

NO. 79027-2

THE SUPREME COURT
OF THE STATE OF WASHINGTON

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MUTUAL OF ENUMCLAW INSURANCE COMPANY,

Respondent and Cross-Petitioner,

v.

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

Petitioners.

SUPPLEMENTAL BRIEF
OF
MUTUAL OF ENUMCLAW INSURANCE COMPANY *(Respondent)*

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A. THE COURT OF APPEALS CORRECTLY HELD THAT MOE WAS NOT ESTOPPED FROM DENYING INSURANCE COVERAGE FOR ANY ELEMENTS OF THE STIPULATED ARBITRATION AWARD THAT WERE NOT INSURED.

1. The Law Of Coverage By Estoppel.

The Martinellis requested, and the trial court granted, an extension of the law regarding insurance coverage. The Court of Appeals corrected that error and held that MOE was not estopped to deny coverage for uninsured aspects of the stipulated Arbitration Award.

It is the general rule that the concept of estoppel may not be used to provide coverage under an insurance policy regarding claims that are not otherwise insured. *Carew Shaw & Bernasconi, Inc. v. General Casualty Co. of America*, 189 Wash. 329, 336, 65 P.2d 689 (1937) (“... under no conditions can the coverage or restrictions on coverage be extended by the doctrine of waiver or estoppel”); *Estate of Hall v. HAPO Federal Credit Union*, 73 Wn. App. 359, 362-363, 869 P.2d 116 (1994). See, *Saunders v. Lloyd’s of London*, 113 Wn.2d 330, 336, 779 P.2d 249 (1989). The rationale for the rule is that an insurance company should not pay for losses for which it did not contract to provide coverage and did not collect a premium. *Saunders, supra*, 113 Wn.2d at 336.

In *Safeco Insurance Co. of America v. Butler*, 118 Wn.2d 383, 823 P.2d 499 (1992), the court created a limited exception to the general rule that insurance coverage cannot be created by estoppel. The court held that under specific circumstances, acts or omissions by an insurance company relating to its duty to defend a claim against its insured may preclude the insurer from denying coverage. The elements which must be examined regarding coverage by estoppel are as follows:

- Whether the insurance company engaged in conduct relating to the third party claim that constituted an act of bad faith.
- If the insurance company engaged in such bad faith conduct, it is presumed that the insured was harmed.
- The insurance company can rebut the presumption of harm by showing by a preponderance of evidence that its act or omission did not harm or prejudice the insured.
- If the insurance company overcomes the presumption of harm, and establishes that the insured was not harmed or prejudiced, then the insurance company is not estopped from denying coverage for uninsured claims.

In the present case, the Court of Appeals held that the conduct of MOE did not constitute an act of bad faith and that the attorney fees incurred by Paulson when he objected to the discovery request was not the

type of harm justifying invoking coverage for uninsured claims. Those two holdings were correct.

2. Mutual Of Enumclaw's Duty To Provide A Good Faith Defense In The Underlying Damage Action Did Not Include The Duty To Allow Paulson And The Martinelli's To Try To Manufacture A Bad Faith Claim And Coverage For Uninsured Claims.

In its opinion, the Court of Appeals noted the strategy engaged in by Paulson and the Martinellis leading up to the arbitration was clearly intended to hide from MOE the insurance coverage determinative facts regarding any Arbitration Award to be entered. In holding that MOE's attempt to determine what portions of any award were insured and uninsured did not constitute an act of bad faith, the Court of Appeals stated as follows:

Paulson's strategy was not illegally 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. 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.

Mutual of Enumclaw Ins. Co. v. Dan Paulson Construction Co.,

132 Wn. App. 803, 813, 134 P.3d 240 (2006) (Footnote omitted).

The Court was correct. MOE's conduct was not an act of bad faith.

The written request from MOE to the arbitrator was not an act of bad faith. To the contrary, MOE's conduct consisted of a good faith attempt to fulfill its duty to pay any insured award which might be entered against Paulson. To suggest otherwise is to sanction procedures whereby insureds and claimants are given free range to try to manufacture both bad faith claims and insurance coverage that do not otherwise exist.

