

56591-5

56591-5

No. 56591-5-I

80937-2

THE COURT OF APPEALS FOR THE STATE OF WASHINGTON,

DIVISION ONE

RED OAKS CONDOMINIUM OWNERS ASSOCIATION,
a Washington nonprofit corporation,

Appellant,

v.

MUTUAL OF ENUMCLAW INSURANCE COMPANY,

Respondent.

APPELLANT'S REPLY BRIEF

Ken Harer, WSBA # 30025
Jessica A. Marden, WSBA # 34058
Condominium Law Group, PLLC
10310 Aurora Ave N.
Seattle, WA 98133
206-633-1520 – Telephone
206-633-1521 - Fax

FILED
COURT OF APPEALS DIV. #1
STATE OF WASHINGTON
2006 JUN -9 PM 3:41

Table of Contents.....	(i)
Table of Authorities.....	(iii)
Argument.....	1
A. There is Coverage for Sundquist Under the UMB 3011 Following the “Washington” Rule.....	1
1. The Actual Policy Language is Unambiguous.....	3
2. The Loss is Not Excluded by Specific Policy Language.....	3
3. The Business-Risk Analysis Should Not Dictate Coverage When the Policy is Clear.....	4
4. Washington Law Requires No Policy Provision be Disregarded.....	6
5. The Average Purchaser Would Not Understand the Merger Doctrine’s Potential to Affect Coverage.....	9
6. The UMB 3011 Predates the “Merger” Doctrine.....	10
7. The “Faulty Workmanship” Exclusion is Not at Issue	11
8. The Authority Cited by MOE is Not on Point.....	11
a. The “Product” Exclusion is Not at Issue.....	12
b. A Finding of Coverage is Consistent With <u>Archer</u>	13
c. Sundquist’s Policy is Significantly Different than the Policy Analyzed in <u>Schwindt</u>	14
9. The “Minnesota Rule” Does Not Preclude Coverage.....	15
B. MOE’s Actions Constitute Bad Faith as a Matter of Law.....	17
1. MOE Cannot Recast History to Support its Current Position.....	17
2. Good Faith Required MOE to Disclose Critical Information, Including its Theory of Denial, Prior to Denying Settlement Authority.....	19
3. MOE Failed to Keep Sundquist Fully Informed of Critical Developments Impacting Coverage.....	19

4. MOE Violated the WAC Unfair Claims Settlement Practices.....	20
5. MOE Elevated its Own Interests Above Sundquist's When it Withheld its Coverage Position.....	21
6. MOE Did Not Reserve its Right to Deny Coverage for Damage To the Work of Subcontractors.....	23
7. At the Very Least, the Undisputed Facts Raise a Triable Issue Whether MOE's Actions Constitute Bad Faith.....	24
C. CPA Claims Are Assignable.....	24
Conclusion.....	25

TABLE OF AUTHORITIES

<u>Allstate Ins. Co. v. Raynor</u> , 143 Wn.2d 469, 21 P.3d 707 (2000).....	9
<u>Boeing v. Aetna Cas. & Surety Co.</u> , 113 Wn.2d 869, 784 P.2d 507 (1990).....	9
<u>Federated Serv. Ins. Co. v. R.E.W.</u> , 53 Wn. App. 730, 770 P.2d 654 (1989).....	12-13
<u>Kitsap County v. Allstate Ins. Co.</u> , 136 Wn.2d 567, 964 P.2d 1173 (1998).....	3
<u>McDonald v. State Farm Fire & Cas. Co.</u> , 119 Wn.2d 724, 837 P.2d 1 (2004).....	4
<u>Morgan v. Prudential Ins. Co. of Am.</u> , 86 Wn.2d 432, 545 P.2d 1193 (1976).....	7
<u>Mutual of Enumclaw v. Patrick Archer Const., Inc.</u> , 123 Wn. App. 728, 97 P.3d 751 (2004).....	12-13, 20
<u>Robinson v. Kahn</u> , 89 Wn. App. 418, 948 P.2d 1347 (1998).....	11
<u>Rodenbough v. Grange Ins. Ass'n</u> , 33 Wn. App. 137, 652 P.2d 22 (1982).....	3
<u>Schwindt v. Underwriters at Lloyd's of London</u> , 81 Wn. App. 293, 914 P.2d 119 (1996).....	12, 14, 15
<u>Steinmetz v. Hall-Conway-Jackson, Inc.</u> , 49 Wn. App. 223, 741 P.2d 1054 (1987), <u>rev. denied</u> , 110 Wn.2d 1006 (1988).....	25
<u>Stuart v. Am. States Ins. Co.</u> , 134 Wn.2d 814, 953 P.2d 462 (1998).....	3
<u>Tank v. State Farm</u> , 105 Wn.2d 381, 715 P.2d 1133 (1986).....	17, 20-22, 24
<u>Tran v. State Farm Fire & Cas. Co.</u> 136 Wn.2d 214, 961 P.2d 358 (2004).....	24
<u>Van Noy v. State Farm Mut. Auto. Ins. Co.</u> , 142 Wn.2d 784, 16 P.3d 574 (2001).....	24
WAC 284-30-380.....	19 - 21, 23
WAC 284-30-330(13).....	19 - 23

