REMODELING DUTIES: AN INSURER'S NEW DUTY TO ADVISE THE INSURED TO REQUEST AN ALLOCATION OF DAMAGES

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In the recently decided *Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co.*, 819 N.W.2d 602 (Minn. 2012), the Minnesota Supreme Court created a new duty on the part of insurers who defend under a reservation of rights to notify their insureds of the insured's interest in obtaining a written explanation of an arbitration award that identifies the claims or theories of recovery actually proved and the portions of the award attributable to each. The court also announced a new burden-shifting approach to enforcing this new duty. While seemingly simple and easily satisfied, these new rules have implications beyond those discussed in the court's opinion.

Coverage disputes requiring court intervention routinely arise between insurers and their insureds. Minnesota courts routinely place burdens upon insurers to notify their insureds of essentially anything and everything, or they run the risk of providing coverage where none was intended under the language of the applicable insurance policy. Further, Minnesota courts have held that "[t]he duty to defend an insured is broader than the duty to indemnify" and that this "duty arises when any part of the claim is 'arguably' within the scope of the policy's coverage." *Westfield Ins. Co. v. Kroiss*, 694 N.W.2d 102, 106 (Minn. Ct. App. 2005). Despite the broad duty to defend, the duty to indemnify does not arise if the damages awarded are for claims not covered by the insurance policy. *See Bobich v. Oja*, 104 N.W.2d 19, 24 (Minn. 1960) (stating that the extent of an insurer's liability is governed by the insurance policy). No published or unpublished Minnesota appellate case had previously addressed whether an insurer who accepts the duty to defend a claim asserted against its insured has any duty to notify that insured of his right to request a detailed written explanation of an arbitration damage award.

I. SETTING THE STAGE

Remodeling Dimensions, Inc. (RDI) was hired to build an addition to a house and to install trim on windows in the original part of the house. After that work had begun, the homeowners hired RDI to remove and reinstall the master bedroom window in the original portion of the house in order to move a large couch into the bedroom. The contract entered into between the homeowners and RDI provided that all disputes related to the construction contract would be resolved by binding arbitration with the American Arbitration Association (AAA).

RDI completed its work in June 2003. In May 2004, the house sustained storm damage and the homeowners hired a consultant to inspect and evaluate the house for

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problems. The consultant informed the homeowners that the house had significant moisture intrusion and damage to several areas. In the spring of 2006, the homeowners hired a second consultant who also found moisture intrusion into the structural portions of the house and recommended repairs. RDI disputed the homeowners' claim that the moisture intrusion was due to RDI's work.

II. THE HOMEOWNERS' ARBITRATION ACTION

In July 2006, the homeowners filed a demand for arbitration with AAA, claiming that the moisture intrusion was caused by RDI. According to RDI, the homeowners advanced three claims in the arbitration: 1) that RDI negligently failed to warn them of preexisting water intrusion and resulting damage to the existing portions of the home that were discovered, or should have been discovered, in the course of RDI's work; 2) that RDI negligently constructed the addition to their home; and 3) that RDI's negligent work to the original portions of the home caused additional water intrusion and resulting damage to adjacent structures and walls of the existing home. The homeowners sought $264,100 in damages at the arbitration hearing.

At some point, RDI tendered the arbitration claim to Integrity Mutual Insurance Company (Integrity), its commercial general liability insurer. By September 7, 2006, Integrity had agreed to defend RDI and had retained an attorney to represent it. AAA appointed an arbitrator to decide the case on September 21, 2006, and Integrity sent a reservation of rights letter to RDI the following day. Although Integrity's reservation of rights letter questioned whether the homeowners' claims were covered and reserved Integrity's right to deny coverage, the letter did not inform RDI of its right to request an arbitration award form that would address the covered and uncovered claims.[1]

On January 10, 2007, Integrity sent RDI a second letter, this time informing RDI of its duties with respect to any request for a detailed arbitration award. Specifically, Integrity notified RDI that it was up to RDI and its counsel to fashion an arbitration award form that addressed the coverage issues. Integrity's letter informed RDI that if it was impossible to determine from the arbitration award whether any of the damages awarded involved property damage that occurred during the Integrity policy period, then Integrity would not be required to indemnify RDI for such an ambiguous award.

1 The court's opinion noted that by the time the reservation of rights was issued, it was too late for RDI to request a detailed award, since Rule 43(b) of the AAA Construction Industry Arbitration rules requires such a request to be made in writing prior to the appointment of an arbitrator.

Following the arbitration hearing, the homeowners were awarded $45,000 for "basic house repairs," $2,000 for "flat roof repair," $1,000 for "final cleaning," and $3,000 for "construction management fees." No damages were awarded for replacement window costs. RDI's attorney requested an explanation of the award, but the arbitrator denied the request because neither party had made a written request for an explanation of the award before the arbitrator was appointed as required by Rule 43(b).

