

Court of Appeals No. A10-1992

**State Of Minnesota  
In Court Of Appeals**

**Remodeling Dimensions, Inc.,**

**Plaintiff / Respondent,**

**v.**

**Integrity Mutual Insurance Co.,**

**Defendant / Appellant.**

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**RESPONDENT'S BRIEF**

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## **II. STATEMENT OF ISSUES PRESENTED.**

- I. Is an insurer, who assumes control of the litigation in defense of its insured with a reservation of its right later to dispute coverage, in breach of its contractual duty to defend the insured when it fails to obtain a reasoned arbitration award or special verdict by which coverage can be determined?**

The district court held that the insurance company breached the contract with its insured by failing to take steps necessary to obtain a reasoned award or verdict.

This is a question of first impression in Minnesota. Guiding authority: *Magnum Foods, Inc. v. Continental Cas. Co.*, 36 F.3d 1491, 1498–99 (10th Cir. 1994) (citing *Duke v. Hoch*, 468 F.2d 973, 978 (5th Cir. 1972)); *Pacific Indem. Co. v. Linn*, 766 F.2d 754 (3rd Cir. 1985).

- II. Is an insurer, who assumes control of litigation in the defense of its insured with a reservation of its right later to dispute coverage, vicariously liable for its hired defense counsel's failure to obtain a reasoned arbitration award or special verdict by which coverage can be determined?**

The district court held that, under the circumstances presented in this case, defense counsel was an agent of the insurer and as such the insurer was vicariously liable for the negligence that prejudiced the insured's ability to assert coverage.

This is also a question of first impression in Minnesota. Guiding authority relied upon by the district court: *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228 (Or. Ct. App. 1989); *Smoot v. State Farm Mut. Auto. Ins. Co.*, 299 F.2d 525, 530 (5<sup>th</sup> Cir. 1962).

- III. Was the district court correct when it held that, from a simple form arbitration award containing no reasoning or apportionment, it could not determine liability coverage under an insurance contract, as a matter of law.**

The district court characterized any attempt to determine insurance coverage from a simple arbitration award was inappropriate guesswork, and correctly proceeded to consider and rule on the question of whether the insurer breached its duty to defend the insured under the contract.

### **III. STATEMENT OF THE CASE & FACTS.**

#### **A. Procedural Posture.**

On or about May 17, 2010, Plaintiff-Respondent, Remodeling Dimensions, Inc. (“Remodeling Dimensions”), initiated this action in Hennepin County District Court, asserting a single claim against Defendant-Appellant, Integrity Mutual Insurance Company (“Integrity”), for breach of the parties’ insurance contract. (AA0001–AA0011.) This case arises out of Integrity’s denial of coverage for liability incurred by Remodeling Dimensions, in an arbitration award in favor of one of its customers, for damage to their home claimed to have resulted from a home addition project built by Remodeling Dimensions. (AA0007–AA0008.) On or about June 7, 2010, Integrity answered Remodeling Dimensions’ complaint with a general denial. (RA7–RA12.) On or about August 25, 2010, counsel for the parties appeared before the Hon. Gary Larson for hearing on their cross-motions for summary judgment. (AA0023–AA0311.) On or about September 30, 2010, Judge Larson issued an order and memorandum granting Remodeling Dimensions’ motion and denying Integrity’s cross-motion. In so doing, Judge Larson found that Integrity had breached the parties’ insurance contract, and ordered the entry of judgment against Integrity in Remodeling Dimensions’ favor in the amount of \$49,000.00. (AA0301–AA0312.) Judgment was entered on October 6, 2010, and Integrity’s Notice of Appeal was filed and served on or about November 9, 2010. (AA0313.)

B. Factual Background.

1. **The Parties & Their Insurance Contract.** Remodeling Dimensions is engaged in the residential design and construction business, and is located in St. Louis Park, Minnesota. (AA0001.) Integrity is in the business of selling various insurance products. (AA0001.) On or about September 1, 2002, the parties entered into an insurance contract (“the policy”) whereby Integrity agreed to provide general liability coverage to Remodeling Dimensions. The policy remained in effect for four years, through September 1, 2006. (AA0034.)

The parties’ insurance contract contains the following salient, operative provisions.<sup>1</sup> With respect to business liability coverage and the defense of any such claims, the contract contains the following broad indemnity provision:

- a. We [Integrity] will pay those sums that the insured [Remodeling Dimensions] becomes legally obligated to pay as damages because of “bodily injury”, “property damage”<sup>2</sup> or “personal and advertising injury” to which this

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<sup>1</sup> The Court should be aware that the policy document cited by Appellant’s brief, “Businessowners [*sic*] Liability Coverage Form,” does not appear to be part of Remodeling Dimensions’ policy. (AA0079–AA0090.) This is reflected in the applicable policy list of contract forms. (RA2–RA6.) As a result, the operative terms are actually contained in that document entitled “Businessowners [*sic*] Coverage Form” (AA0037–AA0078.) This notwithstanding, there is no dispute that the operative language contained in both forms is identical.

<sup>2</sup> The policy defines “property damage” as: “(a) Physical injury to tangible property, including all resulting loss of use of that property. All such loss of use shall be deemed to occur at the time of the physical injury that caused it; or (b) Loss of use of tangible property that is not physically injured. All such loss of use shall be deemed to occur at the time of the ‘occurrence’ that caused it.” (Policy Section II (F)(17) at p. AA0075).

insurance applies. We will have the right and duty to defend the insured against any “suit”<sup>3</sup> seeking those damages. However, we will have no duty to defend the insured against any “suit” seeking damages for “bodily injury”, “property damage” or “personal and advertising injury”, to which this insurance does not apply. We may at our discretion, investigate any “occurrence” and may settle any claim or “suit” that may result.

