogatories, returnable on January 23, 2004. CP 7, 13, 125-7. The

information and documentation sought by the interrogatories and requests for production had already been provided to MOE by the parties. CP 126-7, 649. However, the subpoena also sought the Arbitrator's thought processes, including which witnesses he found credible, itemization of the arbitration award, and his analyses concerning which work had been performed by subcontractors. CP 126-7.

MOE also sent the Arbitrator an *ex parte* cover letter which purported to explain Paulson's insurance coverage, informing him that MOE was defending Paulson under a "reservation of Rights," and stated that MOE "needs more information about the basis of your [future] award." CP 7, 13, 133, 176. The parties first learned of the letter from the Arbitrator at the commencement of the arbitration. CP 7, 13, 36-7 ¶21, 73.¹

AAA, the Martinellis, and Paulson immediately demanded that MOE withdraw its subpoena to the Arbitrator, and provided MOE with extensive authority to support their positions. CP 75-6, 135-144. The Arbitrator also personally telephoned the law partner of MOE's coverage counsel to express his displeasure. CP 13, 77-8. In a *second* such letter to the Arbitrator, sent

¹ MOE's coverage counsel testified he could freely communicate with the Arbitrator *ex parte* because MOE was itself "not a party" to the arbitration. CP 73. He also admitted he had found no authority to support his *ex parte* communications or the subpoena. CP 77. See further, Appendix D, p.5.

during the arbitration trial and over the parties' objection, MOE abandoned some Interrogatories but insisted that the Arbitrator explain his thought processes. CP 146-49, 151-2. Paulson's assigned counsel complained bitterly to MOE, writing (CP 155):

The Paulsons wish that they had been consulted before you contacted the arbitrator. They do not understand why you believed that the arbitrator could be legally subpoenaed. They do not understand why this could not have waited until the conclusion of the arbitration or why it could not have been handled through the declaratory judgment action. The Paulsons are afraid that your actions have prejudiced their defense.

Paulson's corporate counsel also voiced extensive objections. CP 143-44.

Paulson incurred actual, out-of-pocket costs for its private counsel "to review, research and respond to the subpoena issued by Mutual of Enumclaw to the Arbitrator." CP 531 ¶5; CP 527. MOE's conduct also caused tremendous uncertainty and anxiety for Paulson's defense, understandably upsetting Paulson. CP 512-3, 531, 527-8.

During the sixth day of the arbitration trial, the parties entered into a Stipulated Arbitration Award. CP 26-27 ¶¶3-4, 29-30 ¶¶3-4, 39-40 ¶34, 68-73, 179-80. The parties submitted the stipulated arbitration award to the Arbitrator, who approved and found it reasonable. CP 179. San Juan County Superior Court confirmed the Arbitration Award on February 2, 2004. CP

182-87. As part of the settlement, Paulson assigned its contract and bad faith claims against MOE to the Martinellis. CP 189-210.

On February 4, 2004, the Martinellis (as Paulson's assignees) made demand upon MOE to pay the undisputed, covered damages due under MOE's policy. CP 2 ¶6, 212. MOE paid nothing. CP 86. The Martinellis then counterclaimed in MOE's declaratory judgment action, alleging the contract and bad faith claims assigned to them by Paulson against MOE.

The Martinellis moved for partial summary judgment based upon MOE's interference in the underlying arbitration, as well as its failure to timely adjust and pay undisputed, covered claims as required by WAC 284-30-330(6) and 284-30-370. CP 225-258. MOE moved for partial summary judgment asserting that its "initiation of discovery to [the Arbitrator] did not constitute bad faith." CP 259-280. The Martinellis objected to MOE's motion because MOE had prevented the Martinellis from completing their deposition of MOE's coverage counsel by directing him not to answer numerous questions based upon MOE's claims of privilege. CP 1077-92.²

² A few examples of questions for which MOE invoked privilege and directed coverage counsel not to answer include: (1) When did MOE conclude its investigation? (2) Why did MOE *not* serve the declaratory judgment complaint? (3) With whom did coverage counsel discuss his plan to subpoena the Arbitrator? (4) What research, if any, did coverage counsel conduct prior to issuing the subpoena? (5) What did coverage counsel mean when he wrote that MOE would have "some difficulty parsing out what damages may or may not be covered unless [MOE is] allowed to intervene in the arbitration"?

At oral argument, the Martinellis thus explained “why there are no issues of fact relative to the Martinellis’ motion while there are issues of fact relative to [MOE’s] motion.” RP (6/1/04), 28:16-31:17.

In its initial Letter Opinion, the trial court held that: (a) MOE acted in bad faith when it interfered in the arbitration proceeding; (b) MOE had successfully rebutted the presumption of harm; and (c) MOE did not violate WAC 284-30-330(6) and (7). Appendix D, p. 9. The Martinellis moved for reconsideration relative to the presumption of harm because the trial court had overlooked evidence of *actual* harm to the insured due to MOE’s bad faith and misapplied the *Butler* presumption of harm. CP 657-661.

On reconsideration, the trial court agreed that it had inadvertently overlooked the evidence of actual harm and granted the Martinellis’ motion. CP 689; RP (9/7/04), p. 3. The trial court thus held: (1) MOE had interfered in the underlying arbitration, in bad faith; (2) MOE did *not* rebut the presumption of harm; (3) MOE had not shown any genuine issue of fact relative to its affirmative defense of fraud or collusion in connection with the covenant judgment, and; and (4) no genuine issue of fact remained as to the reasonableness of the covenant judgment. Appendix E; CP 689-90. MOE appealed. CP 984. The Martinellis cross-appealed the issue of whether MOE

violated WAC 284-30-330(6) and 284-30-370. CP 1020.

The Court of Appeals reversed in a published opinion, holding: (1) MOE had not acted in bad faith when it subpoenaed the Arbitrator and sent him *ex parte* correspondence because MOE “had a reasonable need to know the elements of a potential damage award”; (2) MOE rebutted the *Butler* presumption of harm because MOE’s potential liability outweighed the actual economic harm to the insured; and (3) MOE did not violate WAC 284-30-330(6) and 284-30-370 because “MOE still does not know whether any portion of the arbitration award was based on covered claims.” The Martinellis moved for rehearing, which the Court of Appeals denied on June 23, 2006. Appendix B.

IV. WHY THE COURT SHOULD GRANT REVIEW

A. *By Condoning MOE’s Unfounded and Unnecessary Interference in the Insured’s Underlying Defense, the Court of Appeals Contradicted Tank, Butler, Overton, Besel, and Smith. [RAP 13.4(b)(1), (4)]*

1. *Interference in the Insured’s Assigned Defense Affects A Major Policy Benefit; the Court of Appeals’ Conclusion to the Contrary Conflicts with Tank, Butler, and Besel. [RAP 13.4(b)(1)].*

The Court of Appeals held [Appendix A, p. 13] that the principles enunciated in *Butler* and *Besel*: “do not directly address the situation here.”

