IADC Committee Newsletter

CONSTRUCTION LAW AND LITIGATION

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IN THIS ISSUE

Steve Sitek and Christopher Haugen of Bassford Remele provide an analysis of an interesting and controversial decision by the Minnesota Supreme Court concerning the tripartite relationship between an insurer, the insured, and the attorney appointed to represent the insured.

Remodeling the Relationship: Modifying the Tripartite Relationship between Insurer, Insured, and the Insured's Attorney

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ABOUT THE COMMITTEE

The Construction Law and Litigation Committee consists of lawyers who represent general contractors, design/build firms, subcontractors, construction lenders, architects, engineers and owners. The Committee provides an opportunity to keep up to date on the latest developments in construction law, as well as a good networking and referral source for experienced construction litigators throughout the country. Members can also obtain information on liability and damage experts with e-mail inquiries to the Committee. Learn more about the Committee at www.iadclaw.org.
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A recent case decided by the Minnesota Supreme Court, *Remodeling Dimensions, Inc. v. Integrity Mutual Insurance Co.*,[1] may have blurred the traditionally clear lines regarding the duties and obligations of an attorney hired by an insurer to defend an insured.

Remodeling Dimensions, Inc. ("RDI") entered into a construction agreement to build an addition on the east side of a house and install trim on windows in the original part of the house.[2] RDI completed the project and one year later the homeowners noticed damage to the siding of the house and hired a consultant to conduct an inspection.[3] The consultant found significant moisture and related damage in several areas. The cause of the moisture damage was disputed by the parties during trial.[4] The homeowners served an arbitration demand on RDI and RDI tendered the homeowner's arbitration demand to Integrity—RDI's insurer—pursuant to RDI's liability insurance policy.[5] Integrity appointed an attorney to represent RDI in the arbitration proceedings and sent RDI a reservation-of-rights letter reserving its right to deny coverage notwithstanding the outcome of the arbitration. Integrity then sent another letter to RDI, a letter which ultimately set the stage for the court's decision, stating:

> The purpose of this correspondence is also 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.[6]

The arbitrator ultimately awarded the homeowners $51,000 of the $264,100 in damages requested by the homeowners.[7] RDI's attorney then requested further written explanation of the award; however, the arbitrator denied the request as untimely because the parties did not request an explanation of the award in writing prior to the appointment of the arbitrator as required by R-43(b) of the AAA Construction Industry Arbitration Rules.[8] Integrity denied coverage of the award, RDI paid the homeowners, and RDI commenced a declaratory judgment action against Integrity alleging breach of contract for Integrity's refusal to pay the arbitration award. RDI and Integrity filed cross-motions for summary judgment.[9]

The district court ruled that it was impossible to determine whether the insurance policy covered any of the homeowner's successful claims because RDI's attorney had failed to request an explanation of the award in accordance with the arbitration rules.[10] The court held Integrity legally responsible for the attorney's conduct, reasoning that the attorney hired by Integrity to defend RDI was an agent of Integrity and that Integrity was therefore vicariously liable for the attorney's failure to request a written explanation of the award.[11] The court of appeals reversed, holding that

[1] Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co., 819 N.W.2d 602 (Minn. 2012).
[2] *Id.* at 608.
[3] *Id.* at 608-09.
[4] *Id.* at 609.
[5] *Id.*
[6] *Id.*
[7] *Remodeling Dimensions*, 819 N.W.2d at 609.
[8] *Id.*
[9] *Id.* at 610.
[10] *Id.*
[11] *Id.*

the attorney hired by Integrity to defend RDI did not have an attorney-client relationship with Integrity so Integrity was not responsible for the attorney's failure to make a timely request for a written explanation of the award. The court of appeals also held that the homeowner's claims against RDI are not covered losses under the insurance policy.[12]

The issue before the Minnesota Supreme Court was whether Integrity was vicariously or directly liable for the failure of the attorney it appointed to defend RDI to request a written explanation of the arbitration award.[13] The court stated, "[i]n order to answer the question presented, we must examine the tripartite relationship between an insurer, the insured, and the attorney defending the arbitration claim."[14] The court began by noting the well-recognized rule that an attorney hired by an insurer to defend a claim against its insured represents the insured, owes an undivided duty of loyalty to the insured, and must faithfully represent the insured's interests.[15] The court then turned to the issue of vicarious liability.

The court held that RDI failed to establish that the attorney appointed by Integrity had a duty to RDI to request a written explanation of the arbitration award.[16] The court reasoned that RDI agreed that the attorney's representation did not extend to the coverage dispute with Integrity, and that the attorney had no independent duty of care to request a written explanation of the arbitration award. Because there was no issue over whether the attorney had a duty of care to request a written explanation of the award, or was otherwise negligent, there was no liability that could be imputed to Integrity.