- b. This insurance applies:
  - (1) To “bodily injury” and “property damage” only if:
    - (a) The “bodily injury” or “property damage” is caused by an “occurrence”<sup>4</sup> that takes place in the “coverage territory”;
    - (b) The “bodily injury” or “property damage” occurs during the policy period.

(Policy Section II (A)(1) at AA0061.) The policy provides a coverage exclusion for damage to or arising out of “your work,” stating:

This insurance does not apply to:

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<sup>3</sup> The policy provides that “suit” means a civil proceeding in which damages because of “bodily injury”, “property damage”, “personal and advertising injury” to which this insurance applies are alleged. “Suit” includes: (a) An arbitration proceeding in which such damages are claimed and to which the insured must submit or does submit with our consent.” (Policy Section II(F)(18) at p. AA0075.)

<sup>4</sup> According to the policy: “Occurrence” means an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” (Policy Section II(F)(13) at p. AA0074.)

k. Damage To Property.

“Property damage” to:

....

- (5) That particular part of any real property on which you or any contractor or subcontractor working directly or independently on your behalf is performing operations, if the “property damage” arises out of those operations; or
- (6) That particular part of any property that must be restored, repaired or replaced because “your work”<sup>5</sup> was incorrectly performed on it.

(Policy Section II B(k)(5) & (6) at pp. AA0066-AA0067.) However, the policy then provides a partial exemption or a limitation to this “your work” exclusion, stating:

Paragraph (6) of this exclusion does not apply to “property damage” included in the “products completed operations hazard.”

(Policy Section II(B)(k) at p. AA0067.) The policy further defines the “products completed operations hazard,” in relevant part, as:

- a. [A]ll “bodily injury” and “property damage” occurring away from premises you own or rent

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<sup>5</sup> “Your work” is defined as: “(1) Work or operations performed by you or on your behalf; and (2) Materials, parts or equipment furnished in connection with such work or operations,” and includes: “(1) Warranties or representations made at any time with respect to the fitness, quality, durability, performance or use of ‘your work,’ and (2) The providing of or failure to provide warnings or instructions.” (Policy Section II(F)(22) at pp. AA0075-0076.)

and arising out of “your product” or “your work, except:

- (1) Products that are still in your physical possession; or
- (2) Work that has not yet been completed or abandoned. However, “your work” will be deemed completed at the earliest of the following times:
  - (a) When all the work called for in your contract has been completed.
  - (b) When all of the work to be done at the job site has been completed if your contract calls for work at more than one job site.
  - (c) When that part of the work done at the job site has been put to its intended use by any person or organization other than another contractor or subcontractor working on the same project.

(Policy Section II (F)(16) at pp. AA0074-0075.)

By operation of these policy sections, the actual work performed by Remodeling Dimensions on any project may be excluded from coverage, by operation of the “your work” exclusion. However, any other damage to *other* property, occurring away from Remodeling Dimensions’ office, which resulted from its completed work, is covered, under the “products completed operations hazard” portion of the policy.

**2. The Provenzano Addition Project.** On or about January 23, 2003, Remodeling Dimensions entered into a construction agreement with Mike and

Peggy Provenzano (the “Provenzos”) whereby it agreed to perform the following work on their home:

- build a lower level, flat roof addition onto the East side of their home; and
- replace the trim around the windows of the existing portion of the home.

(Provanzano Addition Contract at pp. AA0026–AA0033.) The Provanzos’ home was originally built by LeGran Homes in 1993. (AA0012.) The contract provided that any dispute arising out of the parties’ relationship would be submitted to binding arbitration with the American Arbitration Association (“AAA”). (AA0032.)

During the project, the Provenzos requested that Remodeling Dimensions remove a master bedroom window in the original portion of the house so they could move a large armoire into the bedroom. (AA0234.) While the removal of the master bedroom window was not part of the original project, Remodeling Dimensions agreed to do this additional work to accommodate the Provenzos. (AA0234.) Remodeling Dimensions completed the construction of the addition and the replacement of window trim in approximately June 2003. (AA0234.)

**3. The Provenzano Arbitration Claim.** Three years later, in June 2006, the Provenzos hired Northwest Diversified Services (“NDS”) to investigate moisture issues with the house. Following an inspection and testing, NDS found that moisture was invading the structural parts of both the original

construction and the addition, and opined that this moisture intrusion was causing substantial damage to the house, including structural rot and mold infestation. (AA0181–AA0216.) NDS attributed this water intrusion to several sources, including the improper installation and flashing of windows in *both* the addition and the existing home. (AA0184–0185.) The NDS report did not apportion responsibility for these defects to either Remodeling Dimensions or the home’s original builder, LeGran Homes, though it is undisputed that work on the windows in the original portion of the home was performed by both firms.

