

NO. A10-1992

State of Minnesota
In Court of Appeals

Remodeling Dimensions, Inc.,
Plaintiff/ Respondent,

v.

Integrity Mutual Insurance Company,
Defendant Appellant.

APPELLANT'S REPLY BRIEF

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STATEMENT OF ISSUES

- I. **Where Integrity Mutual met its duty to defend Remodeling Dimensions and properly reserved its rights to challenge coverage under the policy, the district court erred in precluding Integrity Mutual from litigating indemnity issues.**

- II. **Requiring an insurer to request a reasoned arbitration award as part and parcel of the duty to defend as advocated by Remodeling Dimensions, is contrary to well settled Minnesota law.**
 - A. **Requiring retained counsel to attempt to fashion awards to address coverage would present an inherent conflict of interest and violates Minnesota law controlling the tripartite relationship.**

 - B. **As there are no claims of bad faith or malpractice, Integrity Mutual cannot be liable for actions of retained counsel as a matter of law. Finding such liability would greatly expand Minnesota's bad faith law.**

ARGUMENT

The dispute at the heart of this appeal is how much power an insurer should have in controlling the defense of the litigation against its insured. Ironically, the insured now claims that the insurer should have more control than currently allowed under Minnesota law, while Integrity Mutual requests that the status quo be maintained. This posture is the result of a flawed decision by the district court, which was based not upon an analysis of the coverage dispute but the perceived breach of the insurer's duty to defend.

Remodeling Dimensions now attempts to support the district court's order by arguing that retained counsel's decision not to request a reasoned arbitration award constituted the breach of the duty to defend. Although, the phrase "duty to defend" appears nowhere in the district court's decision, Integrity Mutual's denial of indemnification was premised upon the

irrefutable fact that coverage did not exist for any of the claims made at the arbitration. However, the district court never examined the underlying claims made at the arbitration. Instead, the district court looked solely at the four corners of the arbitration award in concluding that it could not determine damages and therefore if coverage existed.¹ This error was compounded when the district court decided the case based upon a breach of contract theory, holding that the inaction of retained counsel in requesting a reasoned arbitration award was a breach of contract, barring Integrity Mutual from denying coverage.

This Court should reverse or remand the district court's decision. First, there is no basis for Remodeling Dimensions' contention that Integrity Mutual breached a duty to defend. Integrity Mutual must be given the opportunity to have the coverage claim decided. Additionally, affirming the court's decision and accepting that the duty to defend includes requesting the issuance of a reasoned arbitration award represents a substantial departure from long standing Minnesota case law.

I. Where Integrity Mutual properly defended Remodeling Dimensions and reserved its rights to challenge indemnity, the district court erred in precluding Integrity Mutual from litigating the coverage issues.

Minnesota courts have outlined how insurers properly exercise the duty to defend in the context of coverage disputes. Integrity Mutual complied with the requirements of

¹The district court *did not*, as Remodeling Dimensions argues, determine that it was impossible to determine whether the award was covered as a matter of law. Instead, the district court, based *only* on its review of the award, determined that damages could not be ascertained. The court, however, *did not* examine or determine whether there existed coverage for the claims made at the underlying arbitration.

Minnesota law.

The obligation to defend an insured is contractual in nature and is determined by the allegations in the complaint and the indemnity coverage of the policy. *Prahm v. Rupp Const. Co.*, 277 N.W.2d 389, 390 (Minn. 1979). If any part of a cause of action is arguably within the scope of coverage, an insurer must defend. *Prahm*, 277 N.W.2d at 390. Once a liability insurer assumes the defense, it has the duty to exercise 'good faith.' *Short v. Dairyland Ins. Co.*, 334 N.W.2d 384, 387 (Minn. 1983). The company must also notify its insured of the company's position regarding coverages afforded under the claim or suit. *Id.* Where there is some doubt whether coverage exists for the claim, the company must issue a reservation of rights letter. *American Family Ins. Co. v. Goetzke*, 416 N.W.2d 1 (Minn. Ct. App. 1987). The purpose of the reservation-of-rights letter is to enable insureds to make informed decisions as to whether they should, because of the existence of conflicts of interest between themselves and their insurers, take some action in order to protect their interests. Allan D. Windt, *Insurance Claims and Disputes* 60 (3rd ed. 1995). Thus, by retaining an attorney to represent Remodeling Dimensions in the underlying arbitration, paying for that attorney, and issuing reservation of rights letters, Integrity Mutual followed these precepts.

