IN THE SUPREME COURT OF THE STATE OF OREGON

FOUNTAINCOURT HOMEOWNERS' ASSOCIATION and FOUNTAINCOURT CONDOMINIUM OWNERS' ASSOCIATION,

Plaintiffs,

v.

FOUNTAINCOURT DEVELOPMENT, LLC; et. al.

Defendants.

FOUNTAINCOURT DEVELOPMENT, LLC; et. al.
Third-Party Plaintiffs,

v.

ADVANCED SURFACE INNOVATIONS, INC., an Oregon corporation; et. al.,

Third-Party Defendants.

VOSS FRAMING, INC., assignee for FountainCourt Homeowners' Association, assignee for FountainCourt Condominium Owners' Association, on behalf of FountainCourt Development, LLC,

Washington County
Circuit Court
No. C075333CV

CA No. A147420

SC No. S062691

PETITIONER'S BRIEF ON THE MERITS

FILED: MAY 2015

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on behalf of Matrix Development Corporation, and
on behalf of Legend Homes Corporation,

Fourth-Party Plaintiff,

v.

DANA CHRISTOPHER; and
RED HILLS CONSTRUCTION, INC.,

Fourth-Party Defendants.

FOUNTAINCOURT HOMEOWNERS' ASSOCIATION and
FOUNTAINCOURT CONDOMINIUM OWNERS' ASSOCIATION,

Garnishors-Respondents,

v.

AMERICAN FAMILY MUTUAL

INSURANCE COMPANY,

Garnishee-Petitioner

GARNISHEE-PETITIONER'S BRIEF ON THE MERITS

Petition for Review of the Decision of the Court of Appeals from a Judgment of the Circuit Court of Washington County, Honorable Judge Marco A. Hernandez
Decision Filed: August 6, 2014
Judges: Armstrong, Presiding; and Duncan, J; Brewer, J., pro tempore, Affirmed with Opinion

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INDEX TO THE BRIEF

TABLE OF AUTHORITIES

CASES

STATUTES

OREGON CONSTITUTION

OTHER AUTHORITIES

TREATISE

GARNISHEE-PETITIONER'S BRIEF ON THE MERITS

I. Legal Questions Presented; Proposed Rules

A. Questions Presented

1. If a general verdict is returned against an insured entity in a mixed coverage case, i.e., some involving damage that is payable by an insurer and some damage that is not, and the insurer defended under a reservation of rights, can the insured establish coverage for the awarded damages based on the general verdict?

2. Can an insured establish a prima facie case for insurance coverage with evidence showing only the possibility that a judgment is for damages within the insuring agreement of a liability policy?

3. Does defective work by an insured contractor constitute "property damage" if that term is defined as "[p]hysical injury to tangible property"?

4. If a liability insurer's policy is garnished by a judgment creditor, and a disputed question of fact must be resolved to determine whether the insurer is obligated to pay the judgment, is the insurer entitled to a jury trial?

B. Proposed Rules of Law

1. An insured bears the burden of proving the facts of a loss, i.e., the injury and damages for which the insured seeks coverage. In a mixed coverage case, a general verdict does not disclose what injuries and damages are the basis for that judgment. That being so, the insured cannot prove that an insurer is obligated to pay the judgment based solely on the verdict or how the jury was instructed.

2. A claim for insurance benefits cannot be established through speculation or conjecture. For this reason, an insured who bears the burden of proving that damages awarded in a verdict are within the insuring agreement of a liability policy cannot meet that burden by showing the mere possibility of coverage. To meet that burden, the insured's evidence must what portion of the verdict actually is for damages within the insuring agreement.

3. A building that incorporates an insured contractor's defective work has not sustained a physical injury because of the defects. Thus, when a liability insurance policy defines "property damage" as a "physical injury to tangible property", an insured contractor's defective work is not within the definition.

4. Under Article I, section 17 of the Oregon Constitution, a party in a civil case that is legal in nature where a monetary judgment is sought is entitled to a jury trial on all disputed issues of fact. An insurer's right to have those disputed questions of fact resolved by a jury is not lost simply because the judgment creditor garnishes the policy. To the extent that ORS § 18.782 purports to eliminate an insurer's right to a jury trial to determine questions of fact bearing on coverage, that statute is unconstitutional and cannot be enforced.