The Court of Appeals analysis conflicts with the fundamental principles of this Court’s well-considered insurance bad faith jurisprudence enunciated in *Tank v. State Farm Fire & Casualty Co.*, 105 Wn.2d 381, 715 P.2d 1133 (1986); *Safeco Insurance Co. v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992), *Besel v. Viking Ins. Co.*, 146 Wn.2d 730, 49 P.3d 887 (2002) and *Smith v. Safeco Ins. Co.*, 150 Wn.2d 478, 78 P.3d 1274 (2003).

Washington insurers undertake an “enhanced obligation...[to] deal fairly with an insured, giving **equal consideration in all matters** to the insured’s interests.” *Tank, supra*, 105 Wn.2d at 390, 391 (emphasis added). Accord, *Am. States Ins. Co. v. Symes of Silverdale, Inc.*, 150 Wn.2d 462, 470, 78 P.3d 1266 (2003). Bad faith occurs when an insurer breaches that duty by engaging in “unreasonable, frivolous, or unfounded” conduct affecting a major benefit of the insurance policy. *Smith, supra*, 150 Wn.2d 484-86; *Overton v. Consolidated Ins. Co.*, 145 Wn.2d 417, 433, 38 P.3d 322 (2002). The insurer’s duty to defend constitutes one of the major benefits of an insurance policy. *Butler, supra*, 118 Wn.2d at 392. Accordingly, “[t]he insurer who accepts that duty [to defend] under a reservation of rights, *but then performs that duty in bad faith*, is no less liable than the insurer who accepts but later rejects the duty.” *Id.* (emphasis added). See further, *Tank*,

supra, 105 Wn.2d at 385-88 (identifying four “specific criteria” governing whether an insurer fulfilled its “enhanced obligation” while defending under a reservation of rights: (1) thorough investigation; (2) retention of competent defense counsel; (3) fully informing the insured of all developments; and (4) refraining from any action which would demonstrate a greater concern for the insurer’s monetary interests than for the insured’s financial risks).

An insurer must give equal consideration to the interests of the insured “in *all* matters.” The insured’s assigned defense, in particular, represents a major benefit of the insured’s insurance contract. The principles of *Butler* and *Besel*, therefore, do indeed apply to insurer conduct that interferes in the insured’s assigned defense. The Court of Appeals thus contradicted the fundamental premise of this Court’s insurance bad faith jurisprudence when it held that the principles enunciated in *Butler* and *Besel* “do not directly address the situation here.” Appendix A, p. 13.

The Court should therefore grant review pursuant to RAP 13.4(b)(1).

2. ***What Meaning Does Washington’s Prohibition Against “Unreasonable, Frivolous, or Unfounded” Conduct have if a Legally Baseless Subpoena and Ex Parte Communications to the Insured’s Arbitrator Constitute Good Faith as a Matter of Law? [RAP 13.4(b)(1)].***

The Court of Appeals condoned MOE's interference in the insured's underlying arbitration by rationalizing that MOE "had a reasonable need to know the elements of a potential damage award." Appendix A, p. 10. To justify its conclusion, the Court of Appeals posited a false choice between the "unreasonable options" of whether "to stand by and do nothing", or issue the legally baseless subpoena and *ex parte* communications to the insured's Arbitrator. *Id.*, p. 10.

MOE obviously had other *good faith* means readily available to it, which it chose not to use. For example, Washington insurers do *not* act in bad faith, as a matter of law, by merely pursuing a declaratory judgment complaint while separately providing the insured with an assigned defense in the underlying liability case. *Tank, supra*, 105 Wn.2d at 391; *Truck Ins. Exch. v. Vanport Homes*, 147 Wn.2d 751, 761, 58 P.3d 276 (2002); *Alaska Nat'l Ins. Co. v. Bryan*, 125 Wn. App. 24, 34-5, 104 P.3d 1 (2004). Thus, the Court of Appeals was obviously wrong when it stated [Appendix A, p. 10] that "Paulson could establish a bad faith claim against MOE" if MOE had pursued the declaratory judgment action. MOE could also have timely adjusted the claim using the information it had been provided months earlier. See discussion, *infra*, p. 19-20. Insurance companies adjust claims every day

without forcing Judges or Arbitrators to make their coverage decisions for them. MOE invoked privilege rather than disclose why it did not do that there. CP 1077-92.

An insurer acts in bad faith, as a matter of law, when it engages in “unreasonable, frivolous, or unfounded” conduct affecting one of the main benefits of the insurance policy. *Smith, supra*, 150 Wn.2d 484-86; *Overton v. Consolidated Ins. Co.*, 145 Wn.2d 417, 433, 38 P.3d 322 (2002). See further, in *Transcontinental Ins. Co. v. Washington PUD’s Util. Sys.*, 111 Wn.2d 452, 470, 760 P.2d 337 (1988)(denial of coverage); *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 560, 951 P.2d 1124 (1998)(failure to defend), *Industrial Indemnity Co. v. Kallevig*, 114 Wn.2d 907, 817, 792 P.2d 520, quoting, *Whistman v. West Am.*, 38 Wn. App. 580, 585, 686 P.2d 1086 (1984)(“actions by an insurer done *without reasonable justification*, are done without the good faith mandated by RCW 48.01.030.”). *Smith* reaffirmed that bad faith represents an issue of fact, but also explained the shifting burdens concerning bad faith in the context of summary judgment and held that insureds may rebut the insurer’s justification for its conduct by showing that the insurer’s explanation is pretextual. *Smith, supra*, 150 Wn.2d at 486.

Here, *both* lower courts agreed that MOE’s subpoena and *ex parte* communications directed to the Arbitrator were legally baseless. Appendix A, p. 10 (“**The ex parte cover letters were improper, and we do not accept MOE’s argument that issuing a subpoena to an arbitrator is analogous to proposing special jury interrogatories**”); Appendix D, p. 4-7.

Unanimous legal authority also condemns MOE’s conduct. See, *State ex rel Carroll v. Junker*, 79 Wn.2d 12, 21, 482 P.2d 775 (1971); *Int’l Assoc. of Fire Fighters v. City of Everett*, 146 Wn.2d 29, 38-9, 42 P.3d 1265 (2002)(arbitrators “become the judges of both the law and the facts); *Lent’s, Inc. v. Sante Fe Engineers, Inc.*, 29 Wn. App. 257, 265, 628 P.2d 488 (1981)(arbitrator’s explanation is not part of award); *Legion Ins. Co. v. General Agency*, 822 F.2d 541, 542 (5th Cir. 1987); *Maine Central R.R. v. Bro. of Maint. Way Employees*, 117 F.R.D. 485, 486-7 (D. Me. 1987).