Factually, the relevant matters are undisputed. First, some of the claims asserted against Paulson, if proven, were insured and some were uninsured. Second, Paulson made it clear to MOE that if an Arbitration Award and Judgment were entered against him, and collection efforts begun by the Martinellis, he would be out of business.¹ Third, the claims did not settle prior to arbitration. It

¹ Any uninsured judgment on an arbitration award would immediately impact the contractors' liability bond and thus the ability to obtain additional work.

has not been suggested that such failure was due to any act of bad faith by MOE.

Fourth, until an Arbitration Award was entered, no one could know which of the multiple claims asserted by the Martinellis were in fact valid. Fifth, until the individual damage elements of any Arbitration Award were segregated between insured and uninsured, MOE could not possibly know what it owed or what Paulson owed. Sixth, MOE requested of Paulson that it be given permission to either intervene or at least attend the AAA Arbitration so that it might make some judgment regarding insured and uninsured elements of any arbitration award. Paulson flatly refused those requests.

Seventh, contrary to the AAA Arbitrator's standard procedure, Paulson convinced both the Martinellis and the arbitrator that any arbitration award entered would be a lump sum award as opposed to being segregated into individual damage components. It was the design and intent of Paulson's personal insurance coverage counsel to try and put MOE in a position where it might feel compelled to pay all of the Arbitration Award, insured and uninsured, so as to avoid a claim of bad faith.

In describing Paulson's conduct and strategy directed toward thwarting MOE's insurance coverage analysis, we submit to the Court of Appeals was generous to Paulson. The Court of Appeals stated:

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 [Arbitration Award] regardless of whether it was based on covered claims.

Mutual of Enumclaw Insurance Co. v. Dan Paulson Const. Co., 132 Wn. App. At 813. We submit this Court should go further. The Court should announce a rule which disapproves the very type of gamesmanship in which Paulson and his coverage counsel engaged. When the insured chooses to keep his insurer from access to the information from which it can determine the insured and uninsured portions of a judgment or arbitration award, the insured should be precluded from asserting a claim for coverage by estoppel.

Let us recall that, as Paulson's assignees, the Martinellis are requesting this court to grant insurance coverage for the entirety of the arbitration award, including the uninsured aspects. The Martinellis' base this request upon the concept of insurance coverage by estoppel. However, one may not assert an estoppel

claim unless they have acted in good faith and with “clean hands.” Paulson’s step by step successful effort to keep MOE from knowing the insured and uninsured aspects of the AAA Arbitration award was not acting in good faith and with “clean hands.” Therefore, coverage by estoppel is precluded. *Mutual of Enumclaw Insurance Co., v. Cox*, 110 Wn.2d 643, 757 P.2d 499 (1988). See, *Tycord Title Insurance Co. v. Nissell*, 73 Wn.App. 818, 871 P.2d 652 (1994); *James E. Torina Fine Homes, Inc. v. Mutual of Enumclaw Ins. Co.*, 118 Wn.App. 12, 74 P.3d 648 (2003).

In *Mutual of Enumclaw Insurance Co. v. Cox, supra*, a homeowner’s insurance policy was at issue. The insured sustained a fire loss. Believing that the insured overstated the amount of personal property lost in the fire, MOE commenced a declaratory judgment action. In that coverage lawsuit, MOE contended that the entirety of Mr. Cox’s claim was precluded, based upon fraud. In response, Mr. Cox contended that MOE was estopped to deny coverage. The jury concluded that Mr. Cox did engage in fraud, but also held that MOE was estopped from denying coverage. In holding that Mr. Cox could not rely upon estoppel obtain coverage, this court stated:

Moreover, a party claiming estoppel must have proceeded in good faith and with “clean hands”. 31 C.J.S. *Estoppel* 75 (1964) discusses the clean hands doctrine:

The doctrine of estoppel is for the protection of innocent persons, and only the innocent may invoke it.

A persons may not base a claim of estoppel on conduct, omissions, or representations induced by his own conduct, concealment, or representations, especially when fraudulent.

(Footnotes omitted.) 31 C.J.S., at 453-54. In this case, Cox’s fraud led to MOE voiding his insurance policy. Cox did not have clean hands.

Washington follows the rule that the doctrine of equitable estoppel is available to innocent parties only. *Christman v. General Constr. Co.*, 2 Wash.App. 364, 467 p.2d 867, petition for review denied, 78 Wash.2d 994 (1970). We see no reason to deviate from *Christman*.