Extra-Jurisdictional Authority & Secondary Authority

<u>American Family Mut. Ins. Co. v. American Girl, Inc.</u> , 673 N.W. 2d 65 (Wis. 2004).....	6
<u>Bor-Son Bldg. Corp. v. Employers Comm. Union Ins. Co. of America</u> , 323 N.W.2d 58 (Minn. 1982).....	5, 16
<u>Fejes v. Alaska Ins. Co. Inc.</u> , 984 P.2d 519 (Alaska 1999).....	2
<u>Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co.</u> , 864 F.2d 648 (9 th Cir. 1988).....	<i>passim</i>
<u>Knutson Const. Co. v. St. Paul Fire & Marine Ins. Co.</u> , 396 N.W.2d 229 (Minn 1986).....	<i>passim</i>
<u>O'Shaughnessy v. Smuckler</u> , 543 N.W.2d 99 (Minn.Ct.App. 1996).....	16
<u>Wanzek Const., Inc. v. Employers Ins. of Wausau</u> , 679 N.W.2d 322 (Minn. 2004).....	16, 17
<u>Cassamania & Jerles, Defining Insurable Risk in the Commercial General Liability Insurance Policy: Guidelines for Interpreting the Work Product Exclusion</u> , 12 Const. Law 3 (1990).....	8
21 Eric Mills Holmes, <u>Holmes' Appelman on Insurance 2d</u> (2000).....	6
R. Henderson, <u>Insurance Protection for Products Liability and Completed Operations – What Every Lawyer Should Know</u> , 50 Neb.L.Rev. 415 (1971).....	4
Malecki, “Special Programs for Contractors,” <u>Malecki on Insurance</u> , (Nov. 1996).....	8
Lee R. Russ, <u>Couch on Insurance 3d</u> , (1995).....	7, 10
Schultz, <u>Commercial General Liability Insurance for Faulty Construction Claims</u> , 33 Tort & Ins. Law J 257 (1997).....	8
1 Scott C. Turner, <u>Ins. Coverage of Const. Disputes 2d</u> (2005).....	6, 7, 8
Patrick J. Wielinski, <u>Insurance for Defective Construction: Beyond Broad Form Property Damage Coverage</u> , (2000).....	5, 8

2 Allen D. Windt, Insurance Claims & Disputes, (4th ed. 2001).....22

A. There is Coverage for Sundquist Under the UMB 3011 Following the “Washington” Rule.

It is unnecessary for this Court to adopt either of the so-called “Minnesota” or “Oregon” rules to determine what the deletion of specific language from Sundquist’s insurance policy means. Coverage in Washington is governed exclusively by the specific terms of the insurance contract. The issue before the Court is not an abstract philosophical decision about whether liability insurance functions as a performance bond, but whether damage to the work of subcontractors is excluded by the specific terms of this particular policy.

The Broad Form Property Damage (BFPD) endorsement policy language contained in the UMB 3011 and at issue in this case is the exact same language at issue in the seminal cases of Knutson and Fireguard. Knutson Const. Co. v. St. Paul Fire & Marine Ins. Co., 396 N.W.2d 229 (1986); Fireguard Sprinkler Sys., Inc. v. Scottsdale Ins. Co., 864 F.2d 648 (9th Cir. 1988). The different result reached in those cases turns upon the significance attributed by the respective courts to the deleted language “on behalf of” from the BFPD “your work” exclusion. Knutson concluded the deleted language was a “slight difference in wording” that had no effect on the scope of

coverage. Knutson, 396 N.W.2d at 237. But the Ninth Circuit reasoned that this conclusion “ignores the careful drafting that characterizes insurance policies” and concluded the deleted language limited the scope of the exclusion. Fireguard, 864 F.2d at 653.

The UMB 3011 BFPD endorsement excludes coverage for damage to work performed by the Named Insured, but covers damage to work performed “on behalf of” the Named Insured. Because the property damaged in this case was the work of subcontractors, the exclusion does not apply. Fejes v. Alaska Ins. Co., Inc., 984 P.2d 519, 525 (Alaska 1999).

