10-18-2011

Employers Mut. Cas. Co. v. Donnelly Respondent's Cross Appellant's Brief Dckt. 38623

IN THE SUPREME COURT OF THE STATE OF IDAHO

EMPLOYERS MUTUAL CASUALTY COMPANY, an Iowa corporation, Appellant/Respondent, vs. DAVID DONNELLY and KATHY DONNELLY, husband and wife, Respondents-Cross Appellants,	)	Docket No. 38623-2011

RESPONDENTS/CROSS-APPELLANTS' BRIEF

Appeal from the District Court of the First Judicial District of The State of Idaho, in and for the County of Bonner

Honorable Steven C. Verby

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STATEMENT OF THE CASE

Preliminary note: As authorized by Rule 34(c), I.A.R., the respondents and cross-appellants, Kathy Donnelly and David Donnelly ("Donnellys") choose to consolidate their opening brief opportunities into this single brief. With some exceptions, the Donnellys can find no glaring errors in the "Statement of the Case" contained in the appellant brief of Employers Mutual Casualty Company ("EMC"). The below discussion is intended, primarily, to augment and clarify EMC's Statement of the Case.

Nature of the case: Prior to the verdict in the underlying litigation, plaintiff EMC filed this declaratory judgment action seeking an adjudication that EMC owed no contractual duty under the applicable insurance policy to pay damages awarded by the underlying jury to the Donnellys ($128,611.55) or to pay the costs and attorney fees awarded ($296,933.89) against its insured Rimar Constructions, Inc. ("RCI"). Subsequent to the verdict in the underlying litigation, summary judgment was entered in this case.

In this action, the district court ruled in summary judgment proceedings that there is no insurance coverage for the underlying compensatory damages incurred by the Donnellys but that there is coverage for the awarded costs and fees. The district court also denied Donnellys' requests for attorney fees incurred in this declaratory judgment action. Now this appeal and cross-appeal.

Proceedings and disposition below: Prior to the entry of judgment in this case, EMC and its insured RCI had entered into a settlement agreement wherein RCI agreed not to contest EMC

allegations in this action (Exhibit J to Reid affidavit).[1] At the time the district court entered judgment consistent with its above findings of coverage and non-coverage, he also entered the following order pursuant to the stipulation of the parties:

> That plaintiff Employers Mutual Casualty Company . . . shall not assert any defense, whether by claim of avoidance or otherwise, in reliance on the Settlement Agreement [with RCI] . . . in this action or in any subsequent appeal, to the on-going and continuing standing of the defendants David and Kathy Donnelly to seek the recovery or payment of monies direct from the plaintiff Employers Mutual Casualty Company in satisfaction of the *Amended Judgment On Special Verdict With Regard to Claims of Plaintiffs and Defendant Rimar Construction, Inc.*, entered in Donnelly v. Rimar Construction, Inc. et al, Case No. CV-06-00445 (Bonner County, Idaho).

R. Vol. 3, p. 511.

Upon entry of the judgment following summary judgment proceedings, EMC appealed the district court's judgment with respect to the the decision that the award of attorney fees and costs to the Donnelly's ($296,933.89) is a covered liability under EMC's policy. The Donnellys cross-appealed from the district court's decision that there is no coverage respecting the jury's finding of compensatory damages ($126,611.55).[2] The Donnellys also appeal from the district court's Order Granting Plaintiff's Motion to Disallow Costs and Fees (R. Vol. 3, pp. 541-545).

STATEMENT OF FACTS

Motion for summary judgment initially denied: In this construction case, involving an

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[1] Hereafter all citations to "lettered" exhibits refer to those exhibits originally attached to the Affidavit of James Reid (R. Vol. 2, pp. 202-205). In preparation of the clerk's record, these exhibits were attached to EMC's motion for summary judgment and neither the motion nor the exhibits are paginated.

[2] Donnellys do not appeal the district court's decision that there is no coverage for the jury award of damages under the Consumer Protection Act ($2000).

addition to an existing residence, the district court initially concluded in summary judgment proceedings that there was a question of fact whether the alleged damages were contract based or tort based. (R. Vol. 2, pp. 317-324). The resolution of this factual issue would, in turn, resolve the coverage issue, i.e., if the damages arose from a contract breach, there is no coverage; if tort based, there is coverage. (*Id.*, p. 322). Accordingly, EMC's assertion that the material facts were "essentially stipulated to" is not correct (Appellant's Brief, p. 2).

Allegations of underlying complaint: The Amended Verified Complaint ("Underlying Complaint") alleges both contract and tort damages:

> 10. Defendant RCI's material breaches of contract include, but are not limited to the following actions, which have resulted in the following accidental, additional, incidental, collateral, consequential and/or negligent damage and injury:
>
> > a. Defendant RCI failed to construct an addition on the front of the home that is structurally sound and safe for use. The addition is not properly constructed, properly attached, and/or properly supported by the structure of the original home. The addition has also compromised the integrity of the original home, including but not limited to causing strain on the original structure, breaking windows, buckling and warping the wall, causing the roof line to sag, and other problems with the original home. Said failures and damage have cause (sic) a diminution in the value of the home.
>
> 11. As a direct and proximate result of Defendant RCI's material breaches of contract, Plaintiffs have suffered substantial damages, including but not limited to damage to property, physical injury to tangible property, loss of use regarding said property and damages, damages for repair of defective work, damages for construction delays, damages for failure to comply with governmental rules and regulations, damages for the diminution to the value of the home, attorney fees, and such other damages as may hereafter be discovered or proven at trail. Said damages substantially exceed $10,000.

Exhibit B, pp. 5, 6.

Thus, as can be seen, the Underlying Complaint seeks damages respecting that portion of the residence not under construction which damages arise from negligence.

The Underlying Complaint also alleges Kathy Donnelly became violently ill as a result of a carbon monoxide leak. (*Id.*, p. 5). However, there is no claim for medical bills, wage loss or pain and suffering in the Underlying Complaint. In an Order in Limine (Exhibit C, p. 2), the district court ruled that Ms. Donnelly "may not discuss or mention the fact that she was sick or that her sickness was caused by the stove . . ."

EMC's reservation of rights: In the reservation of rights letter sent to RCI by EMC, EMC concedes that the Donnellys "do not include a claim for bodily injuries" in the Underlying Complaint. (Exhibit I, letter of September 5, 2006, p. 2). However, in that same letter EMC points to provisions in the policy which requires EMC to indemnify for "property damage", i.e., "physical injury to tangible property, including all resulting loss of use". EMC concedes that "the loss of use of the plaintiffs' property is apparent property damage". *Id.*, p. 5. The full policy is Exhibit A.

EMC's reservation of rights letter erroneously recites: "Here there are no allegations of physical injury to tangible property (Exhibit I, p. 4). Paragraph 10(a) of the Amended Verified Complaint alleges such injury to the "original home".

Excerpts from EMC's claims investigation file (R. Vol. 2, pp. 265-271), corroborates EMC's perception that the Donnellys were seeking damages to property outside the construction zone and not merely damages for faulty workmanship:

> under para 10 it appears they are saying that the improperly constructed addition, and porch has compromised the original structure in that it is

> buckling walls, breaking windows, causing the roof line to sag and other problems–this is new infor
>
> clmnt is alleging that the improper workmanship has led to a diminution in value to the home and that parts of the home are unsafe to the point of being uninhabitable, loss of use and also lists other non-specific damages.

Id., p. 267.

Given the foregoing allegations by the Donnellys and the acknowledgment of those allegations, it is somewhat facile and incorrect for EMC to argue in its Statement of Facts that "[i]t was because of the allegation [of carbon monoxide poisoning] that EMC had provided a defense to RCI . . ." (Appellant's Brief, p. 8). The carbon monoxide event is being used by EMC, pretexually, to justify its defense, ignoring its acknowledgment in reservation of rights letters (Exhibit I) that "physical injury to tangible property" is a covered liability.

EMC's reservation of rights letters advised RCI that "it may withdraw its defense if it is later determined that there is no coverage. However, EMC continued its defense even after the Order in Limine (Exhibit C) precluding the Donnellys' reference to Mrs. Donnelly's episode of sickness. Exhibit I (both letters), i.e., undercutting the assertion that the allegation of Mrs. Donnelly being sickened was the only reason a defense was being provided RCI (Appellant brief, p. 8).