Mutual of Enumclaw Insurance Co. v. Cox, supra, 110 Wn.2d at 650 – 651.

The rule of *Mutual of Enumclaw Insurance Co. v. Cox* is applicable here. Both MOE and Paulson owed each other a duty to act in good faith. RCWA 48.01.030.²

Attempts by an insured to thwart his insurance company’s ability to ascertain insured and uninsured portions of a judgment or a settlement are prejudicial and not acts of “good faith.” See *Canron, Inc. v. Federal Insurance Co.*, 82 Wn.App. 480, 485, 918

² RCWA 48.01.030. Public interest

The business of insurance is one affected by the public interest, requiring that all persons be actuated by good faith, abstain from deception, and practice honesty and equity in all insurance matters. Upon the insurer, the insured, their providers, and their representatives rests the duty of preserving inviolate the integrity of insurance.

P.2d 937 (1996) (Insured not entitled to prejudice insurance companies insurance coverage investigation and coverage defenses). See, *Tran v. State Farm Fire and Casualty Co.*, 136 Wn.2d 214, 230 – 232, 961 P.2d 358 (1998) (“Because, in the final analysis, it is uncontroverted that Tran’s intransigence prevented State Farm from completing a legitimate investigation in order to determine whether or not coverage should be provided, it follows the State Farm suffered prejudice.”). Here, Paulson’s deliberate and repeated blocking of MOE’s attempts to determine what portions, if any, of the Arbitration Award and subsequent Judgment were insured and uninsured, precludes a claim for coverage by estoppel. As Paulson’s assignees, the Martinellis should be limited to recovering those portions of the Judgment which they establish are actually insured by Mutual of Enumclaw.

3. The Attorney Fees Incurred By Paulson In The Declaratory Judgment Action Are Not The Type Of Harm Which Justifies Creating Insurance Coverage By Estoppel.

The trial court concluded that Paulson’s defense against the Martinellis’ claims had not been in any way harmed by MOE’s contact with the AAA Arbitrator. Specifically, the only harm which could theoretically have occurred was either the assignment

of a new arbitrator or, after conclusion of the arbitration proceeding with the original arbitrator, someone attempted to set aside the arbitration award as a result of the contact by MOE.³ However, having examined the possible impact of the contact by MOE with the arbitrator, the Martinellis and Paulson both elected to have the arbitration go forward. At that point, the Martinellis and Paulson waived any basis for later objecting to any arbitration award entered.

The Trial Court and Court of Appeals both correctly held that any possibility that Paulson was “harmed” as a result of MOE’s contact with the arbitrator was disproved by the fact that Paulson and the Martinellis agreed to be bound by the arbitration award. Neither Paulson nor the Martinellis presented to the trial court any other possible harm that Paulson may have sustained regarding his defense against the Martinelli claims that resulted from MOE’s contact with the arbitrator.

However, the Martinellis noted to the Trial Court that Paulson had incurred attorney fees in the declaratory judgment action to challenge the subpoena issued to the arbitrator. The Trial Court accepted that form of alleged “harm” as being sufficient to

³ If either of those events had occurred, one can think of many arguments that would suggest Paulson was not in fact harmed, such as receiving the benefit of the delay of any judgment being entered against him.

create insurance coverage by estoppel. In disagreeing, the Court of Appeals stated:

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 of MOE had formerly 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.

Mutual of Enumclaw Ins. Co. v. Dan Paulson Const. Co., 132 Wn. App. At 816. These two conclusions are correct.

First, attorney fees incurred in a declaratory judgment action are not harm which will trigger coverage by estoppel. *Alaska National Insurance Co. v. Bryan*, 125 Wn. App. 24, 104 P. 3d 1 (2004).