The court next addressed whether Integrity was directly liable to RDI for the failure of RDI's attorney to request an explanation of the arbitration award. The court stated that it had yet to address whether an insurance company has a duty to disclose to its insured the availability of obtaining a written explanation of an arbitration award, and the appropriate remedy if it fails to do so.[17] The court held:

> when an insurer notifies its insured that it accepts the defense of an arbitration claim under a reservation of rights that includes covered and noncovered claims, the insurer not only has a duty to defend the claim, but also to disclose to its insured the insured's interest in obtaining a written explanation of the award that identifies the claims or theories of recovery actually proved and the

[12] *Id.* While the Minnesota Supreme Court analyzed and decided the issue of whether certain claims by RDI constituted occurrences under the insurance policy, that portion of the decision is not the focus of the present article. In short, on the coverage issues, the court held:

> the failure-to-inform and negligent-construction (addition) claims are not covered by the insurance policy, and the negligent-construction (original house) claim, if proven, would be covered by the insurance policy. Therefore, the arbitration award may be attributable, in whole or in part, to a covered claim. Thus, the court of appeals erred in concluding that Integrity was entitled to summary judgment because no part of the award could be attributable to a covered claim.

Remodeling Dimensions, 819 N.W.2d at 613.

[13] *Id.* at 613.

[14] *Id.*

[15] *Id.*

[16] *Id.* at 615.

[17] *Remodeling Dimensions*, 819 N.W.2d at 617.

portions of the award attributable to each.[18]

The court went on to place three conditions upon this duty, namely that 1) the insured affirmatively shows that a written explanation of an award is available under the applicable rules, 2) the insurer has the opportunity to provide timely notice to the insured of the insured's interest in a written explanation of the award, and 3) that prejudice was caused by the failure of the insurer to provide such notice.[19] Further, if the insurer fails to provide timely notice to the insured and the insured suffers prejudice, the burden shifts to the insurer to prove by a preponderance of the evidence that some part of the award is attributable to a non-covered claim.[20]

The ruling by the Minnesota Supreme Court in this case muddies the water on what was previously a bright-line standard; that the attorney appointed by the insurer to represent the insured owes its duties solely to the insured, the client, and not the insurer. The practical implication of the court's decision in *Remodeling Dimensions* is that coverage issues now become something an attorney appointed by an insurer must confront. Under the previous standard, the insured and the insured's attorney would decide how to present the best defense to the claims made by the plaintiff. Coverage issues were rarely, if ever, a concern. Once the underlying liability issues resolved, then the insured and insurer determined what portion of the damages or losses would be covered under the insured's policy. Under the new scenario presented by the court, the attorney appointed to represent the insured is now under an affirmative obligation to request a coverage determination during the liability phase of the trial if the insurer puts the insured on notice that an allocated award is required. In effect, the insured's attorney is now must request allocated awards when it is requested by the insurer, not the insured.

In the past, the insured and the insured's attorney would have decided whether to request a written explanation of an award based on what the insured and the insured's attorney believed to be in the insured's best interest. Now, if the insurer notifies its insured that the insured should obtain a written explanation of the award—presumably because the insurer will deny coverage for any non-allocated portions of the award—the insured's attorney must request such an allocation or risk his client being at a decided disadvantage in subsequent coverage litigation. While the crux of the court's holding concerns which party will bear the burden of proving allocation of the award in subsequent litigation over coverage issues, the bigger, and perhaps unintended, consequence of the decision is that the insurer is now in a position to affect the underlying liability litigation. By notifying the insured of an interest in obtaining an allocated award, the insurer now interjects its own desire to obtain or not obtain information for subsequent coverage litigation into the liability phase of the trial and it becomes incumbent on the insured's attorney to then request an allocated award or the insured will face a heavier burden during subsequent coverage disputes.

Some have argued that *Remodeling Dimensions* is confined to the arbitration setting; however, the ruling is not so limited. Insurers who plan to deny coverage when faced with an unallocated award from an arbitrator will likely be similarly required to provide notice to an insured if the insurer will pursue the same course of action if the

[18] *Id.* at 618.
[19] *Id.*
[20] *Id.*

insured fails to obtain such an allocation from a district court. There is no reason to suspect that insurers will not inform the insured and the insured's attorney of the need to draft a jury verdict form that will adequately address the coverage issues when in district court. Under the court's ruling, once notice of such is provided by the insurer, the insured's attorney will need to draft such jury instructions or will place his client, the insured, at a disadvantage in subsequent coverage litigation.

The blurring of the bright-line rule that an attorney appointed to represent an insured represents the insured's interests only can only create confusion. The idea that an insurer can influence how the insured's attorney chooses to proceed in the liability phase of the litigation by notifying the insured about the insured's interest in obtaining an allocated award, does seems to blur that traditionally clear line. Only subsequent cases will tell whether this case is an anomaly which imposes an isolated requirement on the insured's attorney or whether this case remodeled the tripartite relationship between an insurer, an insured, and the attorney appointed to represent that insured.