In its Conclusion to the reservation of rights letters, EMC advised that it had "attempted to identify all of the coverage considerations related to this claim". However, the record is barren as to EMC's notification to RCI of the conflict of interest extant in the failure to request an allocated verdict given the coverage issues articulated in Exhibit I. Of the thirty-nine interrogatories submitted to the jury in the verdict form (Exhibit E), there is no permutation of "yes/no" answers which would result in coverage under EMC's policy. Specifically, the verdict form fails to inquire of the jury

whether RCI was negligent which negligence damaged property which was not part of RCI's construction work.

Interrogatories/instructions to jury: It is undisputed that EMC retained an attorney (Chris Hansen) to defend RCI against the Underlying Complaint. (R. Vol. 2, p. 271; Exhibit I).

The jury verdict included an interrogatory as to whether RCI had "breached the implied warranty of workmanship". Exhibit E. The instructions advised the jury that breach of the implied warranty of workmanship occurs by "failing to perform the agreed upon construction in a workman like manner". See Exhibit D, Instruction Nos. 47 to 51.

There was no instruction which requested the jury to determine whether the damage was with respect to faulty workmanship (no coverage) or with respect to "physical injury to tangible property", respecting which there is coverage. See Exhibit A, section V.17. Also, there was no instruction respecting the allegation that RCI was negligent which negligence caused property damage.

The damages awarded by the jury ($126,611.55) was in response to interrogatories respecting breach of the implied warranty of workmanship.

> Question No. 6: Did Rimar Construction, Inc., breach the implied warranty of workmanship with regard to the manner in which it constructed the Donnelly remodel project and did such breach, if any, cause damage to the Donnellys?
>
> **Answer to Question No. 6: Yes**
>
> Question No. 30: If you determined that Rimar Construction, Inc., breached the express warranty with the Donnellys and the Donnellys are entitled to receive damages, what is the total amount of damages you award for breach of express warranty for the Donnellys?
>
> **Answer to Question No. 30: $126,611.55**

Exhibit E, pp. 3, 8.

Again, there were no jury interrogatories on the verdict form as to whether RCI was negligent and whether that negligence was the proximate cause of damage to the Donnellys.[3] Although the jury found that RCI was in breach of contract (Exhibit E, Question No. 3), it concluded there were no damages arising from that breach (Exhibit E, Question No. 26).

District Court's conclusion that the Donnellys' damages ($126,611.55) were contract based and were not covered by EMC's policy (R. Vol 3, p. 489). The district court recognized that "there are no Idaho appellate cases which have decided whether the breach of the implied warranty of workmanship is contract based or tort based" (R. Vol. 3, p. 479). The Court then ruled that (1) RCI's liability was contract based (notwithstanding the jury found no damages for contract breach) and (2) that the EMC policy did not provide coverage:

> EMC's Commercial General Liability insurance policy does not act as a performance bond; and it does not provide for payment of damages resulting from a breach of contract. In fact, such damages are excluded from coverage. *Because no award was made by the jury for any tort cause of action that was pled and submitted,* and because the breach of the implied warranty of workmanship as presented in the underlying case was a contract related breach, EMC has no obligation to pay the compensatory damages in the amount of $126,611.55 previously awarded to the Donnellys.

R. Vol. 3, p. 483 (emphasis added).

There was no award for "any tort cause of action" because the verdict form did not contain this

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[3] There were jury interrogatories as to whether RCI was negligent as an architect or as an engineer or whether RCI committed fraud (*Id.*, p. 5) which were answered in the negative and for which there is no coverage in any event (Exhibit I to Reid affidavit, p. 6 of September 7, 2007, letter).

question (Exhibit E).

District Court's conclusion that the award of costs and fees is a liability covered by EMC's policy: The district court concluded that this coverage question is controlled by *Mutual of Enumclaw v. Harvey,* 115 Idaho 1009, 773 P.3d 216 (1989). That is, the "Supplementary Payments" coverage (for awarded costs and fees) exists, where EMC provides a defense and whether or not it is ultimately determined that there is a covered liability under the policy. That is, the district court ruled that RCI has coverage for costs and fees assessed against it. (See Exhibit A, p. 7 of 16).

District Court's conclusion that the Donnellys are not entitled to attorney fees under Idaho Code §41-1839: The district court rejected Donnellys' claim for fees under this code section because (1) Donnellys are not an insured under the EMC policy, and (2) Donnellys "provided no evidence that proof of loss has been furnished as provided in such policy" (R. Vol 3, p. 544). Also, the district court ruled that the Donnellys are not entitled to fees under Idaho Code §12-120(3) because of the "absence of a commercial transaction between the Donnellys and EMC" (R. Vol 3, p. 545).

District court's conclusion that the Donnellys are entitled to interest on the $296,933.89 judgment: (R. Vol. 3, p. 489): The Donnellys anticipate that EMC will take the position that this interest should be characterized as post-judgment interest, not pre-judgment interest pursuant to Idaho Code §28-22-104, i.e., the Donnellys stand in the shoes of RCI in this regard.[4]

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[4] If EMC is correct that the Donnellys stand in the shoes of RCI in this declaratory judgment action and are only entitled to the judgment rate of interest (not pre-judgment interest), it would follow, as RCI's alter ego, the Donnellys are entitled to attorney fees under Idaho Code §41-1849.

STATEMENT OF ISSUES PRESENTED

Coverage for damage award:

1. In view of the jury's finding of (a) no contract damages, (b) the ambiguity presented by the EMC policy respecting exclusions from coverage, and (c) EMC's breach of duty in not seeking an allocated verdict, should the district court be instructed to enter a declaratory judgment for the Donnellys, to wit, that the EMC policy provides coverage for the damage award ($126,611.55)?

2. In view of the jury's finding of (a) no contract damages, (b) the ambiguity presented by the EMC policy, and (c) the requirement that all inferences are to be drawn in favor of then nonmoving parties (the Donnellys), did the district court err in concluding, in favor of EMC, that there was no genuine issue of material fact respecting absence of coverage under the policy for Donnellys' compensatory damages ($126,611.55)?

3. As to coverage under the EMC policy for the Donnellys' compensatory damages, should the matter be remanded for litigation of the following issues: (1) whether EMC adequately disclosed to the insured RCI the availability of an allocated verdict; (2) if it did not, whether Donnellys can meet their burden of proving that all or a portion of the assessed damages constitute covered liabilities under EMC's policy?

Coverage for costs and fees awarded:

4. Where EMC's policy provides that it will pay all costs taxed against the insured RCI in any suit against RCI which EMC defends, was the district court correct in concluding that costs and fees awarded the Donnellys ($296,933.89) constitute a

covered liability under the EMC policy?

Attorney fees:

5. Because the Donnellys are the "person[s] entitled" to "the amount justly due" under EMC's policy and the jury verdict constitutes the proof of loss (or the policy does not require a proof of loss), did the district court err in concluding that the Donnellys are not entitled to attorney fees under Idaho Code §41-1839?

Attorney fees on appeal:

6. Whether the Donnellys are entitled to attorney fees on appeal pursuant to Idaho Code §41-1839.

ARGUMENT

STANDARD OF REVIEW

In reviewing the ruling on a summary judgment motion, this Court applies the same standard as that applied by the district court, i.e., there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. *Goodman v. Lothrop,* 143 Idaho 622, 626, 151 P.3d 818 (2007).

The fact that the district court here was presented with cross-motions for summary judgment (R. Vol. 2, p. 329) does not transform the district court, in such circumstance, into a trier of fact, i.e., the standard of review articulated above remains intact.

In the context of construing insurance policies, determination of whether a policy provision is ambiguous is a question of law subject to free review. *Western Heritage Ins. Co. v. Green,* 137 Idaho 832, 835, 54 P.3d 948 (2002).

SUMMARY OF ARGUMENT

(1) Coverage for the damage award as matter of law: (1) The implied warranty of workmanship necessarily creates two levels of protection for the purchaser of a contractor's services: (a) that there will be no faulty workmanship respecting the work which is the subject of the contract; and (b) that the contractor will do nothing to damage the purchaser's property outside the construction zone. That latter protection is redundant to common law of torts, i.e., if an actor is negligent, he must compensate the victim for that negligence, irrespective of the existence of a contract. The EMC policy only excludes contract-based liabilities. An ambiguous policy provision which seeks to exclude the insurer's coverage must be strictly construed in favor of coverage . *Arreguin v. Farmers Ins.*, 145 Idaho 459,461, 180 P.3d 498, 500 (2008).