On July 14, 2006, the Provenzanos commenced arbitration against Remodeling Dimensions with the AAA, claiming it was liable for *all* of the damage to their home—in *both* the addition and the existing home. (AA0012–AA0017.) The Provenzanos based this claim on two alternative theories:

1. They claimed there were a number of defects in the work performed by Remodeling Dimensions on both the addition and on the windows in the existing home that allowed water intrusion causing structural damage the house.<sup>6</sup>
2. Alternatively, they contended that Remodeling Dimensions was negligent, that it should have recognized that the original

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<sup>6</sup> According to the Provenzano’s pre-hearing Case Statement, the defective work performed by Remodeling Dimensions that resulted in water intrusion and structural damage to the house included the following: improperly installed window trim, improperly re-installed master bedroom window, improperly installed patio door, improper installation of addition flat roof, improperly installed fenestrations, improperly flashed dormer roof, and improperly applied window trim. Moreover, the Provenzanos alleged that Remodeling Dimensions’ negligent work exacerbated the existing defects in the original LeGran work. Last, the Provenzanos contended that Remodeling Dimensions was negligent for its failure to recognize and report the defects in the original LeGran construction. (Provenzano Case Statement at pp. AA0218–AA0226.)

construction (performed by LeGran Homes) was defective and causing water intrusion and damage, and that Remodeling Dimensions failed to report this to the Provenzanos so they could take action against LeGran Homes.

(Provenzanos' Summary of Claims at pp. AA0016–AA0017.) Other than the flat roof repair (which was undisputedly part of Remodeling Dimensions addition project), the Provenzanos did not apportion their claims based on the area of the house they believed was damaged, which builder's work caused the damage, or under which theory they believed Remodeling Dimensions was liable. (AA0016–AA0017.)

The Provenzanos sought damages totaling \$264,100.00, broken down into the following general categories:

1. Total low bid from the bid request \$188,500.00;
2. Flat roof repair \$6,000.00;
3. Replacement of various windows and doors \$32,000.00 (location unspecified);
4. Final cleaning and air clearance \$11,100.00;
5. Construction management fees \$17,500.00;
6. Inspection costs \$3,000.00;
7. Design costs \$6,000.00.

(Provenzanos' Summary of Claims at p. AA0225.) Again, none of the bids presented by the Provenzanos apportion these repair costs between the addition and the existing home, nor do they apportion these costs to faulty work performed by Remodeling Dimensions or LeGran Homes. (AA0218–AA0226.) Simply put,

the Provenzanos sought to have Remodeling Dimensions held responsible for all alleged damage, regardless of which builder's faulty work might have actually caused the damage, and this included damage to the existing home that extended beyond Remodeling Dimensions "work." (AA0218-AA0226.)

**4. Remodeling Dimensions Submits The Claim To Integrity & The Two Reservation Of Rights Letters.** After receiving notice of the arbitration, Remodeling Dimensions submitted the claim to Integrity under the policy. (AA0235.) Integrity agreed to defend Remodeling Dimensions in the arbitration, and on about September 7, 2006 Integrity hired Patrick Elliot, Esq. to defend Remodeling Dimensions. (AA0235; RA1.) With Mr. Elliot's full participation, on September 21, 2006, the AAA issued an order removing Eric Forsberg, Esq. and appointing John G. Patterson, Esq. to be the Arbitrator on the claim. (AA0227.) By this same letter, the AAA set a pre-hearing conference for October 2, 2006 and included a Report of Preliminary Hearing and Scheduling Order outlining in detail the items to be covered in the conference. (AAA Letter at p. AA0227.) Contained on this Report form was a section for "form of award" which allowed counsel to select from three forms: a standard award, a reasoned award or findings of fact and conclusions of law. (AA0232.)

The next day, on September 22, 2006, Integrity sent a Remodeling Dimensions a reservation of rights letter. (AA0091-AA0092.) According to Integrity: "At this time it is questionable whether or not there is coverage for all or part of Plaintiffs' alleged damages under this policy. . . . Your policy with

Integrity does not insure, repair, replace or guarantee its contracted and paid for work, which is a business risk in doing business. *Instead the policy provides indemnity insurance for covered occurrences and resultant damages, separate and apart from the actual contracted work.*” (First Reservation of Rights Letter at pp. AA0091–AA0092 (emphasis added).) Importantly, this letter nowhere states that Remodeling Dimensions was responsible for requesting a detailed or reasoned arbitration award so the coverage could be evaluated and determined. (AA0091–AA0092.) There is no evidence in the record indicating whether Mr. Elliot was copied on this reservation of rights letter.

There is also no record of what transpired at the October pretrial scheduling conference with Arbitrator Patterson, other than a final hearing date was set for January 22 and 23, 2007. Yet, three months following Arbitrator Patterson’s appointment and two months after the pretrial scheduling conference, Integrity recognized that a reasoned award was critical to determining coverage. As a result, on January 10, a mere twelve days before the final hearing was to begin, Integrity sent Remodeling Dimensions a second reservation of rights letter, stating for the first time:

The purpose of this correspondence is to alert you of your duties in this matter. It will be up to you and your counsel to fashion an arbitration award form that addresses the coverage issues and your respective burden. If, for example, the arbitration award ultimately rendered makes it impossible to determine whether any of the damages awarded involve “property damage” that occurred during the Integrity policy period, Integrity will not be responsible to

indemnify an ambiguous award. Also, by way of further illustration but not limitation, Integrity Mutual will not be responsible for an ambiguous award that fails to identify the subcontractor found to be liable and the damages allocated specifically to that subcontractor. Please be advised that Integrity Mutual will be requesting that the arbitration proceedings be transcribed. You have the right to request that a court reporter be present at the arbitration hearing under the Rules promulgated by the American Arbitration Association. We expect that you make an independent request of the arbitrator in this regard.