The trial court further held that MOE’s subpoena and *ex parte* communications were unjustified because the information sought “was reasonably available from other sources, with the exception of the [non-discoverable] arbitrator’s thought processes.” Appendix D, p. 6. Specifically, Paulson and the Martinellis had voluntarily provided MOE with all of the information MOE needed to adjust the claim in 2002 and 2003, and MOE

had substantially completed its adjusting process by October, 2003.

If an insurer's unilateral, unnecessary, and legally baseless subpoena to the Arbitrator in the insured's underlying defense, accompanied by equally outrageous *ex parte* communications, does not qualify as "unreasonable, frivolous or unfounded" in Washington then what does? Moreover, how could any court conclude that MOE had "refrained from any action which would demonstrate greater concern for [MOE's] monetary interests than for the insured's financial risks"? This Court should therefore grant review pursuant to RAP 13.4(b)(1) and (4), because the Court of Appeals' approval of MOE's conduct makes a mockery of this Court's insurance bad faith jurisprudence as established in *Tank*, *Butler*, and *Smith*.

B. *By Balancing the Insurer's Potential Liability Against the Insured's Actual Harm, The Court of Appeals Contradicted Butler and Besel. [RAP 13.4(b)(1) and (4)].*

Washington allows insureds one, and only one, meaningful remedy for insurer bad faith occurring while defending under a reservation of rights: coverage by estoppel. As *Butler* recognized, without a *presumption* of harm, the insured would have "the almost impossible burden of proving that he or she is demonstrably worse off because...**[t]he course cannot be rerun, no amount of evidence will prove what might have occurred if a different**

route had been taken.” *Butler, supra*, 118 Wn.2d at 390-91, quoting, A. Windt, *Insurance Claims and Disputes: Representation of Insurance Companies and Insureds*, ¶2.09, at 40-41 (2d ed. 1988) and *Transamerica Ins. Group v. Chubb & Son, Inc.*, 116 Wn. App. 247, 252, 554 P.2d 1080 (1976)(emphasis added). *Butler* further explained the purpose of the presumption as follows (118 Wn.2d at 392):

The shifting 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...[and] **provides a meaningful disincentive to insurer’s bad faith conduct...** [Emphasis added; citations omitted].

Unlike the Court of Appeals in this case, *Butler did not qualify its remedy based on the size or nature of the harm sustained by the insured. Id.*, 118 Wn.2d at 394 (“if the insured prevails on the bad faith claim, the insurer is estopped from denying coverage”). Consistent with the underlying reasons for the presumption, “harm” may take innumerable forms and is not limited to monetary loss. *Id.*, 118 Wn.2d at 396 (harm despite release from liability); *Truck Ins. Exch. v. Vanport Homes*, 147 Wn.2d 751, 765, 58 P.3d 1080 (2002) (bad faith “exposes” insured to increased risks); *R.A. Hansen Co. v. Aetna Cas. Co.*, 15 Wn. App. 608, 611 550 P.2d 701 (lists examples of non-

monetary prejudice). Thus, “the amount of the covenant judgment is the **presumptive measure of an insured’s harm caused by an insurer’s bad faith** if the covenant judgment is reasonable.” *Besel, supra*, 146 Wn.2d at 737, 38. In this case, Paulson suffered both monetary *and* non-monetary harm. CP 512-3, 527-8, 531 ¶5.

Although it superficially acknowledged *Besel*’s command that “the principles [in *Butler*] apply whenever an insurer acts in bad faith” [*Besel, supra*, 146 Wn.2d at 737], the Court of Appeals mistakenly concluded that these same principles should *not* apply in response to an insurer’s bad faith interference in the insured’s liability defense. The Court of Appeals thus ignored the rationale and holding of *Butler*, focusing instead on the *quantity* of Paulson’s economic harm. The Court’s analysis resulted in a “balancing test” to rebut *Butler*’s presumption of harm, “[w]here the damages greatly outweigh the relatively minor economic harm [because] the remedy becomes more punitive than equitable.” Appendix A, p. 14. In so doing, the Court of Appeals applied the analysis of harm used in first party claims, in direct defiance of the presumption of harm established in *Butler*. See, *Coventry v. Am. States Ins. Co.*, 136 Wn.2d 269, 281, 961 P.2d 933 (1998)(holding that a different result occurs in third-party cases “because insurers have a

heightened duty of good faith in such [third party liability] situations”).

Regrettably, this is not the first time Division I has applied such a balancing test to circumvent the *Butler* presumption of harm. In *James E. Torina Fine Homes v. Mutual of Enumclaw*, 228 Wn. App. 12, 18, 74 P.3d 648 (2003), Division I also applied a balancing test, summarily holding that “[t]he initial denial of coverage here, based on a mistake of fact which TFH could easily have corrected, **did not result in prejudice that rises to the level of estoppel.**” (Emphasis added).

The Division I balancing test, which compares the insurer’s potential liability against the insured’s proof of *actual* harm, completely negates *Butler*’s presumption of harm. Furthermore, such a fundamental change in established Washington law implicates a substantial public interest. The Court should thus grant review pursuant to RAP 13.4(b)(1) and (4).

C. **Washington Insurers Must Promptly Adjust and Pay Undisputed, Covered Claims Once the Insured’s Liability is Established. [RAP 13.4(b)(4)].**

Insurance affects the public interest. RCW 48.01.030. To effectuate that public interest, WAC 284-30-300, *et seq.*, establish *minimum* standards for insurer conduct. WAC 284-30-370, for example, requires insurers to promptly “complete investigation” of claims, and establishes a presumptive

30 day period for doing so. WAC 284-30-330(6) requires that insurers promptly pay “property damage claims to innocent third parties in clear liability situations.” If properly enforced, these two regulations require Washington insurers to promptly adjust claims and unconditionally tender undisputed amounts to policyholders and innocent victims *thus narrowing issues in dispute and obviating much litigation.*

The covenant judgment established Paulson’s clear liability and the Martinellis’ “innocence” no later than February 2, 2004. Paulson and the Martinellis had also provided MOE the information it had requested and MOE’s adjusters had substantially completed their work by October 2003, months earlier. CP 97-8, 100, 102-3. There was no reason MOE could not have adjusted the claim. Liability was also clear as to MOE. In its declaratory judgment complaint, MOE admitted that “[s]ome of the damage claimed against [Paulson], **is covered by the [MOE] policy.**” CP 2 ¶6. This was not an inadvertent error in MOE’s pleading; MOE’s coverage counsel confirmed this admission in his deposition. CP 86. MOE had also conceded coverage of major damage elements (*e.g.*, damage caused by subcontractors, stigma). So no dispute existed concerning major damage elements or coverage as to those elements.