II. Nature of the action; relief sought; nature of the judgment rendered by the trial court

Following a judgment in an underlying construction defect case, Plaintiffs FountainCourt Homeowners' Association and FountainCourt Condominium Owners' Association (collectively "FountainCourt") garnished defendant Sideco's insurance policies issued by insurers American Family and Clarendon. The trial court denied American Family's request for a jury trial and instead set the matter for a Show Cause hearing.

Following the Show Cause hearing, the trial court entered judgment against American Family for the full amount of the judgment entered against Sideco in the underlying liability trial and it also dismissed American Family's counterclaim for declaratory judgment.

The supplemental judgment on the garnishment claim was entered on December 20, 2010. The Court of Appeals affirmed. *FountainCourt Homeowners v. FountainCourt Dev.*, 264 Or App 468, 334 P3d 973 (2014).

III. Summary of Argument

The trial court and the Court of Appeals erred by applying inferred factual findings from a jury's general verdict in the underlying liability trial against American Family in a subsequent, independent coverage proceeding. They further erred by only permitting an expedited Show Cause hearing without the full panoply of discovery and without a jury to determine material issues of fact relevant to coverage under American Family's policy.

American Family only had 1/3 of the time on the exposure of damage to the buildings, i.e., 2 out of 6 years. American Family only had potential coverage for 1/3 of the buildings worked on by its insured based on the multi-unit exclusion, i.e., 5 out of 8 buildings had greater than 8 units. Despite only being contractually obligated to pay no more than 1/3 of any awarded damages (without even considering what was excluded to re-do Sideco's work), the trial court ruled that American Family had to pay 100% of the judgment based on assumed factual findings as the jury was instructed in the liability trial and because it was impossible to prove

the jury's deliberative process in reaching its verdict. This was simply wrong and cannot stand.

FountainCourt's garnishment against American Family and American Family's counterclaim for declaratory relief should have followed this process:

First, FountainCourt had the burden to prove "property damage" caused by an "occurrence" within the American Family policy period. The required proof should have been limited to actual facts admitted into evidence in the underlying trial. It should not have been based on assumed factual findings as demonstrated by the jury's verdict, and should not have been based on new, additional factual evidence taken at the Show Cause hearing without a jury.

That is, evidence from the trial should have been considered anew in the context of proving the claimed damages were actually covered by the policy, and not assumed to be true based on the jury's verdict as they were instructed.

The only relevance of the jury's verdict is that it capped the maximum amount of damages that could be owed under the American Family policy. Neither the implicit factual findings underlying the jury's verdict nor how the jury was instructed are determinative of the subsequent coverage issues.

Second, after meeting its burden of proving damages actually covered (not possibly covered based on assumed factual findings as evidenced by the verdict), then the burden would shift to American Family to either challenge whether FountainCourt met its burden and/or prove that some, or all, of the claimed damages were otherwise excluded from coverage. To meet its burden, American Family could introduce factual evidence to be considered in the coverage action that was not in evidence in the underlying liability trial.

Finally, because a determination of coverage necessarily requires consideration of facts in the context of the policy provisions (as opposed to being in the context of liability against the insured), American Family was entitled to a jury.

IV. Material Facts

This case arises out of the construction of a multi-family housing project consisting of 34 condominium units and 63 townhome units in 11 buildings. *FountainCourt*, 264 Or App at 471. The buildings were constructed in stages between September 2002 and July 2004, with each having a different substantial completion date as reflected in the certificates of occupancy. *Id.*

In 2007, FountainCourt sued the developers and general contractor for defects and deficiencies in the development and construction of the

project. *Id.* In 2009, FountainCourt filed a second amended complaint, asserting direct claims against several subcontractors, including Sideco. *Id.* American Family accepted the defense of Sideco subject to a full reservation of rights. *Id.* at 474; Exs. 203-A, 204-A, 205-A.

Sideco "provided labor and certain materials generally involving installation of exterior siding, weather-resistant barriers, windows, and related caulking and flashing." *Id.* at 472. Sideco's job file introduced as an exhibit in the liability trial consisted of 918 pages, evidencing its scope of work. Ex. 29.

Prior to suing Sideco, FountainCourt sent Notices of Defects pursuant to ORS § 701.565, alleging that Sideco's work was defective, stating:

> "These defects must be remediated by means that will ensure that the Condominiums [and Townhomes] are free of moisture intrusion and **that the defective work will be brought into conformance** with applicable statutes, ordinances, building costs, approved plans and specifications, contracts, warranties, industry standards regarding workmanship and materials, and manufacturers' specifications and recommendations."