(Second Reservation of Rights Letter at pp AA0093–0094.) Defense counsel retained by Integrity, Patrick Elliot, was copied on this second reservation of rights letter. (AA0094.) Nowhere does the policy state that it is the insured's obligation or responsibility to obtain a reasoned award or verdict. There is no evidence in the record whether a reasoned award was requested by any party or attorney before the final arbitration hearing.

**5. The Arbitration Hearing & The Simple Form Award.** On January 22 and 23, 2007, Remodeling Dimensions and the Provenzanos participated in a final arbitration hearing. (AA0235.) Mr. Elliot represented Remodeling Dimensions, whose principle defense was that the damage was caused by the negligence of the original builder and the lack of proper maintenance by the Provenzanos, not the result of any work or negligence by Remodeling Dimensions. (AA0235.) LeGran Homes was not a party to the arbitration because the statute of limitations on any claims against it had lapsed. (AA0235.) On or about February 23, 2007, the arbitrator issued an award (the

“Award”), finding for the Provenzanos and awarding them the following limited damages:

Basic house repairs	\$45,000.00
Flat roof repair	\$2,000.00
Replacement window costs	\$0.00
Final cleaning	\$1,000.00
NDS inspection costs	\$0.00
Design costs	\$0.00
Constructions management fees	\$3,000.00
<b>Total</b>	<b>\$51,000.00</b>

(Arbitration Award at pp. AA0097–AA0098.) The Award was in the “simple award” format, containing no reasoning or apportionment based upon theory of liability or portion of the home damaged.<sup>7</sup> (Award at pp. AA0097–AA0098.)

**6. Integrity Requests A Reasoned Award.** On or about February 23, 2007, Mr. Elliot sent a letter to Arbitrator Patterson, for the first time requesting a reasoned award. (AA0217.)<sup>8</sup> On or about March 20, 2007, the Arbitrator responded that “[t]he parties did not request an explanation of the Award in writing prior to the appointment of the arbitrator as required by [Rule 42(b) of the

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<sup>7</sup> The only specific aspect of the arbitration award is the \$2,000.00 award for the flat roof repair, which was a part of the addition project. (AA0097.)

<sup>8</sup> Mr. Elliot’s letter was not included in the record to the district court. However, it is mentioned in Arbitrator Patterson’s reply letter of March 20, 2007, which is part of the record at the district court and here.

American Arbitration Association Rules]. Therefore, no such explanation is required, nor is one permitted after issuance of the Award.”<sup>9</sup> (AA0217.)

7. **Integrity Declines Coverage.** On or about March 22, 2007, Integrity informed Remodeling Dimensions that it was declining coverage on the entire Award. Despite the lack of any apportionment or explanation in the Award, Integrity took the unsupported position that the Arbitrator rejected all damages claims associated with defects from the original construction of the house. (AA0095–AA0096b.) Integrity denied coverage for the following reasons:

- Integrity unilaterally determined that all of the awarded damages were related to the work of Remodeling Dimensions and subject to the “Your Work” exclusion of the contract.
- Integrity claimed that, even if a portion of the damages awarded related to the construction on the original house, it would not involve an occurrence or activity subject to the “products completed operations hazard,” and the damage did not occur during the policy period.
- Integrity claimed that final cleaning and design costs did not constitute damage under the policy, but did not provide any reasons for this decision.
- Integrity stated that, even if these awards did constitute damage, they would not be covered based on the same exclusions that applied to the other damage items.

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<sup>9</sup> AAA Rule 42(b) provides: “The arbitrator need not render a reasoned award unless the parties request such an award in writing prior to appointment of the arbitrator or unless the arbitrator determines that a reasoned award is appropriate.” (AA0232.)

(Declination of Coverage Letter at pp. AA0095–AA0096b.) After Integrity declined coverage, Remodeling Dimensions paid the Provenzanos \$51,000.00 to satisfy the Award. (AA0236.)

#### **IV. STANDARD OF REVIEW.**

“A motion for summary judgment shall be granted when there is no genuine issue as to any material fact and either party is entitled to judgment as a matter of law.” *Medica, Inc. v. Atlantic Mut. Ins. Co.*, 566 N.W.2d 74, 76 (Minn. 1997). Where parties file cross-motions for summary judgment, the parties “tacitly agree[] that there exist no genuine issues of material facts” in dispute. *Am. Family Mut. Ins. Co. v. Thiem*, 503 N.W.2d 789, 790–91 (Minn. 1993); *Frey v. United Servs. Auto. Ass’n*, 743 N.W.2d 337, 344 (Minn. App. 2008). According to the Supreme Court’s decision in *Celotex Corp. v. Catrett*: “Summary judgment is properly regarded not as a disfavored procedural shortcut, but rather as an integral part of the Federal Rules as a whole, which are designed to secure the just, speedy and inexpensive determination of every action.” 477 U.S. 317, 327 (1986) (quotation omitted). “On appeal from summary judgment, this court reviews the record to determine whether there are any genuine issues of material fact and whether the lower courts erred in their application of the law.” *Medica, Inc.*, 566 N.W.2d at 76. But where, as here, the “the parties do not dispute the relevant facts, a *de novo* standard of review is applied to determine whether the district court erred in its application of the law.” *Id.*

## V. ARGUMENT.

### A. *INTEGRITY'S FAILURE TO OBTAIN A REASONED ARBITRATION AWARD WAS A BREACH OF ITS DUTY TO DEFEND REMODELING DIMENSIONS.*

1. **The District Court Was Correct That No Coverage Determination Could Be Made.** Integrity's appeal entirely misses the lynchpin of the district court's opinion: namely, the correct holding that the absence of a reasoned award made it impossible to determine—as a matter of law—whether the Award was covered under the policy or subject to the “your work” exclusion. As Judge Larson adroitly observed:

Despite the apparent certainty of the parties as to whether or not coverage applies under the contract, the Court is not convinced by either argument. The arbitration award contains no explanation as to the damages and no one can say with any certainty what the arbitrator awarded damages for and why. Without further explanation, we are simply left to make an educated guess. Because of this, the Court cannot determine exactly what the damages were awarded for, why they were awarded and what the arbitrator considered in making the award.