Remodeling Dimensions, however, argues that the duty to defend includes the requirement that the insurer, through retained counsel, request a reasoned award to ensure that the award is also determinative of any coverage dispute. This is completely at odds with the governing law in Minnesota. In Minnesota, when issues for the determination of a

coverage dispute are not necessary or essential to the issue of an insured's liability in the underlying action, an insured and insurer must be given the opportunity to litigate the disputed issue. *Brown v. State Auto. & Cas. Underwriters*, 293 N.W.2d 822 (Minn. 1980). A determination of damages stemming from an incident, arguably covered under a policy, does not preclude the insurer from subsequently having the issue of whether the policy affords coverage later determined. *Itasca Paper Co. v. Niagara Fire Ins. Co.*, 220 N.W.2d 425, 427 (Minn. 1928). The Minnesota Court of Appeals, very recently, on January 11, 2011, confirmed this proposition, providing,

when an insurer claims that building damage is entirely attributable to conditions falling within a policy exclusion and not covered, it is within the district court's jurisdiction to determine the meaning and interpretation of the insurance contract and the application of coverage and exclusion clauses; these issues are not properly resolved by appraisers measuring the "amount of loss."

Quade v. Secura Ins., No. A10-714, 2011 WL 68822, at *1 (Minn. Ct. App. 2011). Liability under a policy is a judicial determination reserved for the courts. *Mork v. Eureka-Security Fire & Marine Ins. Co.*, 42 N.W.2d 33, 35 (Minn. 1950). Thus, in Minnesota, when an insurer provides a defense subject to a reservations of rights, issues relating to the duty to indemnify are preserved for findings by a district court.

This case is quite similar to *Brown*. In *Brown*, the insured attempted to leave an airport with a piece of luggage without first producing a baggage claim ticket. *Brown*, 293 N.W.2d at 823. The baggage clerk and Brown struggled with the bag; Brown injured his hand and struck the clerk. *Id.* Brown argued that he struck the clerk reflexively as a result

of the cut on his hand. *Id.* The clerk filed a complaint and the insurer declined to defend on the basis that Brown's act fell under the intentional-acts exclusion. *Id.* The court awarded the clerk damages. The insurer refused to satisfy the judgment and Brown sought a declaratory judgment that the insurer breached its duties to defend and indemnify. *Id.* at 824.

In the declaratory action, the district court granted summary judgment in the insured's favor. The district court held that the insurer breached its duty to defend the insured because it failed to resolve the pleading's ambiguity in the insured's favor. The district court further held that the insurer breached its duty to indemnify the insured. Finally, the district court collaterally estopped the insurer from litigating the issue of intent to injure, resolved in the insured's favor in the underlying action and made it determinative on the issue of coverage afforded by the policy. The insurer appealed. *Id.*

The Minnesota Supreme Court determined that the issue of intent to injure was not a necessary or essential issue in the determination of Brown's liability to the clerk, and that the district court improperly denied the insurer the opportunity to litigate that issue. *Id.* at 825. The intent to injure was not required for the clerk to recover on an assault and battery theory; only that Brown intended to do the act of striking the clerk. *Id.* Therefore, the issue of intent to injure was not necessary or essential to the determination of Browns liability. *Id.* But whether Brown intended to cause injury was an issue necessary and essential to the determination of whether the act fell under an intentional-acts exclusion in his insurance policy. *Id.*

Quade is also instructive. In *Quade*, the insured sought coverage for roofs that were damaged but a disagreement ensued as to whether the damage was attributable to a storm or a failure to maintain. The insurer argued that the appraisal clause of the policy was triggered and was the proper mechanism to employ in determining any obligation it had for the loss.

However, the Court of Appeals observed:

Neither the district court nor respondent identifies a fact question free of confusion with regard to legal issues such that if an appraisal occurred, the appraiser would not have to engage in accessing the law and interpreting the policy. In the instant case, questions of fact regarding the effects of a storm and the effects of faulty maintenance are entangled with questions of law respecting the meaning of the contract, the interplay of coverage and exclusions, shifting burdens of proof, and causation, which must be addressed as a matter of law. Determining coverage, causation, and the operation of the exclusion provision requires the attention of the court in a fashion normal for causation questions. . . because this dispute goes to whether the loss suffered by appellants is covered by the policy, it can be resolved only by analysis and application of the policy by the district court.

Quade, 2011 WL 68822, at *4.