III. RDI SUES FOR COVERAGE

As promised in its January 2007 letter to RDI, Integrity denied coverage for the arbitration award. RDI paid the homeowners and commenced suit against Integrity for breach of contract.

The district court granted a motion by RDI for summary judgment, apparently concluding that it was the failure of the attorney hired by Integrity to request a detailed award that made it impossible to determine whether the insurance policy covered any of the homeowners' successful claims. The court held that Integrity should pay the entire award because it was vicariously liable for the attorney's conduct as an agent of Integrity. The court of appeals, however, reversed and ordered the entry of judgment in favor of Integrity. *Remodeling Dimensions, Inc. v. Integrity Mut. Ins. Co.*, 806 N.W.2d 82 (Minn. Ct. App. 2011).

Upon further review, the Minnesota Supreme Court found, first, that the homeowners' negligent construction (original house) claim presented at the arbitration hearing satisfied the Integrity policy's definition of an occurrence and was not excluded by the business-risk exclusions set forth in the Integrity policy. On this issue, the court of appeals had held that the policy's business-risk exclusions of the policy excluded coverage for damage to existing portions of the home, in part because the district court record contained no claim by RDI, and no evidence to support, that there was any damage to pre-existing portions of the home caused by RDI's work, a point apparently conceded by RDI's counsel at oral argument to the court of appeals. Nevertheless, the Minnesota Supreme Court held that the alleged damage to pre-existing portions of the home, neither argued nor proved in the district court, qualified as an occurrence under the policy. While finding that damage to the pre-existing home caused by RDI would be covered, the court agreed with Integrity that the business risk exclusions in its policy precluded coverage for damage to the addition built by RDI.

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Turning to RDI's argument that Integrity should be vicariously liable for the conduct of the attorney it hired to defend RDI, the Minnesota Supreme Court engaged in an interesting analysis. The court suggested, but did not conclusively decide, that the defense attorney could be an agent of the insurer. It concluded, however, that RDI's vicarious liability claim failed because there was no evidence that the defense attorney owed a duty to his client to request a written explanation of the arbitration award. The court reasoned that the attorney owed no such duty of care, because the scope of the attorney's representation was limited and did not extend to the coverage dispute.

To address this issue, the Minnesota Supreme Court imposed a new duty on insurers:

> *"We conclude that 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 portions of the award attributable to each."*

Remodeling Dimensions, 819 N.W.2d at 618. This new duty is conditioned on the insured "affirmatively showing that a written explanation of an award is available under applicable rules, the insurer had the opportunity to provide timely notice to the insured of the insured's interest in a written explanation of the award, and prejudice was caused by the failure of the insurer to provide such notice." *Id.* The court instructed that insurers should make this required disclosure at or near the time the defense of the claim is accepted under a reservation of rights. If it does not, and the insured can show all of the above noted conditions, then the insurer is estopped from claiming that the insured has the burden of proving allocation of the award. Instead, the burden shifts to the insurer to prove by a preponderance of the evidence that some part of the award is uncovered. If the insurer provides the proper disclosure to its insured, then the insured bears the burden of proving allocation of the award in a subsequent coverage action.

Because the Court found the record unclear as to certain facts needed to address the aforementioned test, it reversed and remanded the matter to the "district court to determine whether timely notice was given and, if not, whether RDI satisfied all of the conditions including prejudice; and to determine whether the burden of proof regarding allocation of the award shifts to Integrity." It remains to be seen how this case will be resolved.

IV. THE UNANSWERED QUESTIONS RAISED BY *REMODELING DIMENSIONS*

While the Minnesota Supreme Court's new requirement that an insurer notify its insured of the right to request a detailed explanation of an arbitration award and the accompanying burden-shifting is fairly straightforward, the practical implications of this new rule, particularly for defense counsel retained by an insurer to defend an insured, are less clear.

A. Does the Minnesota Supreme Court's holding apply outside the context of an arbitration hearing?

The RDI case arose in the context of arbitration governed by AAA rules. As a result, it arguably has no application outside the context of arbitration and would not apply to damage awards at a trial by court or jury. However, the rationale set forth by the court in announcing this new duty would appear to apply equally to district court actions. The court stated that the rule prevents prejudice to an insured caused by conduct of the insurer, which is in a unique position to know the scope of coverage and exclusions in its own policies. Second, the court reasoned that the duty to notify is not onerous. These justifications are not unique to an arbitration setting. Indeed, most of the cases from outside Minnesota cited by the court in support of its decision involved allocation of verdicts, not arbitration awards. *See Duke v. Hoch*, 468 F.2d 973, 979 (5th Cir. 1972) (holding that an insurer's reservation of rights letter was not sufficient to advise its insured of the insured's interest in an allocated verdict); *Camden-Clark Mem'l Hosp. Ass'n v. St. Paul Fire & Marine Ins. Co.*, 682 S.E.2d 566, 575-76 (W. Va. 2009) (holding that the insured's burden to allocate a verdict between covered and uncovered claims does not shift to the insurer unless the insurer had an affirmative duty to defend the underlying claims); *Buckley v. Orem*, 730 P.2d 1037, 1044-45 (Idaho Ct. App. 1986) (adopting the *Duke* holding and remanding for a determination of whether an insurer had disclosed the need for an allocated verdict to the insured's attorney who had been retained by the insurer to defend the insured).