The Court of Appeals inexplicably changed MOE's unambiguous admissions that "some of the damage...is covered" to "some of the Martinellis' claims are **likely** to be covered, [but] MOE still does not know whether **any** portion of the arbitration award was based on covered claims." Appendix A, p. 15 (emphasis added). Without this inexplicable change, the Court of Appeals' analysis falls apart.

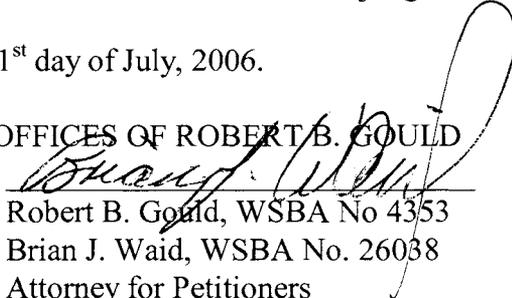
Coupled with Washington's prohibition against punitive damages and limitations on prejudgment interest, the Court of Appeals' construction of WAC 284-30-330(6) and 370 provides Washington insurers with a strong incentive to indefinitely delay adjusting and payment of undisputed claims, and denies policyholders any remedy for those delays. The Court should therefore grant review pursuant to RAP 13.4(b)(4).

V. **CONCLUSION**

Karen and Joseph Martinelli respectfully ask the Court to grant review, reverse the Court of Appeals, and reinstate the trial court judgment.

Respectfully submitted this 21st day of July, 2006.

LAW OFFICES OF ROBERT B. GOULD

By: 

Robert B. Gould, WSBA No 4353

Brian J. Waid, WSBA No. 26038

Attorney for Petitioners

Karen and Joseph Martinelli

APPENDIX A

IN THE COURT OF APPEALS FOR THE STATE OF WASHINGTON

MUTUAL OF ENUMCLAW INSURANCE)	
COMPANY,)	DIVISION ONE
)	
Appellant/Cross-Respondent,)	
)	No. 55342-9-1
vs.)	
)	
DAN PAULSON CONSTRUCTION, INC.,)	PUBLISHED OPINION
a Washington corporation, KAREN and)	
JOSEPH MARTINELLI, and the marital)	
Community composed thereof,)	
)	FILED: May 8, 2006
Respondents/Cross-Appellants.)	
_____)	

BAKER, J. — This case arises from an arbitration claim brought by Joseph and Karen Martinelli against Dan Paulson Construction, Inc. (Paulson) for alleged construction defects in the Martinellis' home. Paulson's commercial liability insurance company, Mutual of Enumclaw (MOE), agreed to defend Paulson under a reservation of rights regarding coverage issues. Before Paulson and the Martinellis commenced arbitration, MOE filed a declaratory judgment action and issued a subpoena duces tecum and interrogatories to the arbitrator seeking information that would help MOE determine which parts of any arbitration award would be insured and which would not. Paulson and the

Martinellis subsequently entered into a stipulated arbitration award for \$1.3 million, whereby Paulson assigned its coverage and bad faith claims against MOE to the Martinellis in return for a covenant not to execute. MOE then dismissed the first declaratory judgment complaint and filed this declaratory judgment action to determine insurance coverage issues. On cross motions for partial summary judgment, the trial court found that MOE's subpoena duces tecum, interrogatories, and ex parte cover letter to the arbitrator constituted bad faith, but because Paulson had not suffered harm, MOE was not estopped from denying coverage for uninsured claims. Upon reconsideration, the court ruled that attorney fees incurred by Paulson in opposing the subpoena to the arbitrator constituted sufficient harm to estop MOE from denying coverage. The court then ruled that the arbitration award was reasonable, and entered judgment against MOE for the full award with interest at 12 percent, plus attorney fees and expenses. The trial court also ruled that MOE's refusal to pay any portion of the arbitration award pending resolution of coverage issues did not violate the Consumer Protection Act¹. MOE appeals, and the Martinellis cross-appeal.

I.

Paulson contracted to build a home on San Juan Island for the Martinellis in 1998. The final construction price was approximately \$1,725,000. Paulson and the Martinellis arbitrated their dispute concerning the construction price. The Martinellis then sued their architects for alleged construction defects, and settled in 2003 for an undisclosed amount.

¹ Ch. 19.86 RCW.

In August 2002, the Martinellis filed a second arbitration claim against Paulson, also asserting construction defects. MOE assigned defense counsel to represent Paulson under a reservation of rights regarding insurance coverage issues. Thus, there were two separate groups of MOE personnel working on the case: Paulson's assigned defense counsel team, and MOE's insurance coverage analysis team. Paulson also retained private defense counsel.

MOE maintained that some of the claims against Paulson might be barred by certain policy exclusions, and that MOE needed to know what damage was allegedly caused by each entity that performed work on the Martinelli home in order to determine the extent and scope of coverage. Soon after the Martinellis filed their arbitration claim, MOE asked Paulson and the Martinellis to provide information concerning the alleged defects, which they made available to MOE. A year later, in August and September 2003, MOE asked Paulson to provide additional information relevant to the arbitration claims. Paulson's attorney offered some documents "as a courtesy," asserting that MOE did not have a right to them, and that document production should not be construed as a concession that any alleged defect was valid or that the Martinellis' claim established an appropriate segregation of any arbitration award.

In October 2003, counsel for Paulson urged MOE to accept the Martinellis' offer to settle the case for \$1 million. The letter noted that Paulson "is personally very troubled that a large arbitration award will ruin his small construction company and cause it to shut its doors," and that accepting the offer would save

“enormous costs and expenses.” MOE countered with an offer to settle for \$550,000, but the Martinellis declined.

MOE requested permission from Paulson and the Martinellis to be allowed to intervene in the upcoming arbitration so that MOE could promptly determine coverage issues, but Paulson and the Martinellis objected. MOE asked to be able to attend the arbitration proceeding as a nonparty observer, but the parties refused. MOE made no further attempts to intervene or appear at the arbitration. Instead, MOE filed a declaratory judgment action against the Martinellis and Paulson seeking information on the claims, but the complaint was not served.