The contract between the Provezanos and Remodeling Dimensions dictated that those parties resolve their dispute in arbitration. Ultimately, the arbitrator only had to decide whether the Provezanos were entitled to make a recovery from Remodeling Dimensions and the extent of that recovery. Thus, the four corners of the arbitration award is rather circumspect in detailing the nature of the recovery. The arbitrator had no need to go beyond the scope of this inquiry so as to render findings explaining whether under the policy an occurrence was involved, whether the occurrence was subject to the policy period that was in effect, whether the completed operations hazard of the policy applied, whether any damage

allowed was subject to a policy exclusion, and so on.

As in *Brown* and *Quade*, Integrity Mutual is not being provided the opportunity to litigate the indemnification issue.

Moreover, the district court's holding presumes that Integrity Mutual denied coverage because of the lack of a reasoned arbitration award. However, it is clear from the record that the declination letter of Integrity Mutual specifies that coverage was denied by reason of the *claims* made by the Provenzanos at the underlying arbitration. (AA 00095-96).

After receiving notice the claims from Remodeling Dimensions, and prior to the arbitration, Integrity Mutual issued reservation of rights letters of September 22, 2006, and January 10, 2007. (AA0091-94).² After the Arbitration Award of February 23, 2007, Integrity Mutual issued a declination of coverage letter. (Ltr. of Integrity Mutual, AA0095-96). In declining indemnification for the award, Integrity Mutual explained a review of the arbitration transcript indicated that the damages claimed related directly to the work of Remodeling Dimensions. (*Id.*) The declination letter provided,

we have studied the Exhibits comprising the documents that were introduced at the arbitration hearing held on January 22 and January 23 of 2007 as well as the 683 page transcript recording the testimony of the witnesses and the parties. We have now completed our investigation and have again carefully considered the claims of the Provenzanos and whether they trigger any duty to defend and/or are subject to indemnification pursuant to the terms and

²While the second letter requested that a reasoned arbitration award be requested, there is nothing in the record indicating why a reasoned arbitration award was requested. While the insurer provided that it would not be bound by a vague award, the declination letter made it clear that the insurer based its coverage determination on the claims made at the arbitration rather than the award.

conditions of the applicable policy referenced above. Having done so, we are constrained to conclude that coverage is not afforded.

(Id.)(emphasis added) The declination was not based upon any failure not to request or obtain a reasoned arbitration award. *(Id.)* Rather, it was based upon the complete absence of any covered claims being made at the arbitration. *(Id.)*

The district court concluded, based upon the arbitration award, that it could not make a determination as to the damages. It based its decision on only its examination of the award, rather than on a study of the claims made at the arbitration. This is error. Rather, liability under a policy is a judicial determination reserved for the district court. *Mork*, 42 N.W.2d at 35. In making a coverage determination, the district court is neither bound by the arbitration award nor precluded from making a distinct factual finding regarding coverage. *Brown*, 293 N.W.2d at 822; *Itasca Paper Co.*, 220 N.W.2d at 427. Thus, the district court erred in holding that the lack of reasoned findings from the arbitrator precluded the litigation of the coverage issues.

Thus, where Integrity Mutual met its duty to defend Remodeling Dimensions and properly reserved its rights to challenge coverage under the policy, the district court erred in precluding Integrity Mutual from litigating indemnity issues.

II. Adopting law imposing a duty to request and shape a reasoned arbitration award within the duty to defend, as suggested by Remodeling Dimensions, is contrary to well settled Minnesota law and significantly and negatively alter long standing law.

Remodeling Dimensions argues that this court follow law from foreign jurisdictions in a fashion that would graft upon the duty to defend the requirement to obtain a reasoned arbitration award. It argues that “subsumed in the exclusive right to defend these claims was the corresponding obligation to ensure that a reasoned award was issued which would allow a coverage determination.” (Respondent’s Brief at 20). Thus, Remodeling Dimensions not only argues that an insurer should have a duty to request an award, but they also have a duty to ensure that this award would allow for a coverage determination. How would such a duty be exercised? The insurer is not a party to the underlying proceeding, whether it is in an arbitration forum or the district court. Therefore, the insurer must necessarily exert this expanded duty through defense counsel retained to represent the interests of the insured. The existence of such an expanded duty and control over the underlying controversy is certainly the basis for the district court’s decision here. However, the district court reached this conclusion without examining or considering the inherent conflict it creates for retained counsel, and which likely explains why retained counsel here did not act on a timely basis in trying to obtain a reasoned award.

A. Requiring retained counsel to attempt to fashion awards to address coverage would present an inherent conflict of interest and would be opposed to Minnesota case law regarding the tripartite relationship.

Remodeling Dimensions argues that the insurer should have the duty, through retained counsel³, to not only request, but also to ensure that a reasoned award clarifies issues for a later coverage determination. However, adopting such a rule would place retained counsel in an inherent conflict between the insured and the insurer anytime coverage was in question.