Insureds and their counsel will undoubtedly argue that the Minnesota Supreme Court's holding in *Remodeling Dimensions* places an affirmative duty on insurers to notify insureds in district court actions as well as in arbitrations. As a result, it would be prudent for insurers to include in their standard reservation of rights letters language advising insureds of their right to request allocated verdicts or awards. By doing so, the insurer will avoid the risk of assuming the burden of showing that some part of the award or verdict is not covered under

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the policy and the associated risk of providing coverage for losses never contemplated.

B. What duties do defense counsel retained to represent insureds have with respect to giving advice regarding detailed awards or verdicts?

While the new duty placed on insurers by the *Remodeling Dimensions* decision will likely be satisfied by the addition of a sentence or two in reservation of rights letters, the implications for defense counsel caught in the middle of a coverage dispute are less certain. In *Remodeling Dimensions*, both RDI and the court agreed that the scope of representation by the defense attorney hired by Integrity to defend RDI did not extend to the coverage dispute between RDI and Integrity. The court, therefore, found that the attorney had no duty of care to request a written explanation of the arbitration award. But what is defense counsel to do when a client presents a new reservation of rights letter containing a "Remodeling Dimensions Notice" and requests advice on how to craft a special verdict form?

A complex tripartite relationship arises when an insurer retains an attorney to represent its insured. *Pine Island Farmers Coop v. Erstad & Riemer, P.A.*, 649 N.W.2d 444, 445-49 (Minn. 2002). The existence of a tripartite relationship "does not displace the enduring fundamental principle that 'defense counsel hired by an insurer to defend a claim against its insured represents the insured.'" *Id.* at 449. As with any attorney-client relationship, the insurer-retained attorney "owes a duty of undivided loyalty to the insured and must faithfully represent the insured's interests." *Id.* As such, the decision to request a detailed explanation of an award, or an itemized verdict separating covered from uncovered claims, must necessarily depend on the best interests of the insured client. However, engaging in such an analysis will require the defense attorney to research, evaluate, and advise the client regarding the coverage issues in the case. Putting defense counsel in that position threatens the foundations of the tripartite relationship. In addition, if the defense attorney is successful in crafting a verdict form acceptable to both the insured and the insurer, has a dual representation been created requiring consultation and consent as described in *Pine Island*? These and other questions remain unanswered by *Remodeling Dimensions*.

C. Practical effects on insureds.

The court's ruling in *Remodeling Dimensions* undoubtedly affects insureds' interests with respect to coverage issues. Under this new rule, if the insurer makes the proper disclosure to its insured, then the insured ostensibly bears the burden of proving allocation of the award in a subsequent coverage action whether or not an allocated award or verdict is actually rendered in the underlying proceeding. In other words, if the insurer makes the newly required disclosure but the trial court refuses to allow the lengthy and potentially confusing verdict form proposed by the insured, then the insured would apparently still bear the burden of proving coverage in a subsequent action against the insurer.

Furthermore, the insured potentially opens itself up to increased damages by giving the arbitrator or jury multiple blank lines for damages, rather than the single damage question favored by most defendants. And is the separation of damage items on a verdict form a tacit admission that some of the items of damage are uncovered? What will juries make of the lengthy and, perhaps, confusing verdict forms that may be submitted in response to this new rule? All of these questions undoubtedly will arise in the future.

V. CONCLUSION

Remodeling Dimensions adds a new wrinkle to the already complex tripartite relationship among insurers, insureds, and defense counsel. The new duty imposed upon insurers by this decision appears simple and straightforward. Henceforth, insurers should notify their insureds in reservation of rights letters that the insured has a right to, and an interest in, obtaining a breakdown of the damages that identifies the specific claims proved and the specific damages attributable to each.

Insureds and defense counsel are confronted with more daunting challenges. Defense attorneys must counsel their insured clients to seek the advice of outside counsel with respect to coverage issues, and to engage coverage counsel in determining whether to seek a detailed arbitration award or jury verdict given the facts of the particular case. Further, as a good practice, defense counsel should advise the insured of the risk of not obtaining a damage award related to covered and uncovered claims so as to avoid placing the insured at risk of not having coverage for any portion of the damages eventually awarded. Counsel will undoubtedly need to be more aware than ever of the coverage issues involved in the representation of an insured client, in order to avoid — or at least manage — the "exceedingly awkward position" encountered when the interests of the insurer and insured diverge.