On December 30, 2003, MOE served arbitrator J. Richard Manning 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. Accompanying the subpoena was a cover letter in which MOE briefly sought to explain why the information requested in the subpoena was necessary to resolve coverage issues. MOE did not send copies to counsel for Paulson or the Martinellis until four days before the arbitration was scheduled to begin. The arbitrator, Paulson, and the Martinellis opposed the subpoena and demanded that it be withdrawn. Over the Martinellis' objections, MOE sent a second letter to the arbitrator abandoning some of the interrogatories, but reiterating its position that the subpoena was appropriate and legal under the circumstances. Paulson incurred unspecified costs for attorney fees and expenses for private counsel to oppose MOE's subpoena to the arbitrator.

The arbitration hearing commenced on January 6, 2004. Paulson was represented by defense counsel assigned by MOE. On January 8, 2004, MOE learned that Paulson and the Martinellis had entered into a stipulation for a lump sum arbitration award at Paulson's request. On January 12, 2004, Paulson and the Martinellis entered into a stipulated arbitration award of \$1,300,000. The arbitrator approved the award, and at the request of the parties, found that it was reasonable. Paulson assigned its contract indemnification and bad faith claims against MOE, and the Martinellis entered a covenant not to execute against Paulson. The superior court confirmed the award on February 2, 2004 and found that the award was reasonable, but did not explain the basis for that finding. On February 4, 2004, the Martinellis, as assignees of Paulson, made demand upon MOE to pay any undisputed, insured portions of the damages. MOE acknowledged that some of the claims were covered under the policy, but declined to remit any payments to the Martinellis until it ascertained which portions of the arbitration award were insured and which were not.

In late January 2004, MOE struck its subpoena, dismissed the original declaratory judgment action, and filed a new complaint for declaratory judgment requesting the court to determine which portions of the arbitration award were insured under the MOE/Paulson contract and which were not insured. The parties filed cross motions for partial summary judgment. The trial court initially ruled that MOE's subpoena and cover letter to the arbitrator constituted bad faith, but that MOE was not estopped from denying coverage because MOE had rebutted the presumption of harm. The court further ruled that MOE's failure to

settle the case within the policy limits or to pay any portion of the award pending litigation of coverage issues was not bad faith, and that the stipulated award was reasonable. The court deferred ruling on the issue of which party bears the burden of proof regarding the subcontractor exception to an exclusion in the contract. The Martinellis then moved for partial reconsideration on the coverage by estoppel issue, arguing that attorney fees incurred by Paulson in opposing MOE's subpoena constituted sufficient harm to create coverage by estoppel. The court agreed, and entered an order estopping MOE from denying coverage for the entire stipulated award. The court later entered a judgment nunc pro tunc in favor of the Martinellis for \$1.3 million plus attorney fees and expenses, with interest. Because issues remain to be litigated, the parties sought and obtained a CR 54(b) order certifying the judgment as final and staying further proceedings pending decision by this court. MOE now appeals and the Martinellis cross-appeal.

II.

This court reviews an order on a motion for summary judgment de novo.² Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."³

² Smith v. Safeco Ins. Co., 150 Wn.2d 478, 483, 78 P.3d 1274 (2003).

³ CR 56(c).

MOE contends that sending a subpoena and cover letter to the arbitrator did not constitute bad faith because these actions were not unreasonable, frivolous or unfounded. MOE argues that its insured's actions created an untenable dilemma for MOE of either paying the entire amount of a stipulated, lump sum award or being accused of bad faith if its refusal to immediately do so led to the insured's business failure. The Martinellis argue that the subpoena and cover letters were improper, unnecessary, and prejudicial.

Both insurer and insured are obligated to exercise good faith.⁴ An insurer has an enhanced obligation to its insured when defending under a reservation of rights.⁵ In Tank v. State Farm Fire & Casualty Company,⁶ our Supreme Court established four criteria for determining whether an insurer has fulfilled this obligation:

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. . . . 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. . . . 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.^[7]

⁴ RCW 48.01.030.

⁵ Tank v. State Farm Fire & Cas. Co., 105 Wn.2d 381, 387, 715 P.2d 1133 (1986).

⁶ 105 Wn.2d 381, 715 P.2d 1133 (1986).

⁷ Tank, 105 Wn.2d at 388.

Because the insurer need not put the insured's interests above its own, but rather on an equal footing, "something less than a true fiduciary relationship exists between the insurer and the insured."⁸

The Martinellis' argument hinges primarily on the fourth Tank criterion: by issuing a subpoena and ex parte cover letter to the arbitrator in an attempt to obtain information that would allow it to determine which portions of any arbitration award were insured and which were not, MOE potentially prejudiced the arbitration and demonstrated a greater concern for its own interest than for Paulson's.

We hold that MOE's actions in this case did not amount to bad faith. When the insured and insurer cannot agree as to coverage issues, the dispute is commonly resolved through a declaratory judgment action. However, Paulson informed MOE that he could be put out of business if the Martinellis prevailed at arbitration and attempted to execute on the judgment. And, if MOE had litigated the coverage issues prior to the Paulson/Martinelli arbitration, Paulson's defense in the arbitration would have been harmed, and Paulson could establish a bad faith claim against MOE. But if MOE waited until after the arbitration concluded to file a declaratory judgment action, it would not be able to challenge the reasonableness of the stipulated arbitration award except by showing that it was the product of fraud or collusion.⁹ MOE was thus forced to decide immediately how it would proceed prior to the arbitration.

⁸ Safeco Ins. Co. v. Butler, 118 Wn.2d 383, 389, 823 P.2d 499 (1992).

⁹ Besel v. Viking Ins. Co., 146 Wn.2d 730, 739, 49 P3d 887 (2002).

MOE strongly suspected that Paulson would seek an undifferentiated lump sum award and then assign its claims to the Martinellis in exchange for a covenant not to execute, thereby absolving himself of personal liability and depriving MOE of the information it needed to determine which portions of the damage award, if any, were for covered claims.¹⁰ MOE therefore sought permission from the parties to attend the arbitration hearing, but this option was foreclosed when its request was rebuffed. The Martinellis argue that MOE should have moved to intervene in the arbitration proceedings. But it is extremely unlikely that the arbitrator would have allowed this over the objection of the parties.¹¹ Moreover, this argument is disingenuous given that the Martinellis fault MOE for injecting insurance issues into the arbitration via the subpoena.

MOE realized that if it did nothing, the arbitration would likely end in a lump sum settlement award which MOE might well be forced to pay in its entirety, regardless of whether only part of the award was based on covered claims. The Martinellis argue that there was no evidence that MOE's hand was forced by the lump sum settlement award, because MOE did not yet know about that

¹⁰ MOE did obtain information from Paulson and the Martinellis that allowed it to make a preliminary determination that some of the Martinellis' claims were covered under Paulson's policy, but this did not tell MOE which portions of the arbitration award, if any, were based on covered claims.