If insurance coverage issues exist, it is not only the right, but the obligation of an insurance company to resolve the coverage issues in an appropriate proceeding. As this court has repeatedly admonished insurance companies, when in doubt about insurance coverage regarding a claim against the insured, provide the insured a defense and litigate the insurance coverage issues in a declaratory

judgment action. *Truck Insurance Exchange v. Vanport Homes, Inc.*, 147 Wn. 2d 751, 761, 58 P.3d 276 (2002).⁴

Second, the Court of Appeals decision noted that no one has suggested MOE defended Paulson in bad faith. In every case in which this Court has invoked coverage by estoppel, or remanded back to the trial court for further proceedings, the act or omission by the insurance company created harm/prejudice to the insured **regarding the underlying tort lawsuit**. Stated differently, no case has invoked coverage by estoppel where it was determined that the insured had not been harmed/prejudiced regarding defense of the underlying tort lawsuit, as was found by the trial court in the present case. *Safeco Insurance Co. of America v. Butler, supra* (allegations that the insurance company improperly delayed defense investigation of tort claim and/or attempt to use defense of tort claim to establish Mr. Butler's uninsured status); *Kirk v. Mt. Airy Ins. Co.*, 134 Wn.2d 558, 951 P.2d 1124 (1998) (bad faith refusal to provide a defense to tort claim); *Truck Insurance Exchange v. Vanport Homes, Inc.*, 147 Wn.2d 751, 761, 58 P.3d 276 (2002) (bad faith refusal to provide a defense); *Besel v. Viking*

⁴ As explained in our prior briefs, it would have been ideal from an insurance coverage determination prospective for the declaratory judgment to have completed before the AAA arbitration. However, if MOE had forced that litigation before completion of Paulson defense against the Martinellis' claims, Paulson would have asserted such conduct constituted bad faith. Brief of Appellant, pp. 19-21; Reply Brief of Appellant, fn. 1 at p. 16.

Ins. Co. of Wisconsin, 146 Wn.2d 730, 49 P.3d 887 (2002) (bad faith failure to effectuate a settlement within the insurance policy limits); *Smith v. Safeco Insurance Co.*, 150 Wn.2d 478, 78 P.3d 1274 (2003) (alleged bad faith failure to disclose insured's policy limits to the claimant, thereby inhibiting settlement within policy limits).

In each of the above cases, the insurance company's act or omission did, or could have, increased the insured's economic exposure to the tort claimant. As explained by the court in *Coventry Associates v. American States Insurance Co.*, 136 Wn.2d 269, 284, 961 P.2d 933 (1998), in the above described instances "...coverage by estoppel is an appropriate remedy because the insurer contributes to the insured's loss [personal exposure to tort claimant] by failing to fulfill its obligation in some way." There is no evidence that MOE's communications to the Arbitrator did contribute to Paulson's economic exposure to the Martinellis. Both the trial court and Court of Appeals so found.

The Martinellis do not cite, nor have we been able to locate, even a single case in the United States in which it was found that the insurance company's conduct did not in any way negatively impact the insured's position regarding the underlying tort claim, in which coverage by estoppel was invoked. *E.g.*, Joseph E. Edwards, *Negligence Or Bad Faith*

In Conducting Defense As Ground Of Liability To Insured, 34 ALR 3d 533 (1970); Douglas R. Richmond, *Truly "Extra Contractual" Liability: Insurer Bad Faith In The Absence Of Coverage*, 29 Tort and Ins. L. J. 740 (1994). There is no justification for expanding the law of coverage by estoppel in this case.

B. THE COURT OF APPEALS CORRECTLY HELD THAT MOE WAS NOT CURRENTLY OBLIGATED TO PAY ANY PORTION OF THE STIPULATED ARBITRATION AWARD/JUDGMENT.

As an alternative method of attempting to establish insurance coverage by estoppel, the Martinellis, as Paulson's assignee, alleged that MOE should have paid some portion of the stipulated Arbitration Award after it was entered. The Martinelli's position is incorrect for three reasons.

First, the alleged wrongful failure to pay some of the Arbitration Award is an act or event occurring after completion of the underlying construction defect litigation between Paulson and the Martinellis. The Martinellis neither cite case law nor present argument supporting the claim that the concept of coverage by estoppel should be expanded to include events occurring after resolution of the claims against the insured.

Second, the Martinellis do not allege nor explain how Paulson, the insured, has been harmed by the failure of MOE to currently pay. Harm to the insured must exist to create coverage by estoppel. *Safeco Ins. Co. v.*

Butler, supra. Here, Paulson has been exonerated from the Judgment entered in favor of the Martinellis. There was no harm to Paulson.