(Order & Memorandum at p. AA0308.) Based on this conclusion, the district court declined both parties' invitation to speculate whether the Provenzanos' claims and the resulting award were an “occurrence” falling within the broad liability indemnification provision of the policy (Policy Section II (A)(1) at AA0061), whether part or all of these claims were barred from coverage by the “your work” exclusion (Policy Section II B(k)(5) & (6) at pp. AA0066–AA0067), or whether all or part of these claims fell within the “products completed operations hazard”

carve-out to the “your work” exclusion (Policy Section II (F)(16) at pp. AA0074-AA0075.) Rather, the district court correctly proceeded to consider the threshold issue at the very heart of this dispute—which party should bear responsibility for the absence of a reasoned award by which coverage might have been determined.<sup>10</sup>

**2. Obtaining A Reasoned Award Was Part Of Integrity’s Duty To Defend.** The district court correctly found, under the unique facts of this case, that Integrity was responsible for defense counsel’s failure to obtain a reasoned award, and that this failure constituted a breach of the parties’ insurance contract. The policy imposes the following duty to defend on Integrity: “We will have the right and duty to defend the insured against any ‘suit.’” (Policy Section II (A)(1) at AA0061.) Included in this “right and duty to defend” is Integrity’s discretion to investigate the claims, appoint defense counsel of its choosing, and the right to settle any asserted claim. (Policy Section II (A)(1)(a) at p. AA0061.) While the scope of Integrity’s duty to defend and its right to control the litigation is not specifically outlined in the policy, several courts have addressed the issue. For example, it is well established that the insurer has the exclusive right to control the litigation, to investigate claims, and to settle claims. *Pine Island Farmers Co-op v. Erstad & Reimer*, 649 N.W.2d 444, 450 (Minn. 2002); *Hooper v. Zurich Am. Ins.*

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<sup>10</sup> In this respect, it is critical that the Appellate Court recognize that the district court’s ultimate determination that Integrity should bear the onus for the absence of a reasoned award was *not* predicated on finding of coverage under the policy, but rather upon its holding that the absence of such an award was a *breach of the parties’ contract*, namely Integrity’s duty to defend Remodeling Dimensions. (Order & Memorandum at pp. AA0309-03010.)

*Co.*, 552 N.W.2d 31, 36-37 (Minn. App. 1996); *Bryan v. Anfield*, No. C8-98-1206, 1998 WL 912142, \*1 (Minn. App. 1999) (“Accompanying the duty to defend is the insurer’s right to *exclusive control* over the litigation” (emphasis added)); *Nandorf v. CNA Ins. Cos.*, 479 N.E.2d 988, 991 (Ill. App. Ct. 1985); 14 George E. Couch, *Couch on Insurance 2d* §51:35 (rev. ed. 1982). Correspondingly, the insured has a duty to cooperate with insurer in the defense of the litigation. (Policy Section II (E)(2) at p. AA0086.)

The relationship that arises between the insurer, its insured, and insurance defense counsel, when an insurer undertakes a duty to defend, is known as the “tripartite relationship.” Obviously, this tripartite relationship creates the potential for conflicts of interest between the insured and the insurer, and these conflicts are prevalent. *Pine Island Farmers Co-op*, 649 N.W.2d at 450 (citing *Atlanta Intern. Ins. v. Bell*, 475 N.W.2d 294, 297 (Mich. 1991). As the court in *Pine Island Farmers Co-op* recognized: “The danger is that, if a conflict of interest does arise, the nature of the tripartite relationship makes it likely that defense counsel will tend to favor interest of the insurer at the expense of those of the insured.” 649 N.W.2d at 450. The potential for such conflict is exacerbated when the insurer defends under a reservation of rights. In this situation, included with an insurer’s duty to defend and right to control the litigation is a duty not to prejudice the insured by failing to request a reasoned verdict or award that would allow a

coverage determination.<sup>11</sup> While no Minnesota Appellate Court has addressed this situation, numerous courts in other jurisdictions have addressed the question directly. For example, the federal Tenth Circuit, in *Magnum Foods, Inc. v. Continental Casualty Co.*, stated:

[A]n insurer who undertakes the defense of a suit against its insured must meet a high standard of conduct. *Duke v. Hoch*, 468 F.2d 973, 978 (5th Cir.1972); *Gay & Taylor, Inc. v. St. Paul Fire & Marine Ins. Co.*, 550 F.Supp. 710, 714-16 (W.D.Okla.1981). The right to control the litigation carries with it certain duties. *Traders & Gen. Ins. Co. v. Rudco Oil & Gas Co.*, 129 F.2d 621, 627 (10th Cir. 1942). 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. *See Gay & Taylor*, 550 F.Supp. at 716. The reason for this is that when grounds of liability are asserted, some of which are covered by insurance and some of which are not, a conflict of interest arises between the insurer and the insured. *If the burden of apportioning damages between covered and non-covered were to rest on the insured, who is not in control of the defense, the insurer could obtain for itself an escape from responsibility merely by failing to request a special verdict or special interrogatories.* *Duke*, 468 F.2d at 979. The insurer is in the best position to see to it that the damages are