Exs. 5 and 12. (Emphases added).

In the underlying liability trial, FountainCourt requested damages from the jury based on a repair estimate from Charter Construction, totaling $3,837,005. FountainCourt's counsel argued that the Charter

Construction cost of repair was "the reasonable cost of repairing the damaged property. That's what it takes to fix the damage **and the bad work that is allowing it to occur.**" Ex. 109; Tr. 4782. (Emphasis added).

The jury was instructed that FountainCourt must allege and prove physical damage to their property, and the measure of damages was the reasonable cost of repairing the damaged property. *FountainCourt*, 264 Or App at 474-75. Using the Charter Construction estimate in support of its claimed damages, FountainCourt's counsel argued the following in closing argument:

> "So the fact that not all of the wood, and a lot of it is not real bad yet, that doesn't deprive these homeowners of a remedy. They still have a remedy here, because there is damage, **and they still need to correct** that damage and **the conditions that are allowing it to occur. Unless those conditions are corrected, it's just going to continue.**" Tr. 4734, lines 15-22.
>
> "We know that Sideco put on all of the siding and all of the weather-resistant barrier and all of the trim and all of the metal flashing and all of the sealant." Tr. 4753, lines 11-14.
>
> "Here's a column that Sideco built. Completely ignored the plan detail. * * * It's a code violation." Tr. 4743, lines 17-23
>
> "Here's a reverse lap in the WRB, Sideco's work." Tr. 4744, lines 22-23.
>
> "You can't not put weather-resistant barrier between those windows. But that's what Sideco did; they omitted any weather-resistant barrier." Tr. 4745, lines 4-7.

> "You remember this installation. This was the one above the stone work. Well, here's a hole in the WRB, Sideco's work. No WRB. It's not continuous. It doesn't cover the whole wall." Tr. 4745, lines 22-25.
>
> "So how do you repair the damage? Well, you have to not only repair the damaged property itself, but **you have to repair the conditions that have allowed the water to come in** and that, if uncorrected, will continue to create damage." Tr. 4773, lines 10-14.
>
> "And there's nothing in the law that - - the law can be pretty crazy sometimes, but it isn't that silly or foolish where it says you may only recover the cost to repair the damaged sheathing. That's all you get is the OSB sheathing. The condition that is allowing the water in, you don't get to fix that, because that's not damaged. So you can fix the sheathing, but you can't fix the condition. And so when it gets damaged again in a few years, tough." Tr. 4773, lines 15-24.
>
> "That – the law does not – it's not that foolish. What it says is, you get the reasonable cost of repairing the damaged property. Here the reasonable cost, under any reasonable analysis is the cost to repair the damage **and the defects that are causing the damage**. That's the only way to put this building back in the condition it should have been in, had it been constructed properly in the first place." Tr. 4773, line 25, Tr. 4774, lines 1-8.

The Charter Construction estimate included the costs to remove and replace Sideco's work, including the exterior siding, weather-resistant barriers, trim, flashing and sealant. Ex. 109. FountainCourt asked the jury to award $3,831,635, and to allocate 39.58% of its award to Sideco. Tr. 4782; Ex. 110.

The jury awarded $2,145,156 and allocated 22.65% of its award to Sideco. ER-3, 4. The jury was not asked to segregate damages by type, building, or date. *FountainCourt*, 264 Or App at 475.

The American Family policy was in effect from May 1, 2004 to May 1, 2006. *Id.* at 472. The insuring agreement states that American Family will pay those sums that Sideco is legally liable for as damages because of "property damage" caused by an "occurrence," which occurs during the policy period. *Id.* "Occurrence" is defined to mean an accident, and "property damage" is defined to mean "physical injury to tangible property, including all resulting loss of use of that property." *Id.* at 473-74.

Assuming the insuring agreement is triggered, the policy excludes from coverage "property damage" to "that particular part of real property" on which [Sideco or its subcontractors] are working on" or "must be restored, repaired or replaced because [Sideco's] work was incorrectly performed." *Id.* at 473. The American Family policy also excludes "property damage" to Sideco's work "arising out of it or any part of it." *Id.*

The American Family policy also excludes "property damage" arising out of Sideco's work for any multi-residential building which has greater than 8 units. *Id.* at 473 -74. Six of eight buildings worked on by Sideco had greater than 8 units, leaving only damages to three buildings

potentially within coverage under American Family's policy. Tr. 5282, 5430; Ex. 49.