¹¹ AAA Rule R-24 provides that "[t]he arbitrator and the AAA shall maintain the privacy of the hearings unless the law provides to the contrary. Any person having a direct interest in the arbitration is entitled to attend hearings. The arbitrator shall otherwise have the power to require the exclusion of any witness, other than a party or other essential person, during the testimony of any other witness. It shall be discretionary with the arbitrator to determine the propriety of the attendance of any person other than a party and its representative." Construction Industry Arbitration Rules, AAA Rule R-24 (Attendance at Hearings) (2005).

stipulation when it issued its subpoena to the arbitrator. But MOE was justified in anticipating that this would occur, and Paulson's private counsel later admitted that he sought a lump sum settlement to minimize Paulson's liability exposure.

Paulson's strategy was not legally improper, but it did force MOE to face two unreasonable options: risking a bad faith claim by litigating coverage issues prior to the arbitration, or paying the entire settlement amount regardless of whether it was based on covered claims. As a last resort, MOE chose a third option: the subpoena and cover letters to the arbitrator. This tactic, while somewhat clumsy, did not amount to bad faith. The ex parte cover letters were improper, and we do not accept MOE's argument that issuing a subpoena to an arbitrator is analogous to proposing special interrogatories to a jury, which has been allowed in certain cases where the interest of the insured will not be compromised.¹² Nevertheless, MOE had a reasonable need to know the elements of a potential damage award. An insurer's enhanced duty to its insured when defending under a reservation of rights does not encompass a duty to stand by and do nothing while its insured strategically eliminates his personal liability by negotiating a lump sum settlement and assigning his claims, while simultaneously preventing the insurer from determining which portions of the settlement award are covered and which are not.

We further hold that the trial court erred in finding that the Martinellis were harmed by MOE's actions. "[H]arm is an essential element of an action for an

¹² Fidelity Bankers Life Ins. Co. v. Wedco, Inc., 102 F.R.D. 41, 44 (D. Nev. 1984); Thomas v. Henderson, 297 F. Supp. 2d 1311, 1324 (S.D. Ala. 2003).

insurer's bad faith handling of a claim under a reservation of rights."¹³ Once there has been a finding of bad faith, a rebuttable presumption of harm arises. The insurer can rebut the presumption of harm by showing by a preponderance of the evidence that its acts did not harm or prejudice the insured. If the insured prevails on the bad faith claim, the insurer is estopped from denying coverage.

The trial court initially found that MOE rebutted the presumption of harm, noting that the arbitrator and the parties all agreed to continue with the arbitration despite the subpoena and cover letters; that the difference between a lump sum settlement award and a differentiated award did not lead to a different financial outcome for Paulson; that the \$1.3 million award came well within the policy limits; and that any affect on Paulson's credit rating or reputation would have occurred whether Paulson entered into a stipulated agreement or not. However, upon reconsideration, the trial court found that the attorney fees incurred by Paulson in challenging the subpoena constituted concrete evidence of harm, thereby creating coverage by estoppel. Therefore, the issue is whether relatively minor attorney fees incurred in the declaratory judgment action to object to the issuance of a subpoena are sufficient to demonstrate harm and create coverage by estoppel, where MOE would be forced to pay a large stipulated settlement award regardless of coverage issues.

MOE acknowledges that Washington courts have imposed coverage by estoppel as a remedy where the insurer acts in bad faith while handling a claim

¹³ Butler, 118 Wn.2d at 394.

under a reservation of rights.¹⁴ However, MOE argues that these cases are limited to situations where the insurer's bad faith conduct harmed or prejudiced the insured regarding defense of the underlying tort lawsuit. Because the subpoena and cover letters did not increase Paulson's economic exposure to the Martinellis, but merely caused Paulson to expend limited attorney fees in opposing the subpoena, MOE contends it is not the type of action that should give rise to coverage by estoppel.

The Martinellis, relying substantially on broad language in Safeco Insurance Company v. Butler¹⁵ and Besel v. Viking Insurance Company,¹⁶ argue that MOE failed to rebut the presumption of harm caused when Paulson was forced to incur attorney fees and expenses, because Washington courts do not qualify the coverage by estoppel remedy based on the size or nature of the harm.¹⁷

In Butler, Safeco assumed the insured's defense under a reservation of rights, asserting that coverage did not exist where the injuries did not result from an accident, but were caused by the insured's intentional conduct.¹⁸ The Butlers

¹⁴ Truck Ins. Exch. v. VanPort Homes, Inc., 147 Wn.2d 751, 761, 58 P.3d 276 (2002); Besel, 146 Wn.2d at 737; Butler, 118 Wn.2d at 392.

¹⁵ 118 Wn.2d 383, 823 P.2d 499 (1992).

¹⁶ 146 Wn.2d 730, 49 P.3d 887 (2002).

¹⁷ As a preliminary matter, we reject the Martinellis' assertion that this, and several other, issues are precluded from appellate review because MOE did not assign error to specific findings and conclusions set forth in summary judgment orders. Findings of fact and conclusions of law are superfluous in summary judgment proceedings, and a litigant need not assign error to superfluous findings. Concerned Coupeville Citizens v. Town of Coupeville, 62 Wn. App. 408, 413, 814 P.2d 243 (1991).

¹⁸ Butler, 118 Wn.2d at 387.

asserted numerous acts as evidence that Safeco handled the defense of the tort claim in bad faith.¹⁹ Our Supreme Court held that if the insured establishes that the insurer acted in bad faith, then harm is presumed, and the insurer has the burden of rebutting the presumption of harm by showing that its acts did not harm or prejudice the insured.²⁰ Moreover, “where an insurer acts in bad faith in handling a claim under a reservation of rights, the insurer is estopped from denying coverage.”²¹ In Besel, the insurer argued that the Butler presumption of harm should not apply where the defense was not tendered under a reservation of rights. Our Supreme Court rejected that argument, holding that “[t]he principles in Butler do not depend on how an insurer acted in bad faith. Rather, the principles apply whenever an insurer acts in bad faith, whether by poorly defending a claim under a reservation of rights, refusing to defend a claim, or failing to properly investigate a claim.”²²

These cases do not directly address the situation here. In Butler, the insured made a clear showing of bad faith and prejudice in investigation and defense of the underlying tort lawsuit, including failure to notify; delayed investigation that favored the insurer at the insured’s expense; and commingling the tort defense and coverage action files.²³ And in Besel, the insurer unpersuasively argued that the insured suffered no bad faith because he was

¹⁹ Butler, 118 Wn.2d at 395.

²⁰ Butler, 118 Wn.2d at 394.

²¹ Butler, 118 Wn.2d at 392.

²² Besel, 146 Wn.2d at 737 (citations omitted).