Mutual of Enumclaw’s (MOE) analysis is flawed because it focuses single mindedly on an abstract business-risk analysis in derogation of the actual policy language. At the risk of over generalizing, the “Minnesota rule” cases MOE relies on ignore the carefully drafted policy language in favor of a philosophical public policy “uninsurable business risk” analysis to decide coverage questions. And MOE conveniently ignores recent Minnesota Supreme Court opinions drastically limiting the application of the business risk doctrine.

MOE also ignores the critical fact that the fundamental

purpose of insurance is to provide protection. Stuart v. Am. States Ins. Co., 134 Wn.2d 814, 818-19, 953 P.2d 462 (1998). The insurer contractually agrees to bear the risk of loss in exchange for a premium. In keeping with this purpose, the umbrella policy Sundquist purchased shifted the risk of damage to the work of subcontractors to MOE, for which Sundquist paid a premium.

1. The Actual Policy Language is Unambiguous.

In Washington, the language in an insurance policy is construed in accordance with rules applicable to construing other contracts. Rodenbough v. Grange Ins. Ass'n, 33 Wn. App. 137, 140, 652 P.2d 22 (1982). Washington courts, when interpreting an insurance policy, look to the definitions provided in the policy itself. Kitsap County v. Allstate, 136 Wn.2d 567, 576, 964 P.2d 1173 (1998). The umbrella policy exclusively defines the "Named Insured" as "the person or organization named in the declarations". CP 72. Only Sundquist Homes, Inc. and its owners are named in the policy's declarations. CP 71. The policy definition of "Named Insured" does not include subcontractors and thus the exclusion does not apply to damage to work performed by subcontractors.

2. The Loss is Not Excluded by Specific Policy Language.

It is incumbent upon MOE to show that the loss is excluded by *specific policy language*. McDonald v. State Farm Fire & Cas. Co., 119 Wn.2d 724, 731, 837 P.2d 1 (2004). MOE has not shown any specific policy language excludes coverage under the UMB 3011 BFPD “your work” exclusion.

When MOE drafted the underlying umbrella policy, it included the language “or on behalf of” in the “your work” exclusion. This reflects MOE’s understanding and intent that there would be no coverage provided by the umbrella for damage to work performed by the Named Insured or subcontractors. CP 75. But the UMB 3011 BFPD endorsement replaces the underlying exclusion and applies only to “work performed by the Named Insured.” CP 87. If MOE intended the BFPD endorsement to exclude coverage for property damage to work performed on behalf of the named insured, i.e. by subcontractors, it could have stated it clearly, just as it did when drafting the underlying policy exclusion.

3. The Business-Risk Analysis Should Not Dictate Coverage When the Policy is Clear.

The source of the business-risk doctrine is a 1971 Nebraska law review article.¹ As one authority has noted, it is unfortunate

¹R. Henderson, Insurance Protection for Products Liability and Completed Operations – What Every Lawyer Should Know, 50 Neb.L.Rev. 415 (1971).

that most of the cases that rely on the article as persuasive authority for the insurer's intent in drafting the "product" and "your work" exclusions have seized on the "business risk" analysis at the expense of reading the actual language of the policy itself. See, P. Wielinski, Insurance for Defective Construction, at 212 (2000).

For example, a careful examination of Bor-Son will show that the only policy provision discussed is an exclusion that was deleted from the policy by the BFPD endorsement. Bor-Son v. Employers Comm. Union Ins. Co., 323 N.W.2d 58 (Minn. 1982). And the Knutson court barely attempted to reconcile the policy language. Knutson, 396 N.W.2d at 237.

Despite the fact that the BFPD deleted the words "or on behalf of" found in the underlying policy exclusion it was intended to replace, some courts, most prominently Minnesota in the Bor-Son and Knutson opinions, missed the intended and expected expansion of coverage for the work of subcontractors.

In doing so, [those courts] voided the completed operations coverage in their respective jurisdictions, which insureds had paid enormous additional premiums to secure. This inadvertently resulted in a windfall to insurers that may have reached hundreds of millions of dollars. Even the insurance industry organization that drafted the policy language, the Insurance Services Office, was embarrassed by the gross misconstruction of its language and, in

response, issued its Circular No. CGL 79-12 dated January 29, 1979, to confirm its original intent and admitting that this 1976 exclusion was “difficult to understand.”

1 Scott C. Turner, Ins. Coverage of Const. Disputes 2d §33:3 at 33-12, 13 (2005)(citations omitted).²

However, most courts understand the significance of the BFPD’s deletion of the language “on behalf of” from the “your work” exclusion on the scope of coverage:

[T]he BFPD deleted several portions from the business risk exclusions and replaced them with more specific exclusions that effectively broadened coverage. Among other changes, the BFPD extended coverage to property damage caused by the work of subcontractors.