It is well-established under Minnesota case law that defense counsel hired by an insurer to defend a claim against its insured represents the insured. *See Miller v. Shugart*, 316 N.W.2d 729, 733 (Minn. 1982); *Crum v. Anchor Cas. Co.*, 119 N.W.2d 703, 712 (Minn. 1963). The court in *Crum* explained:

[A]n attorney retained by an insurer to defend its insured, as long as he represents the insured, is under the same obligations of fidelity and good faith as if the insured had retained the attorney personally. The relationship of client and attorney exists the same in one case as in the other.

119 N.W.2d at 712. However, in the context of the tripartite relationship, there exists potential for conflicts in every case.

Courts and commentators recognize universally that the tripartite relationship between insured, insurer, and defense counsel contains rife possibility of conflict³ and that the relationship between an insurer and insured is permeated with potential conflicts.

In re Rules of Prof'l Conduct, 299 Mont. 321, 2 P.3d 806, 814 (2000). While this potential for conflict exists in all insurance defense scenarios, the law is clear, an attorney retained by

³As insurers in Minnesota cannot be named parties in the cases on the merits, the only way an insurer could act to shape an award is through counsel retained to represent the insured.

an insurer to defend its insured, is not permitted to take a position adverse to the interest of his client. *Crum*, 119 N.W.2d at 712. The Supreme Court has noted, “When the interests of the insurer differ from those of the insured, defense counsel who represents both may find itself in what we have called ‘an exceedingly awkward position.’” *Pine Island Farmers Coop v. Erstad & Riemer, P.A.*, 649 N.W.2d 444, 449 (Minn. 2002)(citing *Shelby Mutual Insurance Co. v. Kleman*, 255 N.W.2d 231 (Minn. 1977)). Indeed, these rules are in place because,

the nature of the tripartite relationship makes it likely that defense counsel will tend to favor the interests of the insurer at the expense of those of the insured. As one commentator has stated, defense counsel “may be tempted to help the client [the insurer] who pays the bills, who will send further business, and with whom long-standing personal relationships have developed.

Id. at 450. (citing *Ronald E. Mallen & Jeffrey M. Smith*, 4 Legal Malpractice § 29.16, at 325 (5th ed. 2000)). The Eighth Circuit Court of Appeals explained,

Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client - the one who is paying his fee and from whom he hopes to receive future business - the insurance company.

Id. at 450-51 (citing *United States Fid. & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 938 n. 5 (8th Cir. 1978)).

Here, Remodeling Dimensions advocates an enlargement of the insurer’s duty to defend. While up to now, the duty runs to the insured, as envisioned by Remodeling Dimensions, the insurer would also be charged with the responsibility of procuring and shaping arbitration awards, verdicts, and the like. They argue that this would enable later

coverage determinations during a declaratory action. However, this creates a nearly impossible position for retained counsel. On one hand, counsel has a duty to represent his client, and it would therefore be his duty to obtain findings of fact that are favorable and that would ultimately provide coverage to his client, the insured⁴. On the other hand, the insurer is paying for the attorney's services and is the one presumably with whom the attorney has a long standing relationship. Thus, if the duty to defend also entails requesting a reasoned arbitration award, there would arise inherent conflicts for retained counsel in every action in which coverage had been called into question. Retained counsel would be forced to not only defend the interests of the insured on the merits, but at the same time would also be required to shape the award or verdict to address coverage disputes.

In addition, *Remodeling Dimensions* does not explain how would the award or verdict questions have to be framed. Is retained counsel supposed to submit questions for the arbitrator to respond to? If so, how could retained counsel shape those questions in such a way so that he did not breach his duty to the insured? While counsel's duty flows only to the insured, there could be significant pressure from the insurer to shape the award in such a way that favors its interests. This is exactly the problematic scenario that Minnesota law seeks to avoid. The Eighth Circuit Court of Appeals explained,

Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps

⁴Under *Brown*, 293 N.W.2d 822, an insurer or insured cannot be bound, in a declaratory action, by findings made at the underlying action that were not necessary for a determination in that action.

unconsciously, in the interests of his real client - the one who is paying his fee and from whom he hopes to receive future business - the insurance company.

Pine Island Farmers Coop, 649 N.W.2d at 450-51 (citing *United States Fid. & Guar. Co. v.*

Louis A. Roser Co., 585 F.2d 932, 938 n. 5 (8th Cir. 1978).

B. As there are no claims of bad faith or malpractice, Integrity Mutual cannot be liable for actions of retained counsel as a matter of law. Finding such liability would greatly expand Minnesota's bad faith law.