²³ Butler, 118 Wn.2d at 395.

protected by a covenant not to execute.²⁴ But here, the alleged harm rests solely on minor attorney fees incurred in the declaratory judgment action to challenge a subpoena. The same or greater fees would have been incurred if MOE had formally moved to intervene in the arbitration proceeding, which the Martinellis assert MOE should have done.

Furthermore, unlike Butler, the alleged harm stemmed from MOE's attempt to determine coverage issues rather than from bad faith in defending the underlying tort lawsuit. As Justice Dolliver pointed out in his dissent in Butler, the majority opinion does not explain the nature of the presumed harm.²⁵ If harm includes easily provable economic loss such as attorney fees, there is no need to presume those losses; and if it broadly encompasses the entire penumbra of losses, then it is unreasonable to presume that harm because the insurer can never rebut it.²⁶ We agree with MOE that Butler and Besel do not address the circumstances present in this case. 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.²⁷ Where the damages greatly outweigh the relatively minor economic harm, the remedy becomes more punitive than equitable.

²⁴ Besel, 146 Wn.2d 736-37.

²⁵ Butler, 118 Wn.2d at 406 (Dolliver, J., dissenting).

²⁶ Butler, 118 Wn.2d at 406-07 (Dolliver, J., dissenting).

²⁷ Besel, 146 Wn.2d at 737-38.

The trial court's original letter opinion was correct on this issue. The subpoena and ex parte cover letter did not harm Paulson or the Martinellis. They found out about MOE's actions prior to the commencement of the arbitration. The parties were unhappy about this development, but they specifically agreed to allow the arbitration to go forward as planned. They were not prejudiced by MOE's actions. The trial court's decision to reverse itself and find that the attorney fees constituted harm is an unwarranted extension of the doctrine of coverage by estoppel.

In their cross-appeal, the Martinellis contend that MOE's refusal to pay undisputed, covered portions of the stipulated arbitration award violated WAC 284-30-330(6), which requires that insurers "effectuate prompt payment of property damage claims to innocent third parties in clear liability situations." They assert that this constitutes an independent basis to affirm the trial court's finding of bad faith and coverage by estoppel. We disagree. Although MOE admitted that some of the Martinellis' claims are likely to be covered, MOE still does not know whether any portion of the arbitration award was based on covered claims. MOE does not have this information because Paulson and the Martinellis agreed to a lump sum settlement award and refused to allow MOE to attend the arbitration. "Clear liability" has not been established. The Martinellis cannot tactically prevent MOE from learning what portions of the stipulated award may be insured and then assert bad-faith when MOE refuses to pay until the coverage issues are resolved.

We hold that MOE's actions did not amount to bad faith and that MOE rebutted the presumption of harm. Accordingly, we reverse the trial court's order of summary judgment imposing coverage by estoppel and vacate the judgment against MOE. We also reverse the trial court's award of attorney fees and expenses to the Martinellis.²⁸ Consequently, we do not need to decide whether the stipulated arbitration award and subsequent judgment were reasonable.²⁹ Nor do we reach the question of whether the trial court applied the proper postjudgment interest rate to the judgment. We also decline MOE's request that we determine which party carries the burden of proving liability coverage under the subcontractor exception to a coverage exclusion pending discovery on contract claim issues. This issue is peripheral to the issues presently before the court, and any opinion on this issue would be purely advisory at this time.

REVERSED.



WE CONCUR:





²⁸ Contrary to the Martinellis' assertions, MOE adequately briefed the question of whether the trial court's award of attorney fees to the Martinellis should be reversed. However, MOE did not request attorney fees and expenses on appeal.

²⁹ We agree, however, that MOE never had a meaningful opportunity to contest the arbitrator's reasonableness finding.

APPENDIX B

APPENDIX C

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[TITLES](#) >> [WAC 284 TITLE](#) >> [WAC 284 - 30 CHAPTER](#)

[284-30-300](#) << [284-30-310](#) >> [284-30-320](#)

WAC 284-30-310 Scope. This regulation applies to all insurers and to all insurance policies and insurance contracts. This regulation is not exclusive, and acts performed, whether or not specified herein, may also be deemed to be violations of specific provisions of the insurance code or other regulations.

[Statutory Authority: RCW [48.02.060](#) and [48.30.010](#). 78-08-082 (Order R 78-3), § 284-30-310, filed 7/27/78, effective 9/1/78.]



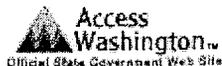
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[TITLES](#) >> [WAC 284 TITLE](#) >> [WAC 284 - 30 CHAPTER](#)

[284-30-320](#) << [284-30-330](#) >> [284-30-340](#)

WAC 284-30-330 Specific unfair claims settlement practices defined. The following are hereby defined as unfair methods of competition and unfair or deceptive acts or practices in the business of insurance, specifically applicable to the settlement of claims:

- (1) Misrepresenting pertinent facts or insurance policy provisions.
- (2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
- (3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies.
- (4) Refusing to pay claims without conducting a reasonable investigation.
- (5) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed.
- (6) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear. In particular, this includes an obligation to effectuate prompt payment of property damage claims to innocent third parties in clear liability situations. If two or more insurers are involved, they should arrange to make such payment, leaving to themselves the burden of apportioning it.
- (7) Compelling insureds to institute or submit to litigation, arbitration, or appraisal to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in such actions or proceedings.
- (8) Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.
- (9) Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which the payments are being made.
- (10) Asserting to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.
- (11) Delaying the investigation or payment of claims by requiring an insured, claimant, or the physician of either to submit a preliminary claim report and then requiring subsequent submissions which contain substantially the same information.
- (12) Failing to promptly settle claims, where liability has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.
- (13) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.
- (14) Unfairly discriminating against claimants because they are represented by a public adjuster.

(15) Failure to expeditiously honor drafts given in settlement of claims. A failure to honor draft within three working days of notice of receipt by the payor bank will constitute a violation of this provision. Dishonor of any such draft for valid reasons related to the settlement of the claim will not constitute a violation of this provision.

(16) Failure to adopt and implement reasonable standards for the processing and payment of claims once the obligation to pay has been established. Except as to those instances where the time for payment is governed by statute or rule or is set forth in an applicable contract, procedures which are not designed to deliver a check or draft to the payee in payment of a settled claim within fifteen business days after receipt by the insurer or its attorney of properly executed releases or other settlement documents are not acceptable. Where the insurer is obligated to furnish an appropriate release or settlement document to an insured or claimant, it shall do so within twenty working days after a settlement has been reached.

(17) Delaying appraisals or adding to their cost under insurance policy appraisal provisions through the use of appraisers from outside of the loss area. The use of appraisers from outside the loss area is appropriate only where the unique nature of the loss or a lack of competent local appraisers make the use of out-of-area appraisers necessary.