American Family Mut. Ins. Co. v. American Girl, Inc., 673 N.W.2d 65, 83 (Wis. 2004). See also, 21 Eric Mills Holmes, Holmes' Appelman on Insurance 2d, § 132.9, 152-53 (2000). Washington should join those states that hold the deleted language from the BFPD endorsement means something and does not exclude coverage for damage to the work of subcontractors.

4. Washington Law Requires No Policy Provision be Disregarded.

In Washington, the endorsement must be read together with the policy and *intent must be given to every insurance policy*

² Circular No. CGL 79-12 is the very same ISO circular discussed and extensively quoted from in the Fireguard opinion.

provision. Morgan v. Prudential Ins. Co. of Am., 86 Wn.2d 432, 434, 545 P.2d 1193 (1976). MOE started out with the limitation “by or on behalf of the named insured” in the umbrella policy form, and then deleted the words “on behalf of” in the UMB 3011 endorsement. The deletion was intended to pick up coverage for completed operations damage to subcontractor work. No other interpretation of the actual policy language is logical or reasonable.

MOE claims it never expressed its intent to limit the BFPD endorsement to the work of the Named Insured and thus the 1979 ISO circular quoted at length in the Fireguard opinion is irrelevant. But neither did MOE express an intent that the “work” of subcontractors merges into the “work” of the Named Insured. Even ambiguous language cannot be controlled by the insurer’s understanding without proof that such was known to the insured. Lee R. Russ, Couch on Insurance 3d, § 22:12 at 22-29 (1995).

When viewing the totality of the policy, omitted language serves to explain the intent of the parties. Couch, § 21-20 at 21-41. The deleted language “was not an unintended, clerical oversight, but was a major, deliberate and intentional broadening of coverage” by weakening the exclusion in exchange for a significant additional premium. Turner, Ins. Coverage of Const. Disputes, §33:3 at 33-

11. In addition to the so-called "Oregon rule" cases, numerous learned treatises document the intent of insurance industry drafters that the BFPD endorsement cover damage to subcontractor's work.³ One authority states:

[W]here damage is either (1) to work performed "on behalf of" the named insured or (2) arises out of work performed "on behalf of" the named insured, the property damage was intended to be covered. However, the courts have been uneven in upholding the drafters' intended meaning (and the policyholders' reasonable expectations of coverage).

Turner, Ins. Coverage of Const. Disputes, §33:3 at 33-11.

Sundquist and its insurance agent believed the BFPD endorsement covered damage to the work of subcontractors.⁴ CP 190, 192. Sundquist paid additional premiums for the increased coverage.⁵ Deleted language is an expression of intent that the

³ See, e.g., P. Wielinski, Insurance for Defective Construction, 157-59, 209 (2000); Cassamania & Jerles, Defining Insurable Risk in the Commercial General Liability Insurance Policy: Guidelines for Interpreting the Work Product Exclusion, 12 Const. Law 3, 8 (1990); Schultz, Commercial General Liability Insurance for Faulty Construction Claims, 33 Tort & Ins. Law J 257, 272 (1997); Malecki, "Special Programs for Contractors", Malecki on Insurance, Nov. 1996 at 1, 2.

⁴ What Brunni-Colbath insurance agents thought the policy language meant is relevant not because Red Oaks seeks to bind MOE under principles of agency, but because it goes to the issue of how the average person would interpret the policy. Further, the trial court only ruled that the unexpressed intent of the parties was irrelevant with respect to the CGL policy, not the umbrella. CP 702.

⁵ MOE claims Red Oaks cannot show it charged additional premiums for the BFPD coverage. MOE's worksheets show the UMB 3011 is not a standard endorsement, and logic dictates that the increased coverage from deleting the product exclusion alone would result in an increased premium. See e.g., CP 469, 470, 474. The facts and all reasonable inferences must be construed in Red Oaks's favor.

exclusion only applies to the Named Insured. Any other conclusion disregards the actual policy language.

5. The Average Purchaser Would Not Understand the Merger Doctrine's Potential to Affect Coverage.

Because the insurance carrier has the opportunity to draft the policy clearly and unambiguously to say exactly what it means, the terms of an insurance contract should be given a fair and reasonable construction as would be given by an average purchaser, rather than in a technical sense. Allstate Ins. Co. v. Raynor, 143 Wn.2d 469, 476-77, 21 P.3d 707 (2000); Boeing v. Aetna Cas. & Surety Co., 113 Wn.2d 869, 881, 784 P.2d 507 (1990).

The average purchaser does not read law review articles and judicial opinions from other jurisdictions before purchasing an insurance policy. The average person reading this policy would not suppose that work performed by subcontractors "merges" into the work of the Named Insured, especially in light of the policy's exclusive definition of "Named Insured" and the deleted language "on behalf of". A purchaser of insurance contracts is entitled to rely on the policy language contained in the insurance contract. The only reasonable interpretation that could be reached by an ordinary person reading this policy is that the UMB 3011 BFPD exclusion is

limited to damages to the work of the Named Insured only.