The conclusion that coverage exists is corroborated by the jury's finding of no contract damages, i.e, the only other alleged basis of liability was tortious conduct, a covered event under the EMC policy.

Finally, as argued more fully below, EMC, through its retained counsel, breached its duty to RCI in not obtaining an allocated verdict which would clarify the coverage issues, e.g., there was no jury interrogatories which queried the existence of negligence and property damage outside the construction zone.

The cumulative impact of these factors (ambiguous coverage exclusion, finding of no contract damages, and the absence of an allocated verdict) requires that the summary judgment against coverage for the compensatory damages ($126,611.55) be vacated and judgment entered in favor of the Donnellys. Given the jury's finding of no contract damages, it would be redundant and punitive to

order the Donnellys back to trial respecting issues which, but for EMC's breach of duty, should have been addressed in an allocated verdict.

(2) In the alternative, a genuine issue of material fact exists as to whether there is coverage for the underlying damage award of $126,611.55: In addition to those factors identified in paragraph (1), which undercut the correctness of summary judgment, an inference must be drawn in favor of the Donnellys, as the nonmoving parties, that the damage award is a covered liability under the EMC policy. At the very least, there exists a genuine issue of material fact as to coverage for the $126,611.55 damage award, and the summary judgment on this issue must be vacated and the matter remanded for trial.

(3) Coverage for costs and fees: The EMC policy recites:

> **SUPPLEMENTARY PAYMENTS - COVERAGES A AND B**
> 1. We will pay, with respect to any claim we investigate or settle or any "suit" against an insured we defend:
> a. All expenses we incur . . .
> e. All costs taxed against the insured in the "suit". . .
>
> These payments will not reduce the limits of insurance.

Exhibit A, Section I.

The district court correctly concluded that an Idaho Supreme Court decision is directly on point and that EMC, because of the language of the policy and the proffered defense, was required to pay RCI's taxed costs and fees irrespective of the existence of coverage. See *Mutual of Enumclaw v. Harvey,* 115 Idaho 1009, 1012, 772 P.2d 216 (1989) (R. Vol 3, pp. 487-489). Apart from the clear language of the policy, because EMC controlled the defense, EMC should bear the consequences of its "case management decisions", including the risk that "the trial court may tax the opponent's costs

against the insured". *Id.,* 115 Idaho at 1012.

(4) Donnellys' entitlement to attorney fees in the case at bench (at the district court level and on appeal): Idaho Code §41-1839 provides that an insurer who, under its insurance policy, fails to "pay the person entitled thereto the amount justly due" shall pay the claimant's attorneys in any subsequent litigation adjudging the insurer liable. The district court erroneously ruled that the Donnellys did not qualify for attorney fees under §41-1839 because (1) they were not insureds under the EMC policy and (2) they failed to submit evidence that "proof of loss" was furnished to EMC.

In *Mutual of Enumclaw v. Harvey, supra,* the insurance company filed a complaint against the plaintiff in the underlying action who had recovered a judgment against Enumclaw's insured, one Bruce Oaks. In holding that the plaintiff, the underlying injured plaintiff, was entitled to attorney fees, the Supreme Court opined:

> In order to receive fees under this statute (§41-1839), the party must prevail in the litigation [citation omitted]. Where the insurer denies any liability, it waives the requirement that proof of loss be furnished as a prerequisite to recovery of attorney fees [citation omitted]. In a declaratory action, a person entitled to an amount justly due under the policy may recover attorney fees at the trial level and also on appeal.

Id., 115 Idaho at 1015.

The Donnellys were the "person[s] entitled to the amount justly due" under the policy and EMC had denied liability, thereby waiving the requirement of proof of loss. In the case of a claim based upon an individual's liability, the amount "justly due", as referenced in §41-1839, "can only be resolved in retrospect, in a court of law, by the jury" *Brinkman v. Aid Insurance,* 115 Idaho 346, 350, 766 P.2d 1227 (1988). Therefore, proof of loss could not be furnished until such time as the verdict was rendered in the underlying litigation and the court ruled on attorney fees (at which proceedings

EMC's attorney was present).

Finally, §41-1839 refers to "proof of loss . . . as provided in such policy". The EMC policy (Exhibit A) is a liability policy and there is no proof of loss provision. It would be absurd for RCI to submit an unprivileged statement of proof of loss, thereby admitting its liability for Donnellys' alleged damages.

The Donnellys are entitled to an award of attorney fees both in the district court and on this appeal.

AS RESPECTS COVERAGE FOR THE $126,611.55 JURY AWARD, COVERAGE SHOULD BE FOUND AS A MATTER OF LAW BECAUSE OF THE JURY FINDING OF (1) NO CONTRACT DAMAGES AND (2) EMC'S BREACH OF ITS DUTY TO RCI TO IMPLEMENT AN ALLOCATED VERDICT

In finding that the Donnellys incurred no contract damages (Exhibit E, p. 7, Question No. 26), the jury was left with only one basis of liability, i.e., tort damages. In its reservation of rights letters Exhibit I, EMC erroneously asserts that "[h]ere there are no allegations of physical injury to tangible property". This statement is belied by EMC's own claim investigation file, e.g., the Donnellys "are saying that the improperly constructed addition and porch has compromised the original structure in that it is buckling wall, breaking windows, causing the roof line to sag and other problems–this is new info" (R. Vol. 2, p. 267).

Notwithstanding the absence of contract damages and the presence of undisputed extra-contractual damages, EMC, in failing to insist upon an allocated verdict, is now able to allege that (1) there is no coverage for RCI and (2) impose upon the Donnellys the "impossible burden" of divining the jury's collective ratiocination in order to reverse the "catastrophic" loss of coverage. *Buckley v. Orem,* 112 Idaho 117, 124, 730 P.2d 1037 (Ct. App. 1986); *Duke v. Hoch,* 468 F.2d 973, 979 (5th Cir.

1972). The duty imposed upon EMC to embed an allocated verdict and the wisdom of that duty is discussed in the next section and incorporated herein by reference. A sample of the rationale underlying the requirement of an allocated verdict is found in *Duke v. Hoch:*

> Home [the insurer], in control of the defense, has protected its interest and secured for itself an escape from responsibility at the expense of the insureds, who remain personally liable for the full judgment . . . The consequence to the insureds of a nonallocated verdict is the catastrophic loss of coverage. . . Assuming as we must that the jury will follow instructions and make a correct allocation, the insurance company loses no benefit to which it is validly entitled from having the jury earmark the losses.

Id., 468 F. 2d at 979 (bracketed material explanatory).

Conclusion: For all of the above reasons, coverage for the $126,611.55 should be imposed as a matter of law.

ALTERNATIVELY THE MATTER SHOULD BE REMANDED TO THE DISTRICT COURT FOR FURTHER PROCEEDINGS BECAUSE (1) THE DONNELLYS ARE ENTITLED TO FAVORABLE INFERENCES AS NONMOVING PARTIES, (2) AMBIGUITIES IN THE EMC POLICY ARE TO CONSTRUED IN FAVOR OF COVERAGE, AND (3) EMC FAILED, THROUGH ITS RETAINED ATTORNEY, TO REQUEST AN ALLOCATED VERDICT

In view of (1) the inferences to which the Donnellys are entitled as nonmoving parties and in view of (2) the principle that the ambiguous EMC policy must be strictly construed in favor of coverage, a material question of fact exists as to whether the jury's award ($126,611.55) is a covered liability under the EMC policy.

Some fundamental truths: The EMC policy does not cover RCI's liability when that liability arises from contractual obligations. As correctly noted in EMC's reservation letter (Exhibit I): "Contractual damages result in economic loss and not property damages", e.g., faulty construction of

a banister which the insured was contractually obligated to construct is an economic loss not covered.

Also, as correctly noted in EMC's reservation letter:

> For property damage to occur [a covered event], there must be a physical change or alteration. "Physical injury" to tangible property has been found when property was *altered* in appearance, shape, color, or in another material dimension.

Exhibit I, p. 4 (letter of September 4, 2006) (explanatory material in brackets).

As this Court noted in *Aardema v U.S. Dairy Systems, Inc.*, 147 Idaho 785, 791, 215 P.3d 505 (2009): "Economic loss is distinguishable from property damage, which would be recoverable under a tort claim. "Property damage encompasses damage to property other than that which is the *subject of the transaction*" (citations omitted).