(18) Failing to make a good faith effort to settle a claim before exercising a contract right to an appraisal.

(19) Negotiating or settling a claim directly with any claimant known to be represented by an attorney without the attorney's knowledge and consent. This does not prohibit routine inquiries to an insured claimant to identify the claimant or to obtain details concerning the claim.

[Statutory Authority: RCW 48.02.060, 48.44.050 and 48.46.200. 87-09-071 (Order R 87-5), § 284-30-330, filed 4/21/87. Statutory Authority: RCW 48.02.060 and 48.30.010. 78-08-082 (Order R 78-3), § 284-30-330, filed 7/27/78, effective 9/1/78.]

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WA ADC 284-30-370

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WAC 284-30-370
Wash. Admin. Code 284-30-370

**WASHINGTON ADMINISTRATIVE CODE
TITLE 284. INSURANCE COMMISSIONER, OFFICE OF
CHAPTER 284-30. TRADE PRACTICES
UNFAIR CLAIMS SETTLEMENT PRACTICES**

Current with amendments adopted through June 1, 2005

284-30-370. Standards for prompt investigation of claims.

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

Statutory Authority: RCW 48.02.060 and 48.30.010. 78-08-082 (Order R 78- 3), S 284-30-370, filed 7/27/78, effective 9/1/78.

<General Materials (GM) - References, Annotations, or Tables>

WA ADC 284-30-370
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APPENDIX D

COPY

SUPERIOR COURT OF THE STATE OF WASHINGTON

FOR THE JUDICIAL DISTRICT OF ISLAND AND SAN JUAN COUNTIES

August 19, 2004

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ALAN R. HANCOCK
Judge

VICKIE I. CHURCHILL
Judge

DONALD E. EATON
Court Commissioner

KAREN A. LERNER
Court Commissioner

SHERRY L. CAMERON
Court Administrator

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

Dear Counsel:

This matter came before the court on the following motions:

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

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

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

Court's Letter Opinion – August 19, 2004
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CP 644

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

The parties agree that the facts are undisputed.

FACTS

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

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

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

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

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

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

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

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

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

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

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

Other facts necessary to this opinion are included below.

LAW

Summary Judgment

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

CP 646

Duty to Act in Good Faith

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

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

DISCUSSION

I. Motions for Partial Summary Judgment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. Did MOE Rebut the Presumption of Harm?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The insurance policy language at issue is as follows:

This insurance does not apply to:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CONCLUSION

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

Sincerely,



VICKIE I. CHURCHILL
Judge

APPENDIX E

COPY

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SEP - 7 2004
MARY JEAN CAHAIL
SAN JUAN COUNTY, WASHINGTON

The Honorable Vickie I. Churchill

IN THE SUPERIOR COURT OF THE STATE OF WASHINGTON
IN AND FOR THE COUNTY OF SAN JUAN

MUTUAL OF ENUMCLAW INSURANCE
COMPANY,

Plaintiff,

v.

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

Defendants.

NO. 04-2-05012-1

**ORDER GRANTING MR. AND
MRS. MARTINELLIS' PARTIAL
MOTION FOR RECONSIDER-
ATION RE: AUGUST 19, 2004
LETTER OPINION**

*[SENT ON 8/27/04 VIA FAX FOR
FILING IN THE SAN JUAN
COUNTY SUPERIOR COURT]*

THIS MATTER came on for telephonic hearing, with oral argument, before the undersigned Judge of the above-entitled Court on Mr. and Mrs. Martinellis' Partial Motion for Reconsideration Re: August 19, 2004 Letter Opinion.

The Court having reviewed the file and pleadings herein; having heard the argument of counsel; and being fully advised in the premises; it is hereby

ORDERED that Mr. and Mrs. Martinellis' Partial Motion for Reconsideration Re: August 19, 2004 Letter Opinion is hereby GRANTED; and it is further

ORDERED that that Mutual of Enumclaw breached its duty of good faith to its insured, Dan Paulson Construction, Inc., when it interfered in its insured's arbitration proceeding through: (a)

ORDER GRANTING MR. AND MRS. MARTINELLIS' PARTIAL
MOTION FOR RECONSIDERATION RE: AUGUST 19, 2004 LETTER
OPINION - 1

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CP 689

1 *ex parte* communications with the Arbitrator, and (b) issuance of a subpoena to the Arbitrator; and it
2 is further

3 **ORDERED** that Mutual of Enumclaw has failed to a rebut the presumption of harm
4 imposed under *Safeco v. Butler*, 118 Wn.2d 383 (1992) as a result of its bad faith; and it is further

5 **ORDERED** that Mutual of Enumclaw has not supported its affirmative defense that the
6 Stipulated Arbitration Award entered into between Dan Paulson Construction, Inc. and the
7 Martinellis resulted from fraud or collusion with competent evidence, and said defense is, therefore,
8 denied as a matter of law; and it is further

9 **ORDERED** that no genuine issue of fact exists as to the reasonableness of the Stipulated
10 Arbitration Award entered into between Dan Paulson Construction, Inc. and the Martinellis; and it
11 is further

12 **ORDERED** that the Stipulated Arbitration Award entered into between Dan Paulson
13 Construction, Inc. is reasonable as a matter of law; and it is further

14 **ORDERED** that Counterclaimants Joseph and Karen Martinelli, and against Mutual of
15 Enumclaw Insurance Company, for the full amount of the Stipulated Arbitration Award, in the
16 amount of \$1,300,000.00, together with interest from January 20, 2004 at the rate of twelve (12%)
17 percent per annum until paid, all costs of these proceedings, and reasonable attorney's fees to be
18 fixed by this court upon proper application by counsel for Mr. and Mrs. Martinelli.

19 DONE IN OPEN COURT this 7 day of September, 2004.

20 **VICKIE I. CHURCHILL**
21 Judge Vickie I. Churchill

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26 ORDER GRANTING MR. AND MRS. MARTINELLIS' PARTIAL
MOTION FOR RECONSIDERATION RE: AUGUST 19, 2004 LETTER
OPINION - 2

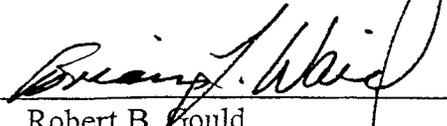
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CP 690

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Presented by:

LAW OFFICES OF ROBERT B. GOULD

By: 

Robert B. Gould
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Brian J. Waid
WSBA No. 26038
Attorneys for Defendants
Joseph and Karen Martinelli

ORDER GRANTING MR. AND MRS. MARTINELLIS' PARTIAL
MOTION FOR RECONSIDERATION RE: AUGUST 19, 2004 LETTER
OPINION - 3

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