Despite the accepted rules of construction, MOE brazenly asserts the deleted language is meaningless. MOE argues that an average purchaser understands the “on behalf of” language was unnecessary because the policy itself incorporated the merger doctrine set forth in Knutson. To the contrary, it is more logical and reasonable to suppose that an average purchaser, if they were to rely on extraterritorial authority, would presume the reasoning of the Ninth Circuit in Fireguard would apply, and thus the deleted language limited the exclusion to the Named Insured only.

Sundquist and its insurance agent believed the policy would provide coverage for damage to the work of subcontractors. This is a fair and reasonable reading of the policy. Sundquist is not a lawyer or a judge, but is the average purchaser. It is Sundquist’s reasonable interpretation that governs the reading of this policy.

6. The UMB 3011 Predates the “Merger” Doctrine.

The critical time for judging whether an insurance policy exclusion is plain and clear is the time the insured accepts the contract, not when the event triggering coverage arises. Couch, § 22:31 at 22-69. MOE sold the UMB 3011 BFPD endorsement to Sundquist as part of its policy as far back as 1993, CP 484, when

Sundquist expressed to his insurance agent concerns about coverage for subcontractor's construction defects. CP 189-90. Because the merger doctrine would not be articulated in Schwindt until 1996, it is patently absurd for MOE to assert the UMB 3011 BFPD endorsement embodied the merger doctrine. When Sundquist accepted the insurance contract, the UMB 3011 BFPD endorsement could not have incorporated future caselaw.

7. The "Faulty Workmanship" Exclusion is Not at Issue.

The trial court determined that the "faulty workmanship" provision did not exclude coverage. CP 899. A party seeking cross-review must file a notice of appeal. RAP 5(d). MOE filed and withdrew a notice of appeal on the faulty workmanship issue, and failed to cross appeal on this issue. A notice of cross appeal is necessary if respondent seeks affirmative relief. Robinson v. Kahn, 89 Wn. App. 418, 948 P.2d 1347 (1998). MOE waived review of the trial court's ruling on the faulty workmanship exclusion.

8. The Authority Cited by MOE is Not on Point.

The issue before this Court is the effect on the scope of coverage when the language "on behalf of" contained in the underlying umbrella policy "your work" exclusion is specifically deleted from the BFPD endorsement's "your work" exclusion. This

issue was not addressed in the Archer, Schwindt, or Federated decisions, which all turn upon the “Product” exclusion contained in the respective comprehensive general liability (CGL) policies.

a. The “Product” Exclusion is Not at Issue.

The UMB 3011 BFPD at issue here deletes entirely the “product” exclusion from the underlying umbrella policy. The trial court properly rejected MOE’s assertion that cases interpreting the “product” exclusion were “equally applicable” to the umbrella policy exclusions. CP 1413; 701-02. Washington cases interpreting product exclusions are inapposite.

MOE’s analysis erroneously collapses the CGL “product” exclusion and UMB 3011 BFPD endorsement “your work” exclusion into a universal “work product” exclusion. MOE then seeks to overcome the specific policy language with this “work product” exclusion via the “merger doctrine.” The policy at issue here contains separate and distinct exclusions pertaining to “your product” and “your work.” MOE erroneously conflates the two and the Court should reject MOE’s sloppy reasoning.

MOE relies on Federated as support for its assertion that a builder’s building is its “work” and thus there is no coverage under the “your work” exclusion. Federated Serv. Ins. Co. v. R.E.W., 53

Wn. App. 730, 770 P.2d 654 (1989). This is misstatement of Federated, which stands for the proposition that a builder's building is its "product" for purposes of the CGL "product" exclusion. Federated at 735. All work was performed by the contractor, so the Federated court never considered whether the "product" exclusion covers damage caused to the "work" of subcontractors.

b. A Finding of Coverage is Consistent With Archer.

The coverage issue in Archer was limited to the "product" exclusion because the BFPD endorsement was explicitly subject to the CGL policy "product" exclusion. Mutual of Enumclaw v. Archer, 123 Wn. App. 728, 738, 97 P.3d 751 (2004). Here the issue is whether there is coverage under the umbrella policy's UMB 3011 BFPD "your work" exclusion. Archer does not control.

Unlike the particular BFPD endorsement at issue in Archer, the UMB 3011 is not subject to the "product" exclusion because it unquestionably replaces it. CP 1415. Thus it is reasonable to conclude there is no coverage under the CGL "product" exclusion, while at the same time concluding there is coverage under the UMB 3011 BFPD endorsement. That is exactly what the trial court did when ruling on MOE's first motion for summary judgment. CP 701-02.

c. Sundquist's Policy is Significantly Different than the Policy Analyzed in Schwindt.

