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WASHINGTON SUPREME COURT CONCLUDES THAT INSURER ACTED IN BAD FAITH VIA SUBPOENA AND *EX PARTE* COMMUNICATIONS TO AN ARBITRATOR

By: William F. Knowles and Joshua M. Rosen

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The Washington Supreme Court, sitting *en banc,* recently held that an insurance company acted in bad faith by issuing a subpoena to and engaging in *ex parte* communications with an arbitrator. The Court further stated that the insurer did not rebut the resulting presumption of harm to the insured and that the insurer had not raised a genuine issue of material fact regarding whether the settlement amount was reasonable. *Mutual of Enumclaw Insurance Co. v. Dan Paulson Construction, Inc.,* No. 79027-2 (Wash. Sup., October 11, 2007).

In August 2002, Karen and Joseph Martinelli initiated arbitration proceedings against Dan Paulson Construction (Paulson) alleging construction defects in their home. Paulson tendered defense of the arbitration proceeding to Mutual Enumclaw Insurance Co. (MOE), Paulson's commercial liability insurer. MOE agreed to defend Paulson under a reservation of rights, assigned defense counsel and began investigating which of the Martinellis' claims against Paulson were covered or excluded under the policy. Paulson's policy excluded coverage for Paulson's work, but provided coverage for work performed by its subcontractors on Paulson's behalf. In order to determine which of the Martinellis' claims were covered, MOE sought to determine which entities performed what work on the Martinellis' home, what construction defects resulted from each entity's work, and the cost of repair for each defect.

By late October 2003, the arbitration hearing had been scheduled, with a start date of January 6, 2004. MOE attempted to participate in the arbitration hearing, but did not formally move to intervene and did not ask the arbitrator for permission to attend. Instead, MOE informally requested permission to intervene from Paulson, or, in the alternative, to have an MOE coverage representative observe. Both requests were denied by Paulson.

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On November 21, 2003, MOE filed a declaratory judgment action in the San Juan County Superior Court against Paulson and the Martinellis, but failed to serve the defendants. More than one month later, and on the eve of arbitration, MOE issued a subpoena duces tecum to the arbitrator, scheduling the arbitrator's deposition upon written questions after the arbitration was concluded. MOE wrote an *ex parte* cover letter to the arbitrator, explaining that it needed information to resolve its coverage dispute with Paulson. The Martinellis and Paulson received a copy of the subpoena three days later and their copy of the subpoena did not include the cover letter. The Martinellis and Paulson requested that MOE withdraw the subpoena. On day two of the arbitration hearing, MOE sent a second letter to the arbitrator and all parties, reiterating its explanation of its coverage dispute with Paulson. MOE later struck the subpoena and dismissed its first declaratory judgment action.

During the arbitration hearing, Paulson and the Martinellis reached a settlement for $1.3 million, the terms of which included assignment of Paulson's coverage and bad faith claims against MOE. The arbitrator approved the settlement and on February 2, 2004, the San Juan County Superior Court confirmed the arbitration award and reduced it to judgment.

MOE filed a second declaratory judgment action against Paulson and the Martinellis, seeking to determine what portions of the arbitration award/judgment were covered. The Martinellis (as the insured's assignee) counterclaimed for breach of contract and insurance bad faith. The Martinellis and MOE filed cross-motions for partial summary judgment. Initially, the trial court held that MOE acted in bad faith but that MOE had successfully rebutted the presumption of harm. The Martinellis moved for partial reconsideration relative to the presumption of harm, which the trial court granted, entering judgment for the sum of $1.3 million, plus attorneys fees, costs, and interest. The appeals court reversed, holding that MOE did not act in bad faith and that there was sufficient evidence to rebut any presumption that the insured was harmed.

The Supreme Count held that MOE's conduct constituted bad faith. As an insurer defending under a reservation of rights, the Court noted that MOE owed Paulson a duty to refrain from engaging in any conduct that was "unreasonable, frivolous or unfounded" (*Kirk v. Mount Airy Ins. Co.,* 134 Wn. 2d 558, 560, 951 P.2d 1124 (1998)) or taking any action "which would demonstrate a greater concern for [MOE's] monetary interest than for [Paulson's] financial risk." *Tank v. State Farm Fire & Cas. Co.,* 105 Wn.2d 381, 385, 715 P.2d 1133 (1986). The Court concluded that through its subpoena and *ex parte* communications to the arbitrator, MOE breached this duty and therefore acted in bad faith. Through the subpoena and *ex parte* communications, the Court felt MOE demonstrated great concern for its monetary interests as to the Martinellis' claim but little concern for the monetary interests of Paulson and how its actions would affect Paulson's risk.

The Supreme Court also held that MOE did not rebut the presumption of harm that arose from its conduct, and in doing so reviewed Washington law on the presumption of harm arising from the insurer's conduct. In *Safeco Ins. Co. of Am. v. Butler,* 118 Wn.2d 383, 823 P.2d 499 (1992), the Washington Supreme Court stated that in the third party context, "if the insured shows by a

preponderance of the evidence the insurer acted in bad faith, there is a presumption of harm." *Id*. at 394. "The insurer can rebut the presumption by showing by a preponderance of the evidence its acts did not harm or prejudice the insured." *Id*. *Butler* held that a presumption of harm is warranted because "the insured should not have the almost impossible burden of providing that he or she is demonstrably worse off because of the insured's actions" *Id*. at 390. The Court noted that MOE's argument echoed the *Butler* dissent that requiring the insurer to prove a negative – that its conduct did not harm or prejudice the insured – is an almost impossible burden. The Court acknowledged that the nature of the tort of insurer bad faith dictated that an "almost impossible burden" of proof will fall either on the insured or the insurer. *Id*. The rationale of the Washington Supreme Court, however, is that since it is the insurer that controls whether it acts in good faith or bad faith, it is the insurer that should bear the burden of proof for the consequences of that conduct.

In holding that MOE did not rebut the presumption of harm arising from its bad faith conduct, the Court stated that MOE did not prove its subpoena and *ex parte* communications with the arbitrator did not harm or prejudice Paulson and that the record supported a finding that MOE's conduct caused significant uncertainty and risk for Paulson's defense. Specifically, the Court found MOE's conduct interfered with the final hearing preparation of Paulson, interjected coverage issues into the arbitration, and created uncertainty concerning potentially prejudicing the arbitrator and the effect of MOE's interference on the confirmability of the arbitration award.

The Court further held that MOE did not raise a genuine issue of material fact concerning the reasonableness of the underlying settlement. Three different triers of fact (the arbitrator and two trial courts) determined the settlement between Paulson and the Martinellis to be reasonable. Though MOE was not a participant in the settlement at the arbitrations, MOE had the opportunity to challenge the award before two other tribunals.

The *Paulson* decision demonstrates that while Washington insurers are encouraged to defend under reservation of rights and file declaratory judgment actions, the insurer must make certain that discovery and investigation in the declaratory judgment action does not "interfere" with the underlying action.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact William F. Knowles in Seattle at 206-224-1289 or wknowles@cozen.com.

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