Given the existence of alleged damage which is covered by the EMC policy and damage which is not covered, the Donnellys are entitled to an inference, as nonmoving parties, that a portion of the jury award included compensation for covered damages: The Amended Verified Complaint by the Donnellys alleges damage to property which is not "the subject of the transaction" arising out of RCI's negligence:

> The addition [constructed by RCI] has also compromised the integrity of the original home, including but not limited to causing strain on the original structure, breaking windows, buckling and warping the wall, causing the roof line to sag, and other problems with the original home.

Exhibit B, para. 10(a).

Excerpts from EMC's claims investigation file corroborates that Donnellys are complaining of property damage to property which is not the subject of the contractual transaction and does not constitute economic loss. See *supra,* pp. 5, 6.. The implied warranty of workmanship covers faulty

workmanship respecting the "subject of the transaction"(*Aardema*) as well as damage to property which is outside the scope of the defendant's work, i.e., construction of the addition to the Donnelly residence which adversely impacted the "original structure".

That the work is being done pursuant to a contract does not, by itself, insulate the contractor from tort liability. As noted by William Prosser:

> Misfeasance or negligent affirmative conduct in the performance of a promise generally subjects the actor to tort liability as well as contract liability for physical harm to persons and tangible things.

Prosser & Keeton on Torts, (West, Fifth Edition), p. 656.

The co-existence of contract and tort liability was recognized in *Aardema v. U.S. Dairy Systems, Inc.,* 147 Idaho 785, 215 P.3d 505 (2009):

> Negligence and breach of contract are "two distinct theories of recovery" [citation omitted]. "Ordinarily, breach of contract is not a tort, although a contract may create the circumstance for the commission of a tort . . ."

Id., 147 Idaho at 790.

That is, where work under the contract is undertaken negligently and proximately causes damage to property which is not the subject of the contract, the Donnellys have two arrows in their quiver: (1) the contract implies that they will do the work in journeyman-like manner and that, during the work correctly done, RCI will undertake due care in not damaging property which is not the subject of the contract; (2) this latter duty tracks common law negligence which exists irrespective of the existence of a contract, imposing a duty on RCI with respect to property outside the construction zone, i.e., "a contract may create the circumstance for the commission of a tort. *Id.,* 147 Idaho at 490.

The EMC policy does not provide coverage for (1) but does provide coverage for (2), i.e.,

property damage arising from RCI's negligence which property is not the subject of the contract ("the original structure"). An example of the judicial treatment of this issue is found in *Western Heritage Insurance v. Green,* 137 Idaho 832, 54 P.3d 948 (2002). The district court found that a court trial should be held because there were issues of material fact whether the alleged damage was covered under the applicable insurance policy. *Id.,* 137 Idaho at 834.

Ambiguity in the EMC policy must be construed against EMC: EMC may argue that, as long as the implied warranty of workmanship arises from the contract and pertains to damage to property not the subject of the transaction ("the original structure"), the co-existence of tort-based liability is not sufficient to establish coverage. EMC's reservation of rights letters recognize the existence of RCI's potential liability in both tort and contract.

> The language in the CGL policy's insuring agreement "legally obligated to pay as damages" refers to liability imposed by tort law, but not liability resulting from contract law. Defects in an insured's performance are the result of a breach of contract. Contractual damages result in economic loss and not property damage.

Exhibit I (September 5, 2006, letter and September 7, 2007, letter, p.4).

However, EMC's policy fails to recite that where there exist multiple bases for liability (contract and tort), whether the exclusion still applies. Given this ambiguity, the policy must be strictly construed against EMC who has the burden of clarity when it seeks to restrict the scope of coverage:

> When we determine whether a policy is ambiguous we ask "whether the policy is subject to conflicting interpretation. [citations omitted]. A provision that seeks to exclude the insurer's coverage must be strictly construed in favor of the insured [citation omitted]. The "burden is on the insurer to use clear and precise language if it wishes to restrict the scope of coverage."

Arreguin v. Farmers Ins. Co., 145 Idaho 459, 461, 180 P.3d 498 (2008).

The district court failed to consider the absence of contract damages and the absence of jury interrogatories addressing the lay negligence of RCI: In reaching its decision that the breach of the implied warranty was contract-related, the district court opined:

> Because no award was made by the jury for any tort cause of action that was pled and submitted, and because the breach of the implied warranty of workmanship as presented in the underlying case was a contract related breach, EMC has no obligation to pay the compensatory damages in the amount of $126,611.55 previously awarded to the Donnellys.

R. Vol. 3, p. 483.

There are two features of the underlying litigation which the district court ignores: (1) the jury did not make any explicit award against RCI for the Donnellys' tort allegation because there was no interrogatory in the verdict form which asked that question;[5] and (2) the jury did explicitly conclude that there were no "contract" damages (Exhibit E, p. 7, Question No. 26). Given the fact that tort and contract were the only asserted bases for RCI's liability, the damage award based on the implied warranty of workmanship must be tort based in view of the absence of contract damages. At least, the Donnellys are entitled to a favorable inference in that regard in these summary judgment proceedings.

The district court's award of attorney fees is not relevant to the coverage issue: The award of fees in the underlying litigation is not inconsistent with the Donnellys' claim of tort-based property damage. As long as the tort is committed in a commercial context, attorneys fees under Idaho Code

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[5]Questions Nos. 15, 17, 20 and 22 in the verdict (Exhibit E) inquired as to the negligence of RCI and Ivan Rimar as architects an engineers. These questions were not answered because the jury concluded that the defendants were not acting in that capacity. See answers to questions Nos. 13, 16, 18, and 21. In any event, the policy (Exhibit A) does not cover liability for engineering or architectural services. See "Professional Liability" endorsement to policy.

§12-120(3) must be awarded to the prevailing party.

> From time to time the Court has denied fees under I.C. § 12-120(3) on the commercial transaction ground either because the claim sounded in tort or because no contract was involved. The commercial transaction ground in I.C. § 12-120(3) neither prohibits a fee award for a commercial transaction that involves tortious conduct, nor does it require that there be a contract. Any previous holdings to the contrary are overruled.

City of McCall v. Buxton, 146 Idaho 656, 665, 201 P.3d 629 (2009)

Conclusion: Reversal is required in view of the Donnellys' entitlement to a favorable Rule 56 (c) inference as well as the principle that ambiguities in an insurance policy shall be strictly construed in favor of the insured. In this declaratory judgment action seeking clarification of coverage, "the injured party [the Donnellys] stand in the shoes of the insured party." *Buckley v. Orem,* 112 Idaho 117, 124, 730 P.2d 1037 (Ct. App. 1986). Accordingly, the Donnellys are entitled that any ambiguity in the policy be construed in favor of coverage. The EMC policy fails to address whether the exclusion for contract-based liability continues to pertain when there is simultaneous tort-based liability for the property damage to property which is not the subject of the transaction. This creates an ambiguity which, under principles governing the interpretation of insurance policies, requires an interpretation that the exclusion is not applicable to the damages arising from the breach of the implied warranty of workmanship.

Likewise, as nonmoving parties, the Donnellys are entitled to all favorable inferences. *Willie v. Board of Trustees,* 138 Idaho 131, 133, 59 P3d 302 (2002). A reasonable inference here is that, since the jury found no contract damages, the damages assessed for breach of the implied warranty of workmanship are tort-based, entitling RCI to coverage under the policy.

Because there is no record that EMC, as insurer, complied with its duty and made known to its insured, RCI, the availability of an allocated verdict in the underlying action, the matter should be remanded for resolution of the factual issue of allocation.

Preliminary note: EMC devotes several pages of its brief to arguing that the underlying verdict was an allocated verdict, evidencing, by implication, EMC's recognition of its duty to RCI in that regard. See discussion in next section. Although EMC references the term "allocated" seven times (Appellant Brief pp. 24-30), it fails to cite a single case dealing with the issue of the insurer's duty to seek an allocated verdict. EMC's sole reliance is on *Magic Valley Potato Shippers v. Continental Insurance,* 112 Idaho 1073, 739 P.2d 372 (1987). The case is not helpful. Unlike the case at bench, the complaint in *Magic Valley* sounded solely in contract, i.e., the underlying litigation there "was an action for breach of contract, and did not involve any claim for damages in tort" *Id.,* 112 Idaho at 1076.