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<sup>11</sup> In fact, in deciding who should bear the onus for failing to obtain a special verdict or reasoned opinion, between an insured and insurer, several courts have held that the issue turns on which of the parties "controlled the defense" of the litigation. *See, e.g., Med-Marc Cas. Ins. Co. v. Forest Healthcare, Inc.*, 359 Ark. 495, 501-502, 199 S.W.3d 58, 62-63 (Ark. 2004); *Camden-Clark Memorial Hosp. Ass'n v. St. Paul Fire and Marine Ins. Co.*, 682 S.E.2d 566, 577, 224 W.Va. 228, 239 (W. Va. 2009). Undeniably, Integrity controlled the defense of the Provenzanos' claims, as Remodeling Dimensions did not have independent or *Cumis* counsel. Therefore, consistent with these cases, the district court properly held that Integrity bore the burden to obtain a reasoned award, and its failure to do so was a breach of the parties' contract.

allocated; therefore, it should be given the incentive to do so.

36 F.3d 1491, 1498–99 (10th Cir. 1994) (emphasis added). The failure of the insurer to fulfill this duty results in the burden shifting to the insurer to prove that no coverage exists. “[W]here any single claim will support coverage, the insurer’s failure to obtain a verdict segregating the damage awards amongst the claims, mandates payment of the entire damage award.” *Herrera v. C.A. Seguros Catatumbo*, 844 So.2d 664, 668 (Fla. Ct. App. 2003) (citing *Morrison v. Hugger*, 369 So.2d 614, 616 (Fla. Ct. App. 1979)); *Duke v. Hoch*, 468 F.2d 973, 978 (5th Cir. 1972); *Gay & Taylor, Inc. v. St. Paul Fire & Marine Ins. Co.*, 550 F.Supp. 710, 714-16 (W.D. Okla. 1981); *U.S. Concrete Pipe Co. v. Bould*, 437 So.2d 1061 (Fla. 1983). In the similar context of a settlement with no allocation between covered and non-covered claims, the federal Third Circuit explained the risks to the insured and the benefits to the insurer.

To reach the opposite conclusion could result conceivably in an insured never being indemnified in a suit that its insurer settles where the insurer defends under a reservation of rights. In such a situation, it would behoove the insurer to reserve its rights and to settle the suit to avoid both the costs of litigation and, at the same time, the costs of indemnification. Such a strategy should not be countenanced. We are persuaded that the approach adopted by the district court cannot be faulted because it is justified by both rational and pragmatic considerations.

*Pacific Indem. Co. v. Linn*, 766 F.2d 754 (3rd Cir. 1985).

The principles announced in these decisions are squarely applicable to the instant case. Integrity undertook to defend Remodeling Dimensions under a reservation of rights. When it did so, Integrity hired Mr. Elliot and it assumed exclusive control over the litigation and the defense of the Provenzanos' claims. 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. By its failure to do so, Integrity has breached that portion of its contract with Remodeling Dimensions, and the district court should be affirmed.

**3. Integrity Was Responsible For Defense Counsel's Failure To Request A Reasoned Award.** The district court was also correct in its determination, under these unique facts, that Integrity was responsible for defense counsel's failure to obtain a reasoned award, and that this failure constituted a breach of the parties' insurance contract.<sup>12</sup> Under Rule 42(b) of the AAA rules, a reasoned arbitration award needs to be requested before an arbitrator is appointed. On or about September 7, 2006, Integrity hired Mr. Elliot to defend Remodeling Dimensions. On September 21, 2006, the AAA, with Mr. Elliot's full participation, issued an order appointing the arbitrator, John G. Patterson, Esq. On

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<sup>12</sup> Integrity attempts to avoid this responsibility by construing the district court's decision in the context of a bad faith claim. (Appellant's Brief at pp. 31-37.) This misses the mark. The district court's decision did not mention bad faith and is not dependent on such a finding. Rather, the district court correctly found that Integrity was responsible for requesting a reasoned award, and the failure by Integrity and Mr. Elliot to do this was a breach of its contract with Remodeling Dimensions.

this same date, the AAA sent a Report of Preliminary Hearing and Scheduling Order, which included a section for “form of award” which allowed counsel to select from three forms: a standard award, a reasoned award, or findings of fact and conclusions of law. Despite having announced to Remodeling Dimensions that there was a potential coverage dispute, neither Mr. Elliot nor Integrity requested a reasoned award, and following the final hearing and issuance of his Award, Arbitrator Patterson—citing AAA Rule 42(b)—exercised his discretion and declined to provide one. As a result of Appellant’s inaction, it not only waived its insured’s right to have a reasoned award, but forever prejudiced Remodeling Dimensions’ ability to have coverage fairly determined. Therefore, the district court also correctly found that Integrity was responsible for Mr. Elliot’s failure to request a reasoned award, and liable to Remodeling Dimensions for the resulting breach of contract.