Similarly, Schwindt does not control the outcome of this case. MOE glosses over the significant differences in the policy language between Schwindt's policy, which is based on Lloyd's forms, and Sundquist's policy, based on Insurance Services Office (ISO) forms. The policy in Schwindt is different in both specific terms and intent from Sundquist's policy, which exclusively defines "Named Insured." There is no way for this Court to know whether or how the Schwindt policy defined the "Named Insured." Schwindt v. Underwriters at Lloyd's of London, 81 Wn. App. 293, 295, 914 P.2d 119 (1996).

The Schwindt opinion held damage *caused by the faulty work* of the *assured* was excluded under the CGL "defective product" and "faulty work" exclusions. Schwindt, 81 Wn. App. at 295. The issue here is whether there is coverage under a particular umbrella policy endorsement. The coverage provided by the UMB 3011 is much broader than Schwindt's policy because it does not contain a "product" exclusion. This case is also different because of the unchallenged trial court determination that the policy's "faulty work" exclusion **does not** preclude coverage. CP 899.

Furthermore, even the Schwindt court implicitly recognized that had the Lloyd's policy deleted the specific language at issue here, it would have affected the scope of coverage. Schwindt distinguished Fireguard and other cases "where the policy had previously omitted the language, 'on behalf of,' **evidencing an intent not to include subcontractors**" in the exclusion provisions. Schwindt, 81 Wn. App. at 305 (emphasis added).

Schwindt rejected the cases Red Oaks relies on because they did not address the Lloyd's policy language. But Fireguard and the other "Oregon rule" cases *do* address the *very same policy language* at issue here, a fact acknowledged by MOE. RB at 11.

Despite the fact that the language in Fireguard is the same as in this policy, MOE hopes to defeat coverage by relying on judicial doctrine: "[b]ecause of the merger rule, the modification of the work exclusion does not provide coverage for the work of subcontractors." RB at 21. MOE's insistence that the Court depart from the language of the contract itself and decide the case based upon a doctrine that even Minnesota has rejected is contrary to Washington law governing the construction and interpretation of insurance contracts.

9. The "Minnesota Rule" Does Not Preclude Coverage.

The business-risk doctrine is an expression of public policy applied to the insurance coverage provided under CGL policies. O'Shaughnessy v. Smuckler, 543 N.W.2d 99, 102 (Minn.Ct.App. 1996). The "Minnesota rule" advanced by MOE is a triumph of doctrine over the actual contract language, a fact acknowledged by the Minnesota Supreme Court in 2004 when it stated:

Although the BFPD was generally thought to provide coverage to a general contractor for work by a subcontractor, in Knutson we ruled to the contrary, applying a more generalized notion of the business-risk doctrine.

Wanzek Const., Inc. v. Employers Ins. of Wausau, 679 N.W.2d 322, 326 (Minn. 2004). In Wanzek, the Minnesota Supreme Court rejected the insurer's suggestion that "the principles of Bor-Son and Knutson, in combination with the general principles of the business-risk doctrine, should drive the interpretation" of the insurance contract. Wanzek, 679 N.W.2d at 327. Instead, it held the extent to which an insurance policy covers the business risk of the general contractor "*must be determined by the specific terms of the contract.*" Wanzek, 679 N.W.2d at 327 (emphasis added).

It is clear that Minnesota applies the same rules as Washington – that exclusions are interpreted narrowly and in favor of

coverage. Wanzek, 679 N.W.2d at 324-25. The issue of coverage must be determined by the specific terms of this policy, which limits the exclusion to damage to the work of the Named Insured only.

B. MOE's Actions Constitute Bad Faith as Matter of Law.

While supplying Sundquist's defense under a reservation of rights, MOE acted in bad faith when it encouraged and agreed to fund a settlement process that established absolute liability for its insured and then, at the process conclusion, denied funding for the compromise settlement without providing a basis for its denial as required by WAC 284-30-330(13), -380. MOE also violated its Tank duty of ongoing disclosure by withholding from Sundquist the fact that it was pursuing parallel litigation during the settlement process that would eliminate coverage under Sundquist's policies. Tank v. State Farm, 105 Wn.2d 381, 715 P.2d 1133 (1986).