The underlying verdict was not an allocated verdict: The verdict form ultimately submitted to the jury (Exhibit E) did not address the Amended Verified Complaint's allegations of negligent conduct against RCI. Nor did the verdict form address, in the event liability was found, whether the property damaged was or was not the "subject of the transaction". What is meant by the term "allocated verdict" is described by the Idaho Court of Appeals in discussing a Fifth Circuit decision:

> In *Duke,* in the injury trial, no request was made by the injured party (Duke) or by the insured (Hoch & Associates) for an allocated verdict. Later, in the garnishment action, Hoch's insurer invoked the defense that Duke could not show what part of his verdict was for negligently caused injuries, covered by the policy, and what part was for separate intentional torts which were not covered.

Buckley v. Orem, 112 Idaho at 124, referencing *Duke v. Hoch,* 468 F.2d 973 (5th Cir. 1972).

A perusal of the jury verdict in the underlying litigation (Exhibit E) indicates that it was not

an allocated verdict which contained interrogatories inquiring of the jury as to RCI's covered and uncovered liabilities. Rather, it focused solely on damages for contract liability and breach of the implied warranty of workmanship without reference to RCI's negligence for property damage which was not the subject of the transaction.

It is undisputed that EMC provided a defense to RCI, its insured: As noted in Exhibit I:

> This letter is in reference to the fact that Employers Mutual Casualty Company ("EMC") will be providing a defense and conducting an investigation in connection with the lawsuit captioned:
>
> **David Donnelly and Kathy Donnelly v. Rimar Construction, Case No. CV-06-00445, filed in District Court of the First Judicial District, Bonner County, Idaho.**

The record does not disclose that EMC or its counsel advised the insured RCI of the availability of an allocated verdict: EMC's reservation of rights letters (Exhibit I) purport to be a comprehensive disclosure of the "coverage considerations" related to the Donnelly claim, i.e., " . . . [W]e have attempted to identify all of the coverage considerations related to this claim . . ." *Id.*, p. 6. There is no reference to the need, or not, of an allocated verdict. Nor does the record disclose any subsequent communications with the insured, RCI, respecting the form of verdict.

Having assumed the defense of RCI in the underlying litigation, EMC owed a duty to RCI to disclose the need for an allocated verdict. Among the "responsibilities" which an insurer owes its insured is to "disclos[e] the need for an allocated verdict". *Buckley v. Orem,* 112 Idaho at 124.

> In *Duke v. Hoch, supra,* the Tennessee Court makes what we believe is a well-reasoned analysis of the interplay between a particular verdict form and the insurer's responsibilities when providing and directing the defense of its insured in the injury action. Thus, in *Duke,* after the trial between the injured party and the insured, when the insurer sought to

> limit its liability to the coverage provided by the contract, the insurer was required to show that it had faithfully and fully performed its responsibilities to its insured by disclosing the need for an allocated verdict.

Id., 112 Idaho at 223, 224.

The *Duke* court specifically discussed the duty of the insurance company, the breach of that duty, and the need to free the judgment creditor of the "impossible burden of proof" as to what the jury intended by its verdict:

> [A]t the merits trial [the insurer's] counsel was required to make known to the insured[s] the availability of a special verdict and the divergence of interest between [the insureds] and the insurer springing from whether damages were or were not allocated. The record before us does not indicate that counsel did so.
>
> . . . .
>
> Since on the present record the insurer failed to fully advise its insureds of the divergence of interest between it and them with respect to the verdict, the insureds [and the judgment creditor, Duke] must, subject to the possibility noted in part III, infra, be freed of the *impossible burden of proof* placed on them.

Duke v. Hoch, 468 F.2d at 979-80 (emphasis added).

The Tenth Circuit has addressed the duty of an insurer with respect to allocated verdicts:

> As an initial matter, we note that an insurer who undertakes the defense of a suit against its insured must meet a high standard of conduct [citations omitted]. One of these is the duty not to prejudice the insured's rights by failing to request special interrogatories or a special verdict in order to clarify coverage of damages.

Magnum Foods, Inc., v. Continental Casualty Company, 36 F.3d 1491, 1498 (10th Cir.1994).

The Vermont Supreme Court weighed in on this issue:

> Therefore, to protect its interests *and meet its burden* it was incumbent upon Pharmacists [the insurer] to notify the trial court and the parties of

> the potential apportionment issue and of the need for special interrogatories allocating damages, to seek permission if necessary to attend the charge conference to propose such interrogatories, or even to intervene in the litigation if all else failed.

Pharmacists Mutual Insurance Co. v. Myer, 993 A.2d 413, 420 (2010) (emphasis added).

Of course, in the case at bench, EMC has assumed RCI's defense and its attorney was actively representing the insured and was in a position to request the appropriate jury verdict. See also *Valley Bancorporation v. Auto Owners Insurance,* 569 N.W. 2d 345, 619 (Ct. App. Wis, 1997); *John Doe v. Illinois State Medical Inter-Insurance Exchange,* 599 N.E.2d 983 (Ct. App. 1992); and cases cited in *Buckley v. Orem,* 112 Idaho at 121-125.

The rationale for imposing a duty on the insurer to effectuate an allocated jury verdict is articulated in *Duke v. Hoch* as follows:

> What is to be required of the insurer with regard to the availability of an allocated verdict depends upon analysis of the interest of the parties, of the harm or prejudice that may come to them, and of the interest of effective judicial administration that absent harm there should only be one trial of the same issue. . . .
>
> Home [the insurer], in control of the defense, has protected its interest and secured for itself an escape from responsibility at the expense of the insureds, who remain personally liable for the full judgment . . . The consequence to the insureds of a nonallocated verdict is the catastrophic loss of coverage. . . Assuming as we must that the jury will follow instructions and make a correct allocation, the insurance company loses no benefit to which it is validly entitled from having the jury earmark the losses.

Id., 468 F.2d at 978 (bracketed material explanatory).

The failure to submit an allocated verdict form to the jury can be cured on remand: In *Buckley v. Orem,* the Court described the remand procedures set forth in part III of the *Duke* decision:

> However, the court remanded the case to give the insurer an opportunity to submit proof as to whether the insurer's counsel, as counsel having the right to control the defense, had adequately disclosed the situation to the insured's own counsel. If the insurer could not make such a showing then the district court was instructed to "face the issue of attempting retrospectively to allocate the damages awarded." 468 F.2d at 984.

Id., 112 Idaho at 124.

Conclusion: In view of EMC's endorsement of a verdict form in breach of its duty to the insured RCI, this Court should direct the district court to enter a judgment of insurance coverage as to the compensatory damage award in the underlying litigation. Alternatively, for each and all of the grounds referenced above, this matter should be remanded for a trial on the merits.

UNDER THE CLEAR LANGUAGE OF THE POLICY, EMC IS REQUIRED TO PAY COSTS/FEES ASSESSED AGAINST ITS INSURED RCI IRRESPECTIVE OF WHETHER THE JURY RETURNS A VERDICT WHICH CONSTITUTES A COVERED LIABILITY

The plain meaning of EMC's policy requires EMC to pay costs/fees assessed against its insured RCI where EMC assumes the defense and notwithstanding a jury verdict which is not a covered liability: The language in EMC's policy which obligates it to pay any costs and fees assessed against RCI is as follows:

> SUPPLEMENTARY PAYMENTS – COVERAGES A AND B
>
> 1. We will pay, with respect to any claim we investigate or settle, or any "suit" against an insured we defend:
>
> ...
>
> e. All costs taxed against the insured in the "suit"
>
> ...
>
> g. All interest on the full amount of any judgment that accrues after entry of the judgment and before we have

> paid, offered to pay, or deposited in the court the part of the judgment that is within the applicable limit of insurance.
>
> These payments will not reduce the limits of insurance.

Exhibit A, pp. 7, 8.

In concluding that this language required EMC to pay the assessed costs and fees in the underlying litigation, the district court correctly opined:

> This language plainly states that with respect to any suit pursued against an insured which it defends, EMC will pay all costs taxed against that insured. The language appears to be unambiguous, and thus, it must be given its plain meaning. EMC has never set forth any specific language in its policy that ties its promise to pay costs on a finding that there is coverage. Because EMC defended its insured, RCI, in the underlying litigation, EMC is responsible to the Donnellys for the $296,933.89 in fees and costs taxed against RCI in that lawsuit, as well as any interest on that judgment which has accrued.