This, too, is a matter of first impression in the State of Minnesota, and the district court’s review of decisions from other jurisdictions for guidance was entirely appropriate. In so doing, Judge Larson properly relied on the decisions in *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228 (Or. Ct. App. 1989) and *Smoot v. State Farm Mut. Automobile Ins. Co.*, 299 F.2d 535, 530 (5<sup>th</sup> Cir. 1962).<sup>13</sup> Again

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<sup>13</sup> Undeniably, there may be a split of authority on this issue. Many have decided the issue favoring an insurer’s liability under agency principles, *see Smoot v. State Farm Mut. Auto. Ins. Co.*, 299 F.2d 525, 530 (5<sup>th</sup> Cir.1962) (Georgia law); *Continental Ins. Co. v. Bayless & Roberts, Inc.*, 608 P.2d 281, 294 (Alaska 1980); *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228, 1231–32 (Or. Ct. App. 1989); *Pacific Employers Ins. Co. v. P.B. Hoidale Co.*, 789 F.Supp. 1117, 1122-23 (D.

relying on the insurance company's duty to defend and right to control litigation, in *Stumpf v. Continental Cas. Co.*, the Oregon Court of Appeals held:

According to Restatement (Second) Agency, §214: "A master or other principal who is under a duty to provide protection for or to have care used to protect others or their property and who confides the performance of such duty to a servant or other person is subject to liability to such others for harm caused to them by the failure of such agent to perform the duty." That duty may be created by contract. See Restatement (Second) Agency, §214, comment e. Stiff's contract with CNA provided, in part: "The company shall have the right and duty to defend any suit against the insured seeking damages which are payable under the terms of this policy applicable to [professional liability] \* \* \* and may make such investigation and settlement of any claim or suit as it deems appropriate." Given CNA's contractual duty and the degree of control that it retained over Stiff's defense, we apply what appears to be the rule in the majority of jurisdictions: An insurer may be vicariously liable for the actions of its agents, including counsel that it hires to defend its insured.

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Kan. 1992); see also *Boyd Bros. Transp. Co. v. Fireman's Fund Ins. Co.*, 729 F.2d 1407, 1409-11 (11th Cir.1984); for others finding an independent contractor relationship which insulates the insurer in the context of malpractice and bad faith claims, see *Feliberty v. Damon*, 72 N.Y.2d 112, 531 N.Y.S.2d 778, 782, 527 N.E.2d 261, 265 (1988); *Aetna Cas. & Sur. Co. v. Protective Nat'l Ins. Co.*, 631 So.2d 305, 306 (Fla. Dist. Ct. App. 1993); *Brown v. Lumbermens Mut. Cas. Co.*, 90 N.C.App. 464, 369 S.E.2d 367, 371 (1988), *aff'd*, 326 N.C. 387, 390 S.E.2d 150 (1990); *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 110 Cal. Rptr. 511, 526-27 (Ct. App. 1973). However, the Court should be aware that Integrity never argued to the district court that it was insulated from liability for Mr. Elliot's failure to obtain a reasoned award by reason of his status as an independent contractor. As a result, this argument, presented for the first time on appeal, has been waived and reversal on such grounds would be inappropriate.

*Stumpf v. Continental Cas. Co.*, 794 P.2d at 1232 (emphasis supplied).

Application of the rule announced in *Stumpf*, and similar decisions, to the unique facts of this case is appropriate for several reasons. First, it dovetails elegantly with the principles and rules set forth in *Magnum Foods, Inc. v. Continental Casualty Co.* and the other cases cited previously regarding an insurer's duty to defend. Second, this case does not involve an issue of attorney malpractice (because the scope of Mr. Elliot's representation of Remodeling Dimensions was limited to the defense of the Provenzanos' claims—not the coverage dispute with Integrity), nor does this case involve allegations of bad faith. These reasons have been the basis for denying vicarious liability involving the actions of independent contractors, and are relied upon by Integrity. (Appellant's Brief at pp. 33-37 (citing *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 110 Cal. Rptr. 511 (Ct. App. 1973) (holding that an insurance company is not vicariously liable for the malpractice of the attorney it selects to defend the insured) and *Feliberty v. Damon*, 72 N.Y.2d 112, 531 N.Y.S.2d 778, 527 N.E.2d 261 (1988) (holding that an insurance company is not liable for bad faith in excess verdict resulting from negligence of defense counsel)). Instead, this case involves insurance defense counsel's failure, in his capacity as an *agent* of Integrity, to obtain a reasoned award that would allow Remodeling Dimensions the opportunity to demonstrate coverage, and his failure in this regard prejudiced Remodeling Dimensions' legal position in the coverage dispute with Integrity—not in the

defense of the Provenzanos' claims. As a result, with respect to the facts of this case, the rule announced in *Stumpf v. Continental Cas. Co.* is on point, and the lower court's decision was well reasoned and should be affirmed.

**B. INTEGRITY'S CONTENTION THAT ALL OF THE PROVENZANOS' CLAIMS ARE SUBJECT TO THE "YOUR WORK" EXCLUSION IS CONTRARY TO THE PLAIN LANGUAGE OF THE POLICY AND THE UNIQUE FACTS OF THIS CASE.**

**1. Integrity's Request For Summary Judgment From This Court Is Improper.** As a threshold matter, the district court was correct in holding that it could not determine coverage—as a matter of law—without a reasoned Award. Consequently, Integrity's principal contention on appeal—that none of the Provenzanos' claims are covered—blithely ignores this critical holding. Instead, Integrity asks this Court to engage in precisely the kind of guesswork Judge Larson wisely avoided, and issue an order granting summary judgment in its favor. (Appellant's Brief at pp. 14–25.) After all, as the lower court understood, summary judgment is not about guesswork: it is about determining the merits of the parties' claims, based on undisputed facts, as a matter of law. Accordingly, the lower court should be affirmed.