1. MOE Cannot Recast History to Support its Position.

MOE is bound by its stipulation to the facts alleged by Red Oaks in Red Oaks Motion for Summary Judgment Re: Bad Faith. CP 902; 1095. MOE's attempts to characterize its letter accepting tender of Sundquist's claim under a reservation of rights as a denial of coverage are specious. The reservation of rights did not explain that MOE was denying coverage, and did not provide the basis in the

policy or law for the March 1, 2004, denial. MOE never issued a written denial or gave Sundquist a policy basis for denial. Nor did MOE offer, as a theory of denial, its “well founded belief” that the UMB 3011 also applied to work performed on behalf of the Named Insured until its second motion for summary judgment.⁶ CP 1441.

The facts are undisputed. MOE undertook Sundquist’s defense under a reservation of rights. CP 44. MOE agreed to fund the ER 408 settlement agreement, which substantially limited its insured’s exposure. CP 902; 937. MOE had access to all information related to the scope of repairs, the nature and cause of the damages at issue. CP 943-44. MOE knew the investigation, through a neutral expert, established Sundquist’s certain liability of over \$1 million. CP 948. MOE knew Red Oaks could use any and all information, including expert witnesses, in any subsequent litigation. CP 905. MOE knew if the settlement negotiations failed to result in a payment to Red Oaks, the ER 408 agreement would be void and Sundquist would face substantial additional exposure. CP 902.

MOE’s claims adjuster, Dave Mitchlitsch, testified that coverage under Sundquist’s policies was an open question up until March 1, 2004. CP 940. On March 1, 2004, three days before the

⁶ MOE first moved for summary judgment on the “product” and “cost of repair” exclusions. CP 1334.

settlement mediation, MOE refused to indemnify Sundquist.⁷ CP 904. MOE did not provide Sundquist with a prompt written denial as required by WAC 284-30-380. Although MOE denied coverage, it failed to disclose its coverage defense until after Red Oaks filed suit as Sundquist's assignee. MOE did not offer its theory of denial based on the UMB 3011 "your work" exclusion until its second motion for summary judgment. CP 1441.

2. Good Faith Required MOE to Disclose Critical Information, Including its Theory of Denial, Prior to Denying Settlement Authority.

Red Oaks does not argue, as MOE asserts, that MOE was required to obtain a declaratory judgment on coverage issues prior to settlement negotiations. Red Oaks does not argue that MOE had a duty to settle Sundquist's claims. But MOE is obliged, when faced with a compromise settlement where the insured's liability was established with certainty, to either indemnify its insured or to deny coverage and state with specificity the reasons why. WAC 284-30-330(13), -380.⁸ MOE did neither.

3. MOE Failed to Keep Sundquist Fully Informed of

⁷ MOE cannot dispute the fact that it first communicated its intention to refuse settlement authority on March 1, 2004. See, RB at 45, FN 14. And if MOE did communicate its intention earlier, then it clearly violated WAC 284-30-380 by not putting it in writing and stating the basis in the policy for doing so.

⁸ Red Oaks included the "scattergun" WAC violations to show a pattern of MOE consistently placing its own interests above that of Sundquist.

Critical Developments Impacting Coverage.

A reservation of rights defense mandates the insurer fulfill an enhanced obligation of good faith, which includes the duty of full and ongoing disclosure. Tank, 105 Wn.2d at 387-88. Tank obligated MOE to keep Sundquist fully informed of all developments that would affect coverage under the policy, which MOE failed to do.

During the course of the ER 408 process, MOE knew but failed to disclose that a trial court had ruled in its favor on the “product” exclusion, which would wipe out its coverage obligation to Sundquist under the CGL. Instead MOE waited for a favorable appellate court decision.⁹ This constitutes a breach of the Tank duty to inform. Because MOE withheld this important information, Sundquist was unable to make an informed decision when it faced the negotiated settlement with certain liability established.

4. MOE Violated the WAC Unfair Claims Settlement Practices.

MOE wants to rewrite history and pretend it always told Sundquist there would be no coverage under the policies. But if this were true, then MOE would have denied coverage and given

⁹ Mutual of Enumclaw v. Patrick Archer Const., Inc., 123 Wn. App. 728, 97 P.3d 751 (2004).

the specific reasons why, in writing, as required by WAC 284-30-330(13), -380. The Office of the Insurance Commissioner declares it an unfair or deceptive practice when an insurer:

[fails] 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.

WAC 284-30-330(13). MOE never gave Sundquist a reasonable explanation for its refusal to settle with respect to the policy, the facts, or the applicable law. This is *per se* bad faith. Tank, at 386.

5. MOE Elevated its Own Interests Above Sundquist's When it Withheld its Coverage Position.

MOE claims they refused to fund the settlement based upon "a well founded belief of non-coverage." RB at 41. But MOE withheld this belief and its basis from Sundquist. An insurance company seeking to disclaim liability should do so seasonably, and not delay action to the detriment of its insured. MOE's failure to do so demonstrates a greater concern for its own interests in violation of the principles articulated in Tank.