FountainCourt's expert testified at the Show Cause hearing that consequential water damage began "within that first weather cycle" after the certificate of occupancy was issued for each building, Tr. 5279-80, and would continue until the defective conditions were repaired. The only three buildings potentially within American Family's coverage – Buildings A, D and K – all had completion dates prior to the inception of American Family's policy period of May 1, 2004.

Accordingly, it is undisputed that damage to the buildings began prior to the inception date of the American Family policy, and continued for three years after the expiration of the policy as the buildings were not repaired at the time of the 2009 liability trial.

V. Argument

A. Coverage in a Subsequent Action Cannot be Established Based on Assumed Factual Findings from the Jury's General Verdict

American Family provided a defense to Sideco in the liability case subject to a reservation of rights, contending that damages claimed by FountainCourt were not covered by its policy. Two insurance coverage concepts are important here. First, while the judgment against Sideco constitutes the universe of what might be collected against American

Family, it is not sufficient that a claimed item of damage is within that judgment – an item of damage must also be within the coverage grant of the policy and not excluded from coverage. Second, assuming some item of damage was covered, the actual cost of repair of each covered item is the measure of damages because that is the "property damage" within the meaning of the policy. These issues necessarily require independent factual determinations in the subsequent coverage action.

For almost a half a century, it has been the law of this state that "an insurer can contest coverage later." *Ferguson v. Birmingham Fire Ins. Co.*, 254 Or 496, 510, 460 P2d 342 (1969); *see also Paxton-Mitchell Co. v. Royal Indem. Co.*, 279 Or 607, 614 n 2, 569 P2d 581 (1977). That is exactly what American Family tried to do and was denied. Despite not being bound by the factual findings made by the tribunal assessing damages in a judgment, the trial court and the Court of Appeals in fact so found that American Family was bound by inferring that the jury necessarily found that its entire award against Sideco was "property damage" caused by an "occurrence" because the jury was instructed that FountainCourt had to prove physical damage to their property, and the measure of damages was the reasonable cost of repairing the damaged property. This necessarily is a factual finding by the jury assessing damage, which cannot be forced on American Family.

1. Nature of a Garnishment

ORS § 18.352 provides that "[w]here a judgment debtor has a policy insurance covering liability, or indemnity for any injury or damage to person or property, which injury or damage constituted the cause of action in which the judgment was rendered, *the amount covered by the policy of insurance* shall be subject to attachment upon the execution issued upon the judgment." (Emphasis added).

FountainCourt proceeded against American Family as a garnishor. As a garnishor, FountainCourt stands in the shoes of the insured. *See State Farm Fire & Cas. Co. v. Reuter*, 299 Or 155, 166, 700 P2d 236 (1985). FountainCourt can only recover to the extent Sideco could have recovered amounts from American Family. FountainCourt bears the same burdens as Sideco would be as an insured seeking coverage for a judgment. *Id.*

2. American Family is Not Bound by the Jury's Factual Findings

American Family only owes for "property damage" caused by an "occurrence" within American Family's policy period, which is necessarily limited to those sums that Sideco must pay to repair the "property damage" caused by Sideco's work to something other its work.

This calculation is not constrained by the judgment in the underlying trial:

> The judgment should operate as an estoppel only where the interests of the insurer and insured in defending the original action **are identical** – not where there is a conflict of interests. If the judgment in the original action is not binding upon the insurer or insured in a subsequent action on the issue of coverage, there would be no conflict of interests between the insurer and the insured in the sense that the insurer would gain any advantage in the original action which would accrue to it in a subsequent action in which coverage is in issue. (Emphasis added).

Ferguson, 254 Or at 510-11 (1969); *see also Ohio Cas. Ins. Co. v. Ferrell Devs., LLC*, 2011 WL 5358620, *5 (D Or), *report and recommendations adopted* 2011 WL 5358592 (D Or) (stating "[i]n an action brought by an insurer seeking a determination by this court with regard to the insurer's obligation to indemnify its insured for damages assessed against it, **this court is not bound by the factual findings made by the tribunal assessing the damages in either a judgment** or award because the interests of the plaintiff and defendant are not the same in both actions") (Emphasis added).

