

STATE OF MINNESOTA  

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**State of Minnesota**

***In Supreme Court***

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**No. A10-1992**

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Remodeling Dimensions, Inc.,

Appellant,

vs.

Integrity Mutual Insurance Company,

Respondent,  

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**REPLY BRIEF OF APPELLANT**

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## I. TABLE OF AUTHORITIES.

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## II. ARGUMENT.

### A. *INTEGRITY MISCONSTRUES THE CENTRAL QUESTIONS TO BE RESOLVED IN THIS CASE.*

Appellant, Remodeling Dimensions, Inc. (“RDI”), submits this memorandum in response to that opposition memorandum submitted by Respondent, Integrity Mutual Insurance Company (“Integrity”). The core issues presented in this case revolve around the conflicts of interest inherent in the “tripartite relationship”—all of which are exacerbated in the context of a reservation of rights. The fundamental tension at issue is how an insurer can fulfill its contractual duty to defend its insured in a third party action—while at the same time preserving its right to later challenge coverage—without prejudice to either party’s right to have coverage fairly determined in a subsequent proceeding.

Undeniably, defense counsel’s failure to obtain a reasoned arbitration award prejudiced RDI’s ability to demonstrate coverage. That was the district court’s key factual determination.<sup>1</sup> (AD 9–10). As a result, the essential question presented by this appeal is under what circumstances an insurer should be responsible for the actions of defense counsel that prejudice an insured in a subsequent coverage dispute. Instead of

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<sup>1</sup> This is not to say that a reasoned award would have guaranteed that the district court would have been able to conclusively determine coverage as a matter of law, but rather that the lack of a reasoned award made it *virtually certain* that Remodeling Dimensions would not be able to sustain its burden of proving coverage. Put another way, the absence of a reasoned award assured that the coverage dispute would not be resolved on the merits, but would be based instead on a failure of proof in the form of a simple explanation of the basis for the award.

analyzing this issue under well-established agency principals, the court of appeals mistakenly applied the rules governing the attorney-client relationship. (AD 19–22).

In so doing, the court of appeals attempted to shoehorn this case into the “dual representation” rubric of *Pine Island Farmers Co-op v. Erstad & Reimer*, 649 N.W.2d 444 (Minn. 2002), and this was in error.<sup>2</sup> (AD 19–22). In its brief, Integrity does not and cannot dispute that *Pine Island* dealt with the discrete question of whether an insurer had standing to assert a legal malpractice claim against counsel it hired to defend its insured; this case does not. Integrity does not dispute that the question presented in *Pine Island* required an analysis of dual representation of an insured and an insurer; the facts of this case do not. Integrity does not dispute that this case involves the scope of an insurer’s defense obligations in the context of a reservation of rights; *Pine Island* did not. Because *Pine Island* was the logical lynchpin to the court of appeals’ flawed opinion, it should be reversed. Concomitantly, this Court should adopt the majority position taken by other jurisdictions which have considered this question; apply the principals announced in *Magnum Foods, Inc. v. Continental Casualty Co.*, 36 F.3d 1491, 1498–99 (10th Cir. 1994); *Pacific Indem. Co. v. Linn*, 766 F.2d 754 (3rd Cir. 1985); *Smoot v. State Farm Mut. Automobile Ins. Co.*, 299 F.2d 535, 530 (5th Cir. 1962); and *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228 (Or. Ct. App. 1989); and reinstate the district court’s decision and order in its entirety.

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<sup>2</sup> It cannot be lost on this Court that Integrity has largely abandoned the analysis employed by the court of appeals. Rather than embrace the lower court’s extension of *Pine Island Farmers Co-op*, Integrity forwards a succession of alternative arguments each of which is legally or factually unsupported, misconstrues RDI’s position in this appeal, or fails to squarely address the core issue presented.