R. Vol. 3, p. 486

EMC's initial argument is that the word "suit" is defined as "a civil proceeding in which damages because of " bodily injury", "property damage", or "personal advertising injury" to which this insurance applies are alleged" (Exhibit A, section V.18). EMC seems to be arguing that the phrase "to which this insurance applies" somehow exculpates EMC from "Supplementary Payments" of costs/fees.

The defect in this reasoning is that, by the definition of "suit", EMC is required to pay fees/costs even in those suits in which the covered liabilities ("property damage", etc) are merely "alleged". In notes contained in EMC's claim investigation file (R. Vol. 2, p. 267), EMC acknowledges that the Donnellys are seeking damages for property damage other than to RCI's constructed work, i.e., damage to the "original structure".

EMC's obligation under the policy to pay RCI's taxed fees and costs is confirmed by *Mutual of Enumclaw v. Harvey*, 115 Idaho1009, 772 P.2d 216 (1989). The language of the policy in *Enumclaw* compares to the EMC policy as follows:

EMC policy

> Supplementary Payments - Coverages A and B
> 1. We will pay, with respect to any claim we investigate or settle or any "suit"against an insured we defend: a. All expenses we incur . e. All costs taxed against the insured in the "suit".

Exhibit A, Section 1.

Enumclaw policy

> Supplemental Coverages 2. (Personal Liability Claims Expenses) a. All expenses incurred by Company and all costs taxed against the insured in any suit defended by Company.

Id., 115 Idaho at 1012.

Both policies provide that payment under these respective coverages will not reduce the insurance limits, i.e."shall not reduce the applicable limit of liability" (Enumclaw) or "will not reduce the limits of insurance" (EMC).

In concluding the language of the Enumclaw policy required Enumclaw to pay the insured's assessed attorney fees even when the insured's conduct was found to be intentional and beyond the scope of coverage, the *Enumclaw* court stated:

> Language in the policy of this case does not indicate that payment of costs is conditioned upon a final determination that the policy covers the insured's conduct. The language of the policy says that the Company will pay all costs taxed against the insured in any suit defended by the

> Company. Beyond what appears to be the clear term of the policy, it is arguable that since the Company has the right to control the defense, including the power to refuse settlement, it should also bear the consequences of its case management decisions, including the consequence that the trial court may tax the opponent's costs against the insured.

Id., 115 Idaho at 1012.

There is nothing in this analysis that would require the Enumclaw Court to reach a different conclusion as respects the language in the EMC policy.

Judicial interpretation of "Supplementary Payment" language identical to the EMC policy: Subsequent to the *Mintarsih* case, heavily relied upon by EMC and discussed in the next section, the California Court of Appeals decided *Arrowood Indemnity v. Travelers Indemnity,* 188 Cal.App. 4th 1452, 116 Cal. Rptr.3d 559 (2010). In that case, a dispute arose between two insurers respecting whose policy was in effect during the period damage was incurred. The underlying complaint alleged that a construction company negligently failed to remediate certain structures affected by dry rot. The issue was whose policy was in effect during the tortious conduct. The Court held that Travelers owed a duty to defend because, like the case at bench, the allegations of the complaint created a "potential for coverage". Also, the Court ruled that under the "Supplementary Payments" section there was coverage for the attorney fees taxed against the insured.

The Travelers' policy contained a section which required Travelers to pay "all costs taxed against the insured in the "suit". This language and the entire "Supplementary Payments" section in the Travelers' policy is identical to the EMC policy, including its heading "Supplementary Payments", which heading looms large in EMC's appellate argument. Like *Mutual of Enumclaw v. Harvey, supra,* the California Court ruled, in Arrowood, that coverage for attorney fees awarded against the insured is

dependent on the duty to defend, not on the indemnification duty:

> This supplementary payment provision has been interpreted to "make the insurer's obligation to pay an award of costs against the insured dependent on the defense duty, not on the indemnification duty (*State Farm v. Mintarsih,* 175 Cal. App.4th 274, 284 (2009).

116 Cal. Rptr. 3d at 572

The citation to *Mintarsih* indicates that the bizarre mixture of claims in that case dictated the result, i.e., there was a different factual basis for the kidnaping claims and wage and hour claims. That is, *Mintarsih* was not a deviation from the rule that the duty to defend triggers the "Supplementary Payments" coverage, irrespective of whether the jury finds a covered liability.[6]

Mintarsih distinguishable: In *State Farm v. Mintarsih*, 175 Cal.App. 4th 274, 95 Cal. Rptr. 3d 845 (2009), the plaintiff in the underlying action sought damages for certain tort allegations as well as damages under California's wage and hour statute. In the litigation, the right to attorney fees "arose solely from the wage and hour claims". *Id.*, 95 Cal. Rptr.3rd 850. The plaintiff conceded that there was no coverage under State Farm's policy for the wage and hour claims. *Id.*, 95 Cal. Rptr 3rd. 856. Under California law, the plaintiff was not entitled to attorney fees in the event she prevailed on the tort allegations (false imprisonment, negligence, fraud).

The jury returned a verdict of $87,000 for the tort damages and $745,671 on the wage and hour violations. The trial court later granted plaintiff attorney fees ($733,323.60) based upon her prevailing

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[6] EMC appears to be arguing that it really had no duty to defend, i.e., "if . . . a company defended under a reservation of rights . . . and was later found not to have a duty to defend" (Appellant brief, p. 22). If EMC believed it had no duty to defend, one is tempted to speculate as to what interest EMC sought to protect by participating in the litigation.

on the wage and hour claims and $161,591.05 on other costs. *Id.*, 95 Cal. Rptr.3rd at 850

State Farm brought a declaratory relief action, and the trial court ruled that State Farm had no obligation to pay the attorney fee award. The appellate court affirmed:

> We conclude that State Farm's obligation under the policies "supplemental payments" provisions, which promise to pay costs awarded against the insureds, extends only to costs arising from claims that were at least potentially covered under one or both of the policies. Mintarsih has not shown that the wage and hour claims that gave rise to the right to recover attorney fees were potentially covered under the policies and therefore has not established that State Farm is obligated to pay the attorney fees awarded as costs. . . . .
>
> We stated that just as an insured could not reasonably expect an insurer to pay defense costs for a suit in which there was not potential for coverage, an insured could not reasonably expect an insurer to pay costs awarded against the insured in such a suit . . . An insurer's implied-in-law duty to defend an entire "mixed" action, including claims that are not even covered does not give rise to an obligation under a supplemental payments provision to pay costs awarded against the insured that can be attributed solely to claims that were not potentially covered.

Id., 95 Cal. Rptr.3d at 849, 854, 855

Unlike *Mintarsih,* EMC in its defense of RCI was not defending a "mixed" action, i.e, the allegations against RCI arose solely out of his construction conduct and there was potential for coverage in the event of damage to property not within the scope of RCI's work. In *Mintarsih*, the wage and hour claim was, factually, a separate, discrete claim from the kidnaping claim. Also, in *Mintarsih,* it was conceded that there was no potential for coverage respecting the wage and hour claim, and the only fees assessed against the insured were with respect to this claim.

Under the Donnellys' complaint the jury should have been given the opportunity to find contract damages or negligence damages. And, unlike *Mintarsih,* because the Donnelly's claim occurred in a

commercial setting, attorney fees would be awarded whether the damages were contract-based or tort-based. *City of McCall v. Buxton,* 146 Idaho at 665.

The wisdom of the *Mintarsih* decision is that, where an insurer provides a defense "mixed" claim where there is the risk of an attorney fee assessment only with respect to alleged liabilities not covered, the insurer should not have to cover assessed fees. That is, if the potentially covered liabilities which did not carry an attorney fee entitlement were in a separate complaint, the insurer could provide a defense with no risk of an attorney fee award. The result should be no different simply because of the serendipity of the plaintiff including claims which carry fees but which are not covered, e.g., the wage and hour claims in *Mintarsih.*

The break which *Mintarsih* affords the insurers is that merely providing a defense in the absence of a duty to defend, (where there is no potential for coverage) does not trigger coverage under the supplemental payments section: "Thus, under a supplemental payments provision similar to those in this case, an insurer is obligated to pay costs awarded against an insured only if the insurer had a duty to defend the insured, regardless of whether the insurer actually provided a defense" *Id.,* 95 Cal.Rptr.3d at 854.