Here, the interests of Sideco and American Family were in conflict as evidenced by the fact that American Family provided a defense under a reservation of rights. Because an actual conflict existed with its insured, American Family and Sideco were not in privity and American Family was not bound by the factual findings assumed within the judgment and it had

the right to fully litigate its coverage issues, including the amount of damages covered under its policy. *Ferguson*, 254 Or at 510-11; *State Farm Fire & Cas. Co. v. Paget*, 123 Or App 558, 860 P2d 864 (1993).

While American Family was not bound by the judgment, as parties to the underlying lawsuit, both FountainCourt and Sideco are bound by the jury's verdict that was reduced to judgment. FountainCourt is suing American Family on that judgment. American Family's policy says it owes indemnity on Sideco's behalf for Sideco's liability to a third party to the extent that liability is within the coverage grant and not otherwise excluded. Therefore, the universe of what FountainCourt can claim against American Family is the judgment.

However, the issue in the underlying lawsuit was Sideco's liability to FountainCourt for damage and defective work. The issue in the coverage action against American Family is different – which of those liabilities, if any, were caused by an "occurrence" resulting in "property damage" within the policy period as those terms are defined in the American Family policy.

This is why insurers like American Family are not bound by the facts of the underlying lawsuit – the insurers were not parties to the underlying cases; the issues of policy definitions and coverage vary considerably from the issues in the underlying construction defect case; and, before

the conclusion of the underlying liability trial, insurers can rarely litigate the minutiae of coverage terms and the facts that apply to those coverage issues without prejudicing their insureds. *N. Pac. Ins. Co. v. Wilson's Distrib. Serv., Inc.*, 138 Or App 166, 908 P2d 827 (1995).

Indeed, defense counsel retained by an insurer cannot ask a court to grant relief or advocate for instructions that would place an insured's coverage at risk. An ethics opinion promulgated by the Oregon State Bar explains that when insurance defense counsel is retained to defend an insured in an action that includes covered and non-covered damages, defense counsel cannot file a motion that would remove the covered damages from the action and thereby jeopardize the insured's coverage. According to the opinion:

> [A]n attorney who is hired to defend the insured in a situation such as the one described * * * cannot file a motion that would adversely affect the insured's right to a defense or to coverage but must indeed act in a manner that is consistent with the interests of the insured.

OSB Legal Ethics Op. No. 1991-121, p.3.

This rule applies where, as here, there may be coverage for some, but not all, of the damages claimed against an insured. Under these circumstances, it is in the insured's best interest to have the allocation issue resolved in a separate proceeding involving the insurer, not in the liability case. That being so, it would have been unethical for Sideco's

attorney to request that damages be allocated according to potential coverage, which also explains why Sideco's retained defense counsel did not object to the statements made by FountainCourt's counsel during closing argument that "physical damage to their property" included the cost to correct the defective conditions.

In sum, because the repair cost allocation, the nature of Sideco's liability, and the source and timing of the damages, all present questions of material fact relevant to whether American Family must pay any portion of the judgment, the trial court and the Court of Appeals erred by applying the assumed factual findings in the liability action against American Family in the coverage action and denying American Family's right to have those facts necessary for the coverage issues to be decided by a jury.

B. Coverage in a Subsequent Action Cannot be Established Based on Possibility that the Judgment as for Damages Within the Insuring Agreement

FountainCourt had the burden of proving what portion of the judgment entered against Sideco was covered under the American Family policy, not merely a loss which the insured Sideco was liable. *See Jarvis v. Indem. Ins. Co.*, 227 Or 508, 512, 363 P2d 740 (1961); *ZRZ Realty Co. v. Beneficial Fire & Cas. Ins. Co.*, 222 Or App 453, 465, 194 P3d 167 (2008). The duty to indemnify is established by proof of facts

demonstrating a right to coverage. *McLeod v. Tecorp Intern., Ltd.*, 318 Or 208, 217-18, 865 P2d 1313 (1993); *W. Equities, Inc. v. St. Paul Fire & Marine Ins. Co.*, 184 Or App 368, 374 (2002). It cannot be based on speculation or conjecture. *Simpson v. Hillman*, 163 Or 357, 364, 97 P2d 527 (1940).

FountainCourt argued, and the lower courts agreed, that all it had to show was that because it was possible that the judgment included covered damages, then American Family must pay for all of it. Indeed, the trial court's order was supported by FountainCourt's expert's testimony at the garnishment hearing that "all of the $485,000 awarded by the jury **could have been** to repair that resulting damage." *FountainCourt*, 264 Or App at 485. (Emphasis added). That is neither the correct analysis of a coverage determination nor is it the law of the State of Oregon.