1. The Legal Limits Of The Duty To Defend. At the opening of its argument, Integrity contends: “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.”<sup>3</sup> (Integrity Br. 15.) This plainly misses the mark: the central issue to be resolved in this appeal is the extent to which an insurer is liable to the insured under the parties’ contract when defense counsel, in defending the underlying action, prejudices the insured in the subsequent

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<sup>3</sup> There is nothing in either the district court’s or court of appeals’ decisions addressing the scope of the insurer’s “power” to direct the defense of a third party claim against its insured or framing this as the issue at the heart of this appeal. Nevertheless, it has been widely and generally held that the duty to defend is a valuable part of the insurance contract. Correspondingly, it is a valuable right of the insurer to be able to control the defense of actions in which the insurer may be required to pay the judgment. *See, e.g., Medical Protective Co. v. Pang*, 606 F.Supp.2d 1049, 1061–62 (D. Ariz. 2008); *Zurich American Ins. Co. v. Frankel Enterprises, Inc.*, 509 F.Supp.2d 1303, 1311 (S.D. Fla. 2007); *Travelers Indem. Co. of Ill. v. Royal Oak Enter., Inc.*, 344 F.Supp.2d 1358, 1374 (M.D. Fla. 2004); *Bruce v. Junghun*, 912 N.E.2d 1144, 1148 (Ohio. Ct. App. 2009); *Milroy v. Allstate Ins. Co.*, 151 P.3d 922, 927 (Okla. Civ. App. 2006). Practically speaking, if the insurance policy entitles the insurer to “defend the insured,” the insurer will either designate an in-house lawyer to represent the insured or, as in this case, hire a lawyer from a defense firm to which the insurer refers such matters. Because only the insurer, on the defense side of the case, has (or at this stage is believed to have) a financial stake in the case, the lawyer will report to the insurer on the progress of the litigation, as well as (or possibly instead of) to his client. An insurance adjuster employed by the insurance company will be monitoring the lawyer carefully, both because the company is paying his fee (or salary, if he is in-house) and, more importantly, because it might be liable for any settlement or judgment up to the policy limit. Thus “the insurer’s duty to defend includes the right to assume control of the litigation . . . to allow insurers to protect their financial interest in the outcome of litigation and to minimize unwarranted liability claims. Giving the insurer exclusive control over litigation against the insured safeguards the orderly and proper disbursement of large sums of money involved in the insurance business.” *Nandorf, Inc. v. CNA Ins. Cos.*, 479 N.E.2d 988, 991 (Ill. Ct. App. 1985); *see also Stoneridge Development Co. v. Essex Ins. Co.*, 888 N.E.2d 633, 644 (Ill. Ct. App. 2008); *R.C. Wegman Const. Co. v. Admiral Ins. Co.*, 629 F.3d 724, 727–28 (7th Cir. 2001).

coverage dispute. Integrity takes this misstatement of the case further when it suggests that the outer limits of its obligation to RDI was to retain an attorney to defend RDI, pay that attorney, and issue a reservation of rights letter. (Integrity Brief at p. 17). Integrity ignores the well-settled law that bound up in the insurer's contractual duty to defend is a *fiduciary duty* to the insured to "represent his or her best interests and to defend and indemnify." *Short v. Dairyland Ins. Co.*, 334 N.W.2d 384, 387 (Minn.1983); *see also Kissoondath v. U.S. Fire Ins. Co.*, 620 N.W.2d 909, 914–15 (Minn. App. 2001). Certainly, the faithful execution of this fiduciary duty includes the simple act of requesting a reasoned arbitration award or a special verdict that explains the legal and evidentiary basis for any verdict or award.<sup>4</sup>

Accordingly, under the unique facts of this case, Integrity breached its fiduciary duty and its duty to defend RDI by counsel's failure to obtain a reasoned arbitration award; the court of appeals should therefore be reversed, and the opinion and order of the district court reinstated.

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<sup>4</sup> Undeniably, Integrity understood and, in fact, anticipated RDI's present predicament when it said in its second reservation or rights letter (sent days before the arbitration was to commence): "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.***" (AA 195 (emphasis added).) This is important for several reasons. First, because Integrity appreciated the importance of a reasoned award, fulfillment of its fiduciary duty to RDI necessitated that it take all steps reasonably necessary to secure such an award—not foist it onto RDI late in the process and disclaim coverage for the failure to do so. Second, it acknowledges that Integrity viewed it as part of defense counsel's function to obtain a reasoned award. Third, this letter flatly contradicts Integrity's oft-repeated contention that it denied coverage based on an analysis of the pleadings, reports and transcript of the arbitration hearing—not on the lack of a reasoned award. (Integrity Br. 21, 22, 32.)

