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## ARIZONA APPELLATE COURT PRECLUDES INSURER FROM DENYING COVERAGE BECAUSE OF DELAYED RESERVATION OF RIGHTS

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An Arizona appellate court recently refused to apply the “your work” exclusion where an insurer delayed 18 months in reserving its right to deny coverage. *Pueblo Santa Fe Townhomes Owners' Association Inc. v. Transcontinental Insurance Co. and Transportation Insurance Co.*, 2008 WL 714285, No. 1 CA-CV 07-0215 (Ariz. App. March 13, 2008).

In *Pueblo Santa Fe*, the Pueblo Santa Fe Townhomes Owners' Association Inc. (the “Association”) sued a subcontractor for defective exterior stucco work that led to water intrusion. The subcontractor’s insurers initially defended against the claim, but failed to notify their insured for 18 months that they intended to raise the “your work” exclusion as a defense to paying on a claim for damage to the actual faulty work as opposed to resulting damage to other property. The insurers later filed a declaratory judgment action, claiming that they had no duty to indemnify the insured for damages other than those resulting in damages to other property. The Association and the insured subsequently stipulated to a judgment and entered into an agreement assigning the insured's rights under the policy to the Association.

After argument, the trial court concluded that the insurer’s delay in reserving its rights prejudiced the insured because the subcontractor did not have the opportunity to have its own expert participate in destructive testing that took place without its knowledge to determine the cause of the water intrusion. Further, the trial court

noted that a conflict of interest arose between the insurers and insured when the insurers were aware of the potential coverage defense, but that the insured was not afforded an opportunity to defend itself independent of the insurer given that it was provided no notice of the insurers' reservation of rights.

The Arizona appellate court agreed with the trial court and rejected the insurers' argument that granting the Association whatever estoppel rights the insured possessed gave the Association an unfair windfall. The equities did not favor the insurers, the appellate court reasoned, as the insurers should not be able to avoid the consequences of their conduct simply because the insured chose to protect itself from the risk of litigation by assigning its rights. It concluded that the consequences of the insurers' failure to promptly notify the insured of its coverage defense do not vanish simply because the insured has assigned its right to coverage to another party.

The *Pueblo Santa Fe* Court invoked long-standing precedent in concluding that an insurer is equitably estopped from denying coverage because of its delay in issuing a reservation of rights letter, even where the insured has insulated itself from all liability by virtue of its agreement with the Association. Thus, while the Court emphasized that prejudice to the insured is required to apply the estoppel doctrine, the prejudice established in this action was merely superficial because the insured was not exposed to any liability. The *Pueblo Santa Fe* decision underscores the importance of an insurer properly and timely communicating its reservation of rights to its insurer to avoid liability for uncovered damages.

*For a balanced analysis of the Pueblo Santa Fe decision and its impact on construction industry insurers, please contact Joe Bermudez, Chris Clemenson, Jason Melichar or Suzanne Meintzer of Cozen O'Connor's Denver, Colorado office. Cozen O'Connor is a nationally recognized leader in representing the insurance industry in all coverage areas, including construction defect claims.*

*The analysis, conclusions, and/or views expressed herein do not necessarily represent the position of the law firm of Cozen O'Connor or any of its employees, or the opinion of any current or former client of Cozen O'Connor.*