Conversely, if the insurer provides a defense as to claims which are both covered and uncovered and which arise out the same factual scenario, the insurer has an obligation to cover any taxed fees. *Mutual of Enumclaw v. Harvey, supra,* to wit, "the language of the policy of this case does not indicate that payment of costs is conditioned upon a final determination that the policy covers the insured's conduct". *Id.,* 115 Idaho at 1012.

EMC's characterization of *Mintarsih* underscores its inapplicability to EMC's defense of RCI:

> Thus, the California court held that if no contractual duty to defend arose, a company would not have to pay costs taxed against an insured, even if the company did defend under a reservation of rights. The rationale encourages insurance companies to provide a defense to their insureds in cases involving mixed claims.

Appellant's Brief, p. 22.

EMC misunderstands the *Mintarsih* decision. Apparently, EMC is arguing that it had no duty to defend because the district court ruled that the compensatory damages awarded against RCI were not covered. Of necessity, ascertainment of whether there is a duty to defend occurs at outset of the claim, not when the liability of the insured is ultimately determined.

The seminal California case *Gray v. Zurich Insurance Co.*. 65 Cal.2d 263, 419 P.2d 168 (1966) was quoted in *Arrowood v. Travelers Indemnity, supra:*

> An insurer, therefore bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy. In the present case. . . . Thus, even accepting the insurer's premise that had not obligation to defend actions seeking damages not within the indemnification coverage, we find, upon proper measurement of the third party action against the insurer's liability to indemnify, *it should have defended because the loss could have fallen within that liability.*

419 P.2d at 177 (emphasis added).

The insurer's duty to defend arises, if at all, at the time the underlying complaint is filed against its insured. If the insurer provides a defense because there is a duty to defend, under the language of the EMC's policy, i.e., the section entitled "Supplementary Payments", the insured is entitled to coverage for any costs and fees taxed against it. The duty to defend does not vanish, *nun pro tunc*, because a jury subsequently renders a verdict outside coverage provided by the policy. "Language in the policy of this case does not indicate that payment of costs is conditioned upon a final determination that the policy

covers the insured's conduct". *Mutual of Enumclaw v. Harvey,* 115 Idaho at 1012. As *Arrowood* held, the language in EMC's policy, which creates its obligation to cover RCI's assessed fees and costs, arises from the duty to defend, not the duty to indemnify. *Id.,* 116 Cal. Rptr. 3d at 572.

There is a sound public policy underlying the clear mandate of the EMC policy (Exhibit A):

> Beyond what appears to be the clear term of the policy, it is arguable that since the Company has the right to control the defense, including the power to refuse settlement, *it should also bear the consequences of its case management decisions, including the consequence that the trial court may tax the opponents costs against the insured.*

Mutual of Enumclaw v. Harvey, 115 Idaho at 1012 (emphasis added).

Conclusion: The district court correctly concluded that EMC's policy provided coverage for the costs and fees assessed against its insured, RCI, in the amount of $296,933.89. However, the district court erred in concluding that the Donnellys were not entitled to judgment in that amount. *Sweeney v. American Nat'l Bank,* 62 Idaho 544, 115 P.2d 109 (1941) and denying their motion to amend the judgment accordingly.

THE DISTRICT COURT ERRED IN NOT AWARDING THE DONNELLYS ATTORNEY FEES AS AUTHORIZED BY IDAHO CODE §41-1839

Preliminary note: The district court erroneously ruled that the Donnellys are not entitled to attorney fees under Idaho Code §41-1839 because (1) they were not insureds under EMC's policy and (2) did not furnish EMC a proof of loss (R. Vol. 3, p. 544). In addition, EMC erroneously argues that, because this declaratory judgment action is not for a sum certain, the statute does not apply.

Section 41-1839 states in pertinent part:

> (1) Any insurer issuing any policy, certificate or contract of insurance, surety, guaranty or indemnity of any kind or nature whatsoever, which shall fail for a period of thirty (30) days after proof of loss has been

> furnished as provided in such policy, certificate or contract, to pay to the person entitled thereto the amount justly due under such policy, certificate or contract, shall in any action thereafter brought against the insurer in any court in this state or in any arbitration for recovery under the terms of the policy, certificate or contract, pay such further amount as the court shall adjudge reasonable as attorney's fees in such action or arbitration.
> (2) In any such action or arbitration, if it is alleged that before the commencement thereof, a tender of the full amount justly due was made to the person entitled thereto, and such amount is thereupon deposited in the court, and if the allegation is found to be true, or if it is determined in such action or arbitration that no amount is justly due, then no such attorney's fees may be recovered.

Prior to the judgment being entered in the underlying case as well as subsequent thereto, EMC has denied liability for both compensatory damages and attorney fees awarded against its insured RCI. See Petition for Declaratory Relief filed May 24, 2007 (R. Vol. 1, pp. 17-24) and Plaintiff's Motion for Reconsideration filed August 23, 2010 (R. Vol. 3, pp. 457-459).

EMC concedes that EMC provided a defense to RCI in the underlying litigation (Appellant's Brief, p. 8). It is also undisputed that EMC's retained defense counsel was Chris Hansen (R. Vol. 2, p. 271). At the time of the jury verdict (Exhibit E) EMC's retained attorney was present in the courtroom, and Mr. Hansen was an addressee on the certificate of service attached to the Order on Post Trial Motions, awarding the Donnellys attorney fees in the underlying litigation. See Exhibit G, p. 15.

EMC admits, absent an allegation to the contrary in the herein action, that RCI, as its insured, has complied with the provisions of EMC's policy (Exhibit A) which is entitled "Duties in the Event of Occurrence, Offense, Claim or Suit" (*Id.*, p. 10)

EMC acknowledges that, in the event of a final judgment, the Donnellys may sue EMC for the amount "payable" under the EMC policy.

> A person or organization may sue us to recover on an agreed settlement or

> on a final judgment against an insured; but we will not be liable for damages that are not payable under the terms of this Coverage Part . . .

Exhibit A, p. 11.

The Donnellys filed a motion that the judgment in this matter be amended to include a money judgment in the amount of the fees and costs awarded by the district court in this declaratory judgment action (R. Vol 3, pp. 524, 525). The motion was denied.

Based upon these undisputed premises and the authorities set forth below, the Donnellys are "person[s] entitled" to the "amount justly due" under the EMC policy of insurance, which, in turn, validates the award of attorney fees pursuant to §41-1839. That is, by reason of the jury verdict awarding the Donnellys $296,933.89, and EMC failing to pay that amount, the statute entitles the Donnellys to attorney fees in this declaratory judgment action.

Section §41-1839 is not solely for the benefit of the insured under an insurance policy: The failure to pay insurance proceeds to "the person entitled thereto the amount justly due" does not constitute limitation to only the class of insureds. The fact that the Donnellys are not the insureds under the EMC policy is not a bar to recovery of fees under the subject statute, i.e., they are persons "entitled" to "the amount justly due" under the EMC policy.

In *Mutual of Enumclaw v. Harvey,* 115 Idaho 1009, 772 P.2d 216 (1989), Enumclaw filed a declaratory judgment action against the plaintiff in the underlying action who had recovered a judgment against an individual insured by Enumclaw. The Idaho Supreme Court affirmed the district court on the following issues: (1) the underlying plaintiff had standing to counterclaim against Enumclaw because of language in the policy similar to language contained in the EMC policy (Exhibit A, p. 11); (2) attorney fees awarded the plaintiff in the underlying action are covered by the "Supplementary Coverage" section

of the Enumclaw policy; and (3) attorney fees were properly awarded by the district court in the declaratory judgment action: "In a declaratory action a person entitled to an amount justly due under the policy may recover attorney fees at the trial level and also on appeal". *Id.,* 115 Idaho at 1015. That is, the fact that the underlying plaintiff was not an insured did not prevent the application of Idaho Code §41-1839.

In *Pocatello Railroad Federal Credit Union v. Dairyland Insurance Co.,* 129 Idaho 444, 926 P.2d 628 (1996), the Supreme Court explicitly held that §41-1839 does not limit the award of attorney fees to an insured: "This provision does not limit the award of attorney fees to an insured, but speaks of "the person entitled to "the amount justly due." *Id.,* 129 Idaho at 447.