2. The Court's Exclusive Jurisdiction To Determine Coverage & Framing Awards. Integrity next contends that requiring an insurer and defense counsel to obtain a reasoned award or special verdict would infringe on the trial court's exclusive jurisdiction to interpret insurance contracts and determine issues of coverage. (Integrity Br. 18–19.) Integrity takes this argument even further by asserting that such a requirement would result in arbitrators and juries deciding such questions as whether an “occurrence” exists, whether the occurrence fell within the policy period, whether the “completed-operations hazard” applies, and whether the damage was subject to any policy exclusion. (Integrity Br. 21.) In its final gyration of faulty logic, Integrity argues that simply requiring counsel to obtain a reasoned award or special verdict would result in defense counsel “framing” or “shaping” the award or verdict—thereby creating an actual conflict of interest, placing retained counsel in an “impossible position,” and ultimately depriving the insurer of the ability to rely on counsel to provide them information necessary to make a “good faith evaluation” of the case. (Integrity Br. 26, 29-30.)

Integrity's argument goes too far and misses the point. Nowhere does RDI contend that coverage questions should be delegated to arbitrators and juries in the third party action. Rather, all RDI suggests is that the *form* of the award or verdict is important in a reservation of rights case. There is no scenario under which any of the parties here would have been harmed by a reasoned award. In fact, such an award would have likely revealed several important things: the theory of liability adopted by the arbitrator; the type, method of calculation, and amount of damages being awarded; and an explanation of the causal connection between liability and damages. Certainly, each of these elements

would have been “necessary and essential” to deciding the Provenzanos’ claims, but they would also have made it possible for the district court to make a coverage determination as a matter of law—something it said was impossible without such an award.<sup>5</sup> (AD 8.)

Because the rule of law advocated by RDI in this case does not invade or degrade the jurisdiction of the district court to interpret insurance contracts or determine questions of coverage, Integrity’s arguments lack merit and the court of appeals should be reversed.

3. Bad Faith As A Precondition For An Insurer’s Liability. Integrity next argues that it should bear no liability for counsel’s failure to obtain a reasoned award—regardless of the resulting prejudice to RDI—absent a demonstration of bad faith. Integrity goes so far as to assert all of the cases imposing liability that are cited by RDI stand for the proposition that a demonstration of bad faith is a precondition to any such liability.<sup>6</sup> (Integrity Br. 23–26.) Again, Integrity overstates its case.

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<sup>5</sup> Integrity contends that “[I]n Minnesota, when an insurer provides a defense subject to a reservation of rights, issues relating to the duty to indemnify are preserved for findings by the district court.” (Integrity Br. 19.) To the extent this implies that *all* issues of fact bearing on the question of indemnity are for the district court to determine in a coverage action, Integrity again goes too far. As this Court reiterated in *Brown v. State Auto. & Cas. Ins.*, 293 N.W.2d 822, 825 (Minn. 1980), fact issues resolved in the third party action which are “necessary and essential” to that judgment (as opposed to gratuitous) will have collateral estoppels effect and preclude the re-litigation of those issues in the subsequent coverage action.

<sup>6</sup> The cases cited by Integrity in support of this contention (Integrity Br. 25 n.8.) all involve the question of imposing liability on an insurer for the malpractice or bad faith of defense counsel. What Integrity fails to recognize is the tangible and important difference between holding an insurer responsible for retained counsel’s malpractice and a negligent act that prejudices an insured in a coverage dispute. In the former, both the insurer and insured have the right to rely on counsel’s professional advice and judgment. In the latter, the insurer reaps the benefit of counsel’s conduct at the expense of the insured. Integrity

While some—but not all—of the cases relied upon by RDI involve allegations of bad faith, *none* of these decisions stands for the proposition that a demonstration of bad faith is a *precondition* for an insurer’s liability in these circumstances. As the federal court stated in *Magnum Foods, Inc. v. Continental Casualty Co*, 36 F.3d 1491, 1498–99 (10th Cir. 1994) (citations omitted): “The right to control the litigation carries with it certain duties. 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.” As a result, the issue presented is one of contract—an issue onto which the additional burden of demonstrating bad faith should not be grafted. Because the duty to request a reasoned award arises out of and is a part of the insurer’s contractual duty to defend, the district court was correct in its determination that Integrity’s failure constituted a breach of the parties’ contract (AD 10), and its order should be reinstated.<sup>7</sup>