The trial court improperly focused on the impossibility of allocating the jury's verdict after the fact, i.e., not knowing what items of claimed damage were actually awarded or what Sideco was being held responsible for. However, it is just as likely, based on counsel's closing argument, that the jury held Sideco liable for the cost to repair and replace all of its work, which would undisputably not be covered. By way of

example, Charter Construction's estimate included the following line items to re-do Sideco's work:

2070 Demo - Siding
2070 Demo - Fiber Cement Lapped Siding
2070 Demo - Fiber Cement Board & Batten Siding
2070 Select Demo - Stone Veneer
2070 Select Demo – Brick Veneer
2070 Demo – Entry Column Cladding @ Craftsman Units

6210 Exterior Finish Carpentry
6210 Install New Inside/Outside Corner Trim (Included)
6210 Install New Trim @ Windows Doors & SGDs (Included)
6210 Install New 12X Deck Fascia
6210 Install New 12X Belly Band
6210 Install New 6X Belly Band
6210 Remove & Reinstall Corbels (To Remain in Place)
8210 Remove & Reinstall Shutters
6210 Remove & Reinstall Trellises
6210 Install New Cedar Blocks @ Vents (Included)

7468 Mineral Fiber Cement Siding
7468 Install New Fiber Cement Lap Siding
7468 Install New Fiber Cement Board & Batten Siding
7468 Re-Clad Entry Columns @ Craftsman Units
7468 Install Delta Dry Drainage Mat

7600 Flashing and Sheetmetal
7600 Head Flashing @ Windows
7600 Head Flashing @ Entry Doors
7600 Head Flashing @ SGDs
7600 Head Flashing @ Deck Man Doors
7600 Radius Head Flashing @ Windows
7600 Head Flashing @ Utility Box Assemblies
7600 Saddle Flashing @ Private Decks
7600 Z Flashing @ Belly Band
7600 Z Flashing @ Stone
7600 Deck to Wall Flashing @ Private Decks
7600 Deck Edge Flashing @ Private Decks

7600 Column Base Flashing @ Corner Decks
7600 Z Flashing @ Deck Head Trim
7600 Column Cap Flashing @ Craftsman Entry Unit Columns
7600 Deck to Wall Flashing @ Slat Decks (excluded)

Ex. 109. The costs of these items to re-do Sideco's scope of work totaled $1,229,624 without including mark-ups for general conditions, overhead, contingencies or architectural fees. Ex. 109. This is why an insurer is not bound by the judgment (or assumed factual findings) in a subsequent coverage action where its interests were in conflict with the insured's in the liability trial.

Rather, what FountainCourt was required to do, and did not, was present actual factual evidence submitted at the trial to determine what amount of the judgment against Sideco was covered under the American Family policy. The jury's verdict acts as a limit on the amount American Family could potentially be required to pay on Sideco's behalf but it neither determines coverage nor constrains any coverage argument that American Family can make. FountainCourt, as the party wishing to collect on the policy, must prove what portion of the damages assessed against Sideco is for "property damage" caused by an "occurrence" that is covered by the policy.

Because it was FountainCourt's burden, as a judgment creditor standing in the insured's shoes, to show the existence and cost of

property damage within the American Family policy period, its failure to do so in the garnishment proceeding limits or eliminates its recovery. *Ferrell Devs.,* 2011 WL 5358620, at *8. (holding that because the insured did not present evidence from the underlying arbitration as to the proper allocation between covered and non-covered damages, the insured had not met its burden of proof).

C. Defective Workmanship is Neither an "Occurrence" Nor "Property Damage"

CGL policies, including the American Family policy, limit coverage to "property damage" caused by an "occurrence" within its policy period. Oregon law is clear that costs incurred to replace Sideco's defective work are neither an "occurrence" nor "property damage" under the American Family policy.

1. Rules for Interpreting Insurance Contracts

Under Oregon law, the meaning of an insurance contract, like every other contract, is a question of law. *Timberline Equip. v. St. Paul Fire & Marine Ins. Co.*, 281 Or 639, 643, 576 P2d 1244 (1978). The rights and obligations under the policy are determined from the terms and conditions therein, and not from extrinsic evidence. ORS 742.016; *Employers Ins. of Wausau v. Tektronix*, 211 Or App 485, 505, 156 P3d 105 (2007). Interpretation of an insurance policy is governed by its four corners, and

the court considers the policy as a whole. *Hoffman Constr. Co. v. Fred S. James & Co.*, 313 Or 464, 469, 836 P2d 703 (1992). If coverage is not afforded under the plain terms of the policy, the court will not rewrite the policy to provide coverage. *Allstate Ins. Co. v. State Farm Mut. Auto. Ins.*, 67 Or App 623, 627, 679 P2d 879 (1984).