In the event an insurer believes there is no coverage, it should do one of two things: (1) either attempt to stay the action against its insured and institute a declaratory judgment action, or (2) settle the action against its insured subject to reservation of

rights to seek indemnification from the insured. 2 Allen D. Windt, Insurance Claims & Disputes, §11:10, 424 (4th ed. 2001). MOE did neither. MOE's failure to take a clear position prejudiced its insured. As a consequence, Sundquist entered into the March 4, 2004, settlement negotiations in the awkward position of not knowing with certainty whether MOE was denying coverage, or its basis for denial. WAC 284-30-330(13) obliges the insurer to provide that information. MOE failed to do so, and that failure is bad faith as a matter of law.

MOE argues that WAC 284-30-330(13) does not apply because it did not deny coverage or offer to compromise a coverage dispute. MOE reserved its right to deny coverage, but did not issue a written denial, even though MOE now states it determined there was no coverage under the policies:

As a result of the determination that there was no coverage in the policy for Red Oaks' claim the company declined to provide money at the mediation or for the settlement later achieved by Sundquist and Red Oaks.

CP 1111 (MOE's Opposition to Summary Judgment Re: Bad Faith). Instead, MOE withdrew settlement authority. The withdrawal of settlement authority after establishing its client's liability is a denial of coverage and triggered MOE's obligations under WAC 284-30-

330(13).

Red Oaks does not argue that MOE had a duty to settle Sundquist's claim if there is no coverage. But MOE should either have sought a coverage determination in a declaratory judgment action, or settled the action against its insured while reserving its right to seek indemnification from Sundquist in the event the claims were not covered. MOE also had a right to deny coverage, but it was required to provide a basis for that denial once its insured's liability was established. WAC 284-30-330(13); -380(1). The failure to do so is a clear violation of the WAC and is bad faith as a matter of law.

6. MOE Did Not Reserve its Right to Deny Coverage for Damage to the Work of Subcontractors.

MOE did not disclose its coverage position or theory of denial in its reservation of rights letters. MOE only stated the umbrella policy did not cover damage to Sundquist's own work:

The Umbrella Policy will not pay for the cost of damage to **your client's own work** or products, or products they sold, damage caused by their "faulty workmanship" or for the loss of use of undamaged property caused by your clients' delay, failure to perform a contract, or failure of their products or work to meet the standards represented or warranted.

CP 47. It was not until 14 months after denying settlement

authority that MOE took the position that it considered the work of subcontractors to be the work of the Named Insured.

7. At the Least, the Undisputed Facts Raise a Triable Issue Whether MOE's Actions Constitute Bad Faith.

Whether an insurer acted in bad faith is a question of fact.

Van Noy v. State Farm Mut. Auto. Ins. Co., 142 Wn.2d 784, 796, 16 P.3d 574 (2001). Summary judgment is only appropriate if no reasonable juror, when viewing the facts and all reasonable conclusions therefrom in the light most favorable to Sundquist, could conclude MOE's actions violated the WAC or constitute bad faith. Tran v. State Farm Fire & Cas. Co. 136 Wn.2d 214, 223-24, 961 P.2d 358 (2004). When the facts and all reasonable inferences are drawn in favor of Red Oaks, the evidence is sufficient to raise a triable issue of fact whether MOE's actions constitute bad faith.

C. CPA Claims Are Assignable

MOE erroneously claims that only an insured may bring a CPA claim, citing Tank. That case stands for the proposition that third party claimants may not sue the insurance company *directly* for CPA violations. Tank, 105 Wn.2d at 394. Red Oaks is not a third party litigant, but stands in the shoes of Sundquist. Since Tank was authored, this Court has explained that an assignee may

maintain a CPA claim:

A dispute between an insured and his insurer has sufficient effect on the public interest to permit a private action for damages under the Consumer Protection Act. ... Palmer, as the assignee, took those rights possessed by Steinmetz at the time of the assignment. Therefore we conclude summary judgment for [the insurance broker] on the CPA claim was improperly awarded.

Steinmetz v. Hall-Conway-Jackson, Inc., 49 Wn. App. 223, 228, 741 P.2d 1054 (1987), rev. denied, 110 Wn.2d 1006 (1988)(citations omitted).

CONCLUSION

Red Oaks respectfully requests the Court reverse the trial court's coverage determination and direct the trial court to enter judgment in its favor on its bad faith and CPA claims, or in the alternative, a jury determination of bad faith.

Respectfully submitted this 8 day of June, 2006.

CONDOMINIUM LAW GROUP, PLLC



C. Kenworthy Harer, WSBA No. 30025
Jessica A. Marden, WSBA No. 34058
Attorneys for Appellant Red Oaks