Third, as the Court of Appeals correctly held, the fact that MOE conceded that some of the damages claimed by the Martinellis would be insured, does not establish what portions, if any, of the stipulated Arbitration Award were insured under the Paulson/MOE insurance contracts. As the ones seeking insurance coverage for the Award, the Martinellis have the burden of establishing all elements necessary to create insurance coverage for an award. *Oberton v. Consolidated Insurance Co.*, 145 Wn.2d 417, 424-425; 431, 38 P.3d 322 (2002). As both the trial court and Court of Appeals correctly held, the Martinellis have not established whether any portions of the Arbitration Award were insured. As of today, MOE has no rationale basis to determine what sum, if any, it might pay. Washington law is clear, if an insurance company has a reasonable basis to withhold payment, its refusal to make the payment is not a violation of the WAC provisions and may not be the basis of a bad faith claim. *American Manufacturers Mutual Ins. Co. v. Osbourne*, 104 Wn.App. 686, 699-700, 17 P.3d 1229 (2001).

The Court of Appeals and trial court correctly held that the Martinellis have failed to establish that there is “clear liability” under the

insurance contract for the Award, and thus no violation of the WAC provision has been established.

C. MOE MUST BE GIVEN THE RIGHT TO CONTEST THE REASONABLENESS OF THE PAULSON/MARTINELLI SETTLEMENT.

In addition to finding coverage by estoppel, the trial court held that the settlement between the Martinellis and Paulson was “reasonable”. A finding that a settlement between a claimant and an insured was “reasonable” is significant, because it becomes the presumptive measure of harm if it is established that the insurance company acted in bad faith. *Besel v. Viking Insurance Co. of Wisconsin*, 146 Wn.2d 730, 738, 49 P.3d 887 (2002); *Werlinger v. Warner*, 126 Wn.App. 342, 349, 109 P.3d 22 (2005).

Any individual or entity who may be impacted by the settlement has a due process right to receive notice of the proposed settlement, and participate in a hearing before the tribunal which will determine whether the settlement was or was not reasonable. *Brewer v. Fibreboard Corp.*, 127 Wn.2d 512, 524-528, 531, 901 P.2d 297 (1995). *See, Howard v. Royal Specialty Underwriting, Inc.*, 121 Wn.App. 372, 379-380, 89 P.3d 265 (2004).

In the Court of Appeals, it was MOE’s position that the trial court in the present lawsuit relied upon the finding of “reasonableness” reached

by either the private arbitrator and/or the Judge in the earlier Superior Court proceeding in which the Arbitration Award was confirmed. Obviously, MOE was not a party to either of those proceedings, thus its right to challenge the reasonableness of the settlement has not been fulfilled.

Further, even though MOE was given notice of the prior Superior Court proceeding in which the Arbitration Award was confirmed, there was no valid basis for MOE to intervene, because the trial court in that proceeding could not overturn the Arbitrator's finding of reasonableness unless an error was apparent on the face of the Arbitration Award. *Barnett v. Hicks*, 119 Wn.2d 151, 153-154, 829 P.2d 1087 (1992); *Northern State Construction Co. v. Banchemo*, 63 Wn.2d 245, 249-250, 386 P.2d 625 (1964).

In its Opinion in this case, the Court of Appeals did not decide the merits of the "reasonableness" issue, because it concluded that the Paulsons had not established bad faith conduct by MOE or harm to Paulson. Therefore, the stipulated Arbitration Award, reasonable or unreasonable in amount, was not binding upon MOE. However, the Court did note:

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

Mutual of Enumclaw Ins. Co. v. Dan Paulson Construction Inc.,
132 Wn. App. Fn 29 at 818.

It is important for the Court to resolve this issue, even if the Court concludes that the trial courts finding of bad faith and resultant of monetary judgment, must be overturned. Though even more tenuous, the Martinellis do assert additional "bad faith" claims in the trial court proceeding, which have not yet been resolved.⁵

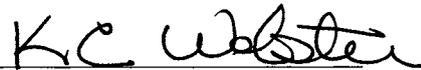
The Court should examine the issue of whether there has yet been a proper determination that the settlement between the Martinellis and Paulsons was reasonable, and thus binding upon MOE.

D. CONCLUSION.

The trial court should be directed to vacate the Summary Judgment and Judgment granted the Martinellis, and enter Partial Summary Judgment for MOE regarding the claim of coverage by estoppel.

DATED this 4th day of May, 2007.

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⁵ The present appeal is pursuant to a CR54(b) certification by the trial court. Cp 1009-1019.