4. Misstatements Regarding Work Performed By Remodeling Dimensions & Potential Coverage. Last, as to the issue of potential coverage, Integrity repeatedly misstates the record related to the work performed by RDI on the original portion of the Provenzanos’ home when it contends that this work was limited to removing and replacing the master bedroom window. (Integrity Br. 34, 35, 36, 38-39, 42.) Integrity omits the fact that RDI replaced all the molding, flashing and trim on windows in the

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also suggests that RDI’s proper remedy is a malpractice suit—ignoring the fact that counsel was not retained to represent RDI in the coverage dispute. (Integrity Br. 25.)

<sup>7</sup> In the unlikely event this Court should hold that a demonstration of bad faith is a necessary prerequisite to imposing liability upon Integrity in this case, RDI should be afforded the opportunity to amend its complaint and the matter remanded to the district court for discovery and trial on that issue.

original portion of the home as well as on the patio door in the rear of the house. This is reflected in several pieces of evidence in the record:

- The Provenzanos' Summary of Claims to the American Arbitration Association: "The work included an addition to the Resident which included a bedroom, entertainment room, a 700 square foot flat roof, a deck, installation of window trim around windows on the original section of the house, and removal and installation of a master bedroom window." (AA 127)
- The Provenzanos' Pre-Hearing Brief: Factual Background: "The 2000 project did include, however, the installation of a new sliding patio door off the kitchen eating area. The project also included removal of a bay window off the kitchen eating area and replacing it with a three-panel box window. Both the patio door and the box window were installed incorrectly and are part of the Provenzanos' claim . . . . [During the 2003 project] Remodeling Dimensions also did exterior work on the original section of the Home. This work included installation of window trim and removal and reinstallation of the master bedroom window." (AA 178)
- The Provenzanos' Pre-Hearing Brief Argument: "The construction deficiencies caused by and not repaired or reported by Remodeling Dimensions on both the original construction and the addition are set forth in the July 12 and October 13, 2006 NDS reports.... As part of the 2000 remodel project, Remodeling Dimensions: (1) improperly installed the patio door of the kitchen eating area; (2) improperly installed the three-panel box window off the kitchen eating area.... As part of 2003 remodel [addition] project, for work on the original part of the Home, Remodeling Dimensions: (1) ***improperly installed the window trim which directly caused damage***, and failed to report and correct preexisting window installation problems and moisture damage that was visible as a result of the window trim installation work; (2) improperly reinstalled the master bedroom window.... (4) improperly reinstalled the patio door off the kitchen eating area." (AA 180–81 (emphasis added)).... Further, the large complex mullied window installation on the rear elevation of the Home is supported by a wall assembly that contains extensive moisture damage. The window itself is out of plane and appears to be collapsing into the Home, indicating that the wall itself is collapsing. ***Notably, the window developed cracks only after the window trim work was completed by Remodeling Dimensions.***" (AA 182 (emphasis added))

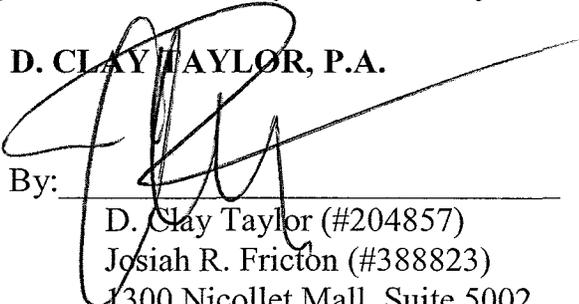
Because there is sufficient evidence in the record indicating that a portion of the Provenzanos' claim related to wall damage resulting from water intrusion around the windows in the original home, on which RDI performed work, there is clearly a factual

basis for a potentially covered claim that falls outside of the “your work” exclusion. Considering there is a solid factual basis for a potentially covered claim, the court of appeals clearly erred in holding all of the Provenzanos’ claims were outside the indemnity provisions of the parties’ contract, and this decision should be reversed.

**III. CONCLUSION.**

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

Dated: December 15, 2011.

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