**2. The Provenzanos' Claims Fall Within The Broad Indemnity Provision Of The Policy, But Integrity Cannot Demonstrate All Their Claims Are Barred By The "Your Work" Exclusion.** The paradigm of proof applicable to this case is well established: "While the insured bears the initial burden of demonstrating coverage, the insurer carries the burden of establishing the

applicability of exclusions.” *Travelers Indem. Co. v. Bloomington Steel & Supply Co.*, 718 N.W.2d 888, 894 (Minn. 2006).

a. The Provenzanos’ Claims Fall Within The Indemnity Provision Of The Policy. Under the broad indemnity provision of the policy, Integrity promised to indemnify Remodeling Dimensions for any amount that it is legally obligated to pay as a result of “property damage” that is caused by an “occurrence” or “accident.” (Policy Section II (A)(1) at AA0061 (emphasis added).) The policy defines an occurrence as “an accident, including continuous or repeated exposure to substantially the same general harmful conditions.” (Policy Section II(F)(13) at p. AA0074.) While the policy does not define “accident,” Minnesota Courts have held that an “Accident, as a source and cause of damage to property, within the terms of an accident policy, is an unexpected, unforeseen, or undesigned happening or consequence from either a known or an unknown cause.” *Hauenstein v. Saint Paul-Mercury Indem. Co.*, 65 N.W.2d 122, 126 (Minn. 1954); *see also American Family Ins. Co. v. Walser*, 628 N.W.2d 605, 611 (Minn. 2001).

In this instance, *all* of the Povenzanos’ claims fall within this broad promise of indemnity. The claims involve damage to property. Remodeling Dimensions was legally obligated to pay them money on account of this property damage. The property damage (namely mold, rot and structural damage) resulted from an “occurrence or accident” in so far that it was undisputedly the consequence of an unintended happening that included the “continuous and repeated exposure” to an unknown harmful condition—water intrusion into the

walls through improperly flashed windows and other sources. Accordingly, from the face of the Provenzanos' claims, it is clear that Remodeling Dimensions has borne its burden of demonstrating that they fall within the indemnity provision of the policy.

b. Integrity Cannot Demonstrate Coverage Is Barred Under The "Your Work" Exclusion. Next, the burden shifts to Integrity to prove that the Award was premised on claims barred from coverage under the business risk doctrine and the "your work" exclusion. The policy defines "your work" in relevant part as: "(1) Work or operations performed by you or on your behalf; and (2) Materials, parts or equipment furnished in connection with such work or operations." (Policy Section II(F)(22) at pp. AA0075-0076.) Under this exclusion, Integrity is not responsible for damage to the actual work performed by Remodeling Dimensions. *Bor-Son Building Corp. v. Employers Commercial Union*, 323 N.W.2d 58, 63–64 (Minn. 1982). But this exclusion is *not* applicable to damage to *other portions of the structure or property* caused by Remodeling Dimensions' allegedly defective work once the project is completed. This is true for two reasons. First, damage to those portions of the home not touched as part of Remodeling Dimensions work on the project expressly fall outside the policy definition of "your work." Second, this type of damage is clearly contained in the carve-out from the "your work" exclusion known as the "products completed operations hazard." The policy defines this carve-out, in part, as *all* property damage occurring away from a premises owned or rented by the insured and arising out of "your work" where that

work has been completed. Therefore, if Remodeling Dimension completes a project and that work later should damage other parts of the structure or property, such damage is covered under the “products completed operations hazard” proviso, and the “your work” exclusion does not apply.

Integrity cannot bear its burden of proving the Award is excluded from coverage under the “your work” exclusion for several reasons. Nowhere does Integrity address the Provenzanos’ claims regarding Remodeling Dimensions’ work on the window trim of the original house that they contended caused water damage to its walls and structure. While Remodeling Dimensions’ actual “work” on the window trim might be excluded from coverage, the alleged moisture penetration and resulting damage to the surrounding structure—which Remodeling Dimensions did not touch and was not part of its “work”—is plainly covered by the policy. Moreover, this same item of claimed damage, even if it results from Remodeling Dimensions’ work, is covered by operation of the “products completed operations hazard” carve-out. Consequently, there may have been coverage for a significant portion of the damages *alleged* by the Provenzanos, but we will never know what the *award* was intended to compensate them for—Remodeling Dimensions’ defective work product or resultant damage to other portions of the home. Certainly, the bulk of the Award’s allocation of damages to “basic house repairs” lends nothing that would allow a coverage determination as a matter of law. The result is a failure of proof, and Integrity’s argument fails.

Because Integrity cannot bear its burden of demonstrating that the Award was excluded from coverage by the “your work” provision of the policy, the lower court should be affirmed in all respects.

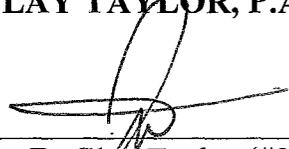
**VI. CONCLUSION.**

Based upon all of the foregoing, Respondent respectfully requests that this Court issue an order affirming the district court in its entirety and awarding it such costs as may be allowed by law.

Dated: January 7, 2011.

**D. CLAY TAYLOR, P.A.**

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