2. Defective Workmanship is Not Covered

Costs to remove and replace defective work is not the result of a covered "occurrence." *Milgard Mfg., Inc. v. Cont'l Ins. Co.*, 92 Or App 609, 612-13, 759 P2d 1111 (1988). Similarly, defective conditions in a building are not "physical injury" as to constitute "property damage." *Wyo. Sawmills, Inc. v. Transp. Ins. Co.*, 282 Or 401, 406, 578 P2d 1253 (1978).

For a claim of defective workmanship to give rise to "property damage," a claimant must demonstrate that there is damage to property separate from the defective work of the insured. *Oak Crest Constr. Co. v. Austin Mut. Ins. Co.*, 329 Or 620, 628-29, 998 P2d 1254 (2000). The *Oak Crest* court cited, among other authorities, a well-known passage from Roger C. Henderson, *Insurance Protection for Products Liability and Completed Operations – What Every Lawyer Should Know*, 50 Neb. L. Rev. 415, 441 (1971), for the proposition that defective workmanship resulting in business expenses such as repairs is not the type of risk insured by commercial liability policies:

> The insured, as a source of good or services, may be liable as a matter of contract law to make good on products or work which is defective or otherwise unsuitable because it is lacking in some capacity. This may even extend to an obligation to replace or completely rebuild the deficient product or work. This liability, however, is not what the coverages in question are designed to protect against. The coverage is for tort liability for physical damages to others and not for contractual liability of the insured for economic loss because the product or completed work is not that for which the damaged person bargained.

Id. at 628.

This Court made clear in *Oak Crest* that the focus of the "accident" inquiry is on the nature of the damage. *Id.* at 627-29. The mere fact that a party titles its claim "negligence" in an attempt to trigger insurance coverage does not create coverage under the policy. Neither does a jury's finding that a defendant is liable for certain categories of damage create insurance coverage, when the damages awarded clearly are contractual in nature.

The Ninth Circuit followed the *Oak Crest* decision in *MW Builders, Inc. v. Safeco Ins. Co. of Am.*, 267 Fed Appx 552, 554 (9th Cir. 2008). In *MW Builders*, the court found that the costs to replace an exterior insulation and finishing system ("EIFS"), which was the insured's work, was not within the policy's coverage, but damage to other property resulting from the improper EIFS installation was covered. *Id.* Under Oregon law, if resulting property damage is covered, costs related to

repair or replacement of the insured's work are not. "For a claim of faulty workmanship to give rise to "property damage," a claimant must demonstrate that there is damage to property separate from the defective property itself. *Id.* at 554-55.

The Ninth Circuit again confirmed the rule of law that costs incurred to replace defective work by the insured are not a covered event in *Calif. Ins. Co. v. Stimson Lumber Co.*, 325 Fed Appx 496 (9th Cir 2009). The *Stimson Lumber* case addressed facts similar to those at issue in this case.

In *Stimson*, the insured entered into a settlement agreement to compensate claimants for claims relating to the insured's defective siding installed on buildings. The damages related to the replacement of the insured's product, including the cost of labor and materials for the removal and replacement of other materials including wrap paper, flashing, waste, overlap, painting, disposal and replacement of trim. *Id.* at 5.

The Ninth Circuit rejected the insured's arguments that the policies at issue covered the cost of removing other parts of the building that were damaged by siding, or damage incurred as a result of removing the defective siding, such as damages to wrap paper, flashing, overlap and trim. *Id.* There must be damage beyond mere failing to provide what was contemplated in performance.

Moreover, the mere incorporation of an insured's work as a component is not actual injury to property. *See Wyo. Sawmills, Inc. v. Transp. Ins. Co.*, 282 Or 401, 578 P2d 1253 (1978); *Naumes, Inc. v. Chubb Custom Ins. Co.*, 2007 WL 54782 (D Or Jan 5, 2007): *Milgard Mfg., Inc. v. Cont'l Ins. Co., Inc.*, 92