Whether the "proof of loss" has been furnished, has been waived, or is simply not a requirement under the EMC policy, the issue does not constitute a defense to attorney fees under §41-1839:

The EMC policy is a liability policy, it does not address proof of loss: Since §41-1839 only requires compliance in this regard "as provided by the policy", silence in the policy concerning "proof of loss" denotes EMC has dispensed with this requirement. The EMC policy is a liability policy dealing with RCI's liability to third persons; it does not purport to insure loss or damage to RCI's personal property. The absence of a proof of loss provision makes perfect sense.

The policy does impose upon the insured, RCI, the obligation to provide EMC with certain information respecting potential claims and litigation, i.e., "Duties in the Event of Occurrence, Offense, Claim, or Suit" (Exhibit A, p. 10). EMC does not allege that RCI has failed to comply with its duties identified in that section.

Assuming proof of loss is required, it has been furnished: EMC, through its retained attorney, was present or had notice of the jury verdict upon its announcement and of the subsequent award of attorney fees. Clearer and more certain "proof" could not be forthcoming.

In *Brinkman v. Aid Ins. Co.*, 115 Idaho 346, 766 P.2d 1227 (1988), the insured sued his insurer alleging a claim arising from an accident with an underinsured motorist. The insurer defended arguing no "proof of loss" had been filed. The policy provided only that proof of loss must be filed when required by the insurer, and the insurer never demanded a proof of loss. More to the point, the Supreme Court observed that the amount "justly due" under §41-1839 is the amount "ultimately determined by the jury". *Id.* 115 Idaho at 350:

> If the plaintiff chooses to pursue the matter, the matter goes to court. The jury determines what amount is justly due. If the insurance company was right, no attorney fees will be charged. If the plaintiff was right, attorney fees will be charged. Both sides realize this when they go to court. Both sides assume an equal and inevitable risk. By its very nature, the question of what amount is justly due can only be resolved in retrospect, in a court of law, by the jury. We affirm the determination of the trial court that Brinkman is entitled to an award of attorney fees under I.C. § 41-1839.

Id., 115 Idaho at 350.

The underlying jury verdict and costs/fees award with EMC's retained attorney present constitutes the ultimate proof of loss

Assuming proof of loss was required, it has been waived: According to *Mutual of Enumclaw v. Harvey,* "[w]here the insurer denies any liability, it waives the requirement that proof of loss be furnished as a prerequisite to recovery of attorney fees". *Id.,* 115 Idaho at 1015. See also *Bonner County v. Panhandle Rodeo Ass'n.,* 101 Idaho 772, 620 P.2d 1102 (1980). EMC has denied and continues to deny any liability under its policy.

The strategem of filing a declaratory judgment action does not allow EMC to avoid the application of Idaho Code §41-1839.

EMC argues that where "the suit is not for recovery of a sum certain the policy, . . . the prevailing party is not entitled to an award of fees" (Appellant's Brief, p. 35).

In *Unigard Insurance Co. v. United States Fidelity,* 111 Idaho 891, 728 P.2d 780 (Ct. App. 1986), the insurer brought a declaratory judgment action against its insured and others as to whether a particular incident of damage constituted a single "occurrence" under the policy. The insurer lost the declaratory judgment action. The insurer argued that because the declaratory judgment action was not an "action . . . brought against the insurer", as recited in §41-1839, the imposition of attorney fees was contrary to the statute. The Court of Appeals disagreed:

> Unigard also contends that the statute is inapplicable because this case is not an "action . . . brought against the insurer". We think this is a distinction without a genuine difference in light of the statutory purpose. The economic burden of litigation is virtually the same regardless of whether the insurer is sued as a defendant or the insurer brings a declaratory judgment action as a plaintiff. . . We hold that the statute is not defeated by the *strategem* of seeking a declaratory judgment. The district court did not err by awarding attorney fees.

Id., 111 Idaho at 896 (emphasis added).

The reasoning in *Unigard Insurance* was reiterated in *Northland Insurance v. Boise's Best Autos,* 132 Idaho 228, 234, 970 P.2d 21 (Ct. App. 1997)[7]

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[7] The Supreme Court reversed the decision by the Court of Appeals in *Northland Insurance* because, at the time of the declaratory judgment action, the underlying action was still underway and an amount "justly due" had not yet evolved. See *Northland Insurance v. Boise's Best Autos,* 131 Idaho 432, 434, 958 P.2d 589 (1998). However, the Supreme Court did not disturb the Court of Appeals' critique of the insurer's futile "strategem" of a declaratory judgment action.

The cases cited by EMC are distinguishable and are not authority for the district court's failure to award attorney fees pursuant to Idaho Code §41-1839. In these cases, there is either not an amount "justly due" or the insured failed to comply with a proof of loss provision.

Case/Citation	Appellant Brief	Distinguishing Feature
Carter v. Cascade Ins. Co. 92 Idaho 136, 139 (1968)	page 34	Until uninsured motorist's liability was judicially declared, insured not entitled to fees under §41-1839.
Hansen v. State Farm 112 Idaho 663, 671 (1987)	page 34	In uninsured motorist claim, plaintiff failed to furnish proof of loss until five months after suit filed.
Reynolds v. American Mut. Ins., 115 Idaho 362, 366 (1988)	page 35	Allegations of negligence against insurer for untimely settlement of fire loss. Section 41-1839 is not applicable; applicable statute is § 12-121.
Union Warehouse v. Jones, 128 Idaho 660, 669 (1996)	page 35	Insured seed cooperative sued insurer seeking coverage for claims of contaminated seed. Held: no attorney fee entitlement because no evidence of amount "justly due".
Northland Ins. v. Boise's Best Autos 131 Idaho 432, 434 (1998)	page 36	Insurer provided defense in underlying action. At time declaratory judgment action litigated, underlying matter not decided and, thus, insurer had not failed to to pay amount "justly due" under policy.

As noted above, the EMC policy (Exhibit A) does not contain a proof of loss provision. In any event, such provision has either been waived or complied with, or both. Because the district court found an amount "justly due" under the EMC policy (R. Vol. 3, p. 489), the Donnellys are entitled to an award of fees under §41-1839.

CONCLUSION

Coverage for the compensatory damages assessed against RCI: Because the jury found that RCI has inflicted no contract damages on the Donnellys and because EMC breached its duty to protect RCI with an allocated verdict, this Court should conclude as a matter of law that the underlying compensatory damage award of $126,611.55 is a covered liability, i.e., negligently caused property damage, under the EMC policy. The Donnellys request that the district court be ordered to enter judgment in this amount, plus accrued interest.

Genuine issue of material fact respecting allocation: Alternatively, in view of the Donnellys' status as nonmoving parties, the ambiguities in the EMC policy, and EMC's failure to protect its insured RCI with an allocated verdict, the matter should be remanded for a factual determination of the allocation of the $126,611.55.

Coverage for fees/costs assessed against RCI: Under the clear language of the EMC policy and under Idaho case law, EMC is required to pay the costs/fees assessed against its insured RCI. This obligation exists irrespective of whether the compensatory damages assessed are ultimately found to be a covered liability under the EMC policy. The statute and common law are corroborated by the common-sense observation that, having interposed itself in the litigation by assuming RCI's defense, EMC should "bear the consequences of its case management decisions", i.e., pay the fees assessed against its insured. See *Mutual of Enumclaw v. Harvey,* 115 Idaho at 1012. The Donnellys request that the district court be ordered to enter judgment for the Donnelly's in the amount of $296,933.89, plus accrued interest.

The Donnelly's entitlement to attorney fees in this action: The district court erred in not awarding attorney fees to the Donnellys under Idaho Code § 41-1839. As successful plaintiffs against EMC's

insured RCI and given the existence of adjudicated insurance coverage of awarded costs/fees ($296,933.66), the Donnellys are the persons entitled to that amount which amount is "justly due". That is, the Donnellys qualify for fees under all the criteria of § 41-1839.

Respectfully submitted this 18th day of October, 2011.

Allen B. Ellis
Attorney for Respondent/Cross-Appellant

I HEREBY CERTIFY That on this 18th day of October, 2011, I caused to be served two true and correct copies of the foregoing document by the method indicated below, and addressed to the following:

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Ringert Law Chartered
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_____ U.S. Mail, postage prepaid
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_____ Overnight delivery
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Allen B. Ellis