Remodeling Dimensions argues that Integrity Mutual should be liable for any alleged damages where a reasoned award was not requested, stating, "Integrity Was Responsible For Defense Counsel's Failure To Request A Reasoned Award." (Resp. Br. at p. 20). However, extending liability to insurers based solely upon the decisions of retained counsel, without a finding of bad faith, would represent an unwarranted extension of Minnesota's bad faith law.

Remodeling Dimensions admits that this case is neither a case of alleged bad faith on the part of the insurance company nor a case of alleged malpractice on the part of retained counsel. Nevertheless, it argues that the rule set forth in *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228 (Or. Ct. App. 1989), should be controlling.⁵ However, *Stumpf* was a case involving legal malpractice. In fact, Remodeling Dimensions has not identified any case extending liability to an insurer for the decisions made by retained counsel without a finding of either bad faith or attorney malpractice. There is simply no support for Remodeling Dimensions'

⁵Despite Remodeling Dimensions' contentions, the issue of vicarious liability is properly before the court as it was argued at Summary Judgment.

argument or the trial court's determination that, in the absence of malpractice or bad faith, the insurer is nevertheless liable for the decisions of retained counsel.

Moreover, many other jurisdictions have declined to extend liability to an insurer, even where there was a finding of malpractice on the part of the attorney. *Merritt v. Reserve Insurance Co.*, 34 Cal.App.3d 858 (1973); *Feliberty v. Damon*, 72 N.Y.2d 112, 531 N.Y.S.2d 778, 527 N.E.2d 261 (1988). Thus, even if there was an allegation of malpractice, which there is not, there is still no basis to extend liability to Integrity Mutual.

Extending liability to Integrity Mutual, where there is no showing of bad faith or malpractice, where there is no breach of the contractual terms, and where there is no violation of statute, would greatly expand insurer liability in Minnesota. In Minnesota, aside from breaching the terms of its contract, insurer is not liable to an insured without a showing that the insurer acted in bad faith in failing to settle a lawsuit within policy limits, and therefore exposing the insured to excess exposure,

[t]he insurer's duty of good faith is breached in situations in which the insured is clearly liable and the insurer refuses to settle within the policy limits and the decision not to settle within the policy limits is not made in good faith and is not based upon reasonable grounds to believe that the amount demanded is excessive.

Short, 334 N.W.2d 384. If this court adopts the argument of *Remodeling Dimensions*, however, rather than being able to rely on counsel to provide information necessary to make a good faith evaluation, insurers would also have to protect themselves from the potential that counsel had otherwise acted improperly. This would significantly expand the potential liability of insurers. Applying the rule set forth in *Merritt* and in other jurisdictions, however,

would not pose these adverse effects. Under those holdings, the attorney, not the insurer, would be liable for the negligence of the attorney. Thus, insurer's liability would not be greatly expanded, and the duty to provide proper counsel to a client would remain upon the attorney.

Thus, the trial court erred in applying *Stoop* and *Stumpf* in determining that the insurer should be vicariously liable for the decision not to request a reasoned arbitration award.

CONCLUSION

This Court should not affirm the district court's holding. Doing so would be contrary to Minnesota law governing the tripartite relationship and bad faith claims. Moreover, it would sanction a new practice that encroaches upon the jurisdiction of the court and allows insurers to wield more power over the duty to control litigation.

Instead, this court should reverse the district court where it is clear that there exists no coverage for any of the claims made at the underlying arbitration. Alternatively, the court should remand the case to the district court to address the indemnification issues. Under Minnesota law, Integrity Mutual is entitled, at the very least, to a determination as to whether the claims are subject to coverage.

Respectfully Submitted,

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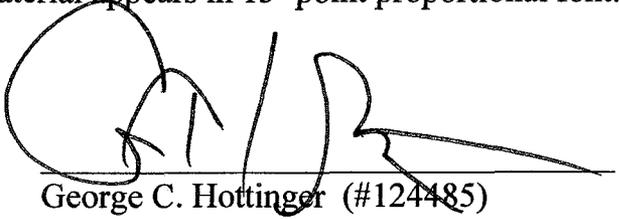
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CERTIFICATION OF COMPLIANCE WITH WORD COUNT LIMIT

This brief contains 4232 words as confirmed by the Document Information Tool of Corel Word Perfect 9, which word-processing software was used to prepare this brief. This brief also complies with the typeface requirements of Rule 132.01 of the Minnesota Rules of Civil Appellate Procedure as the printed material appears in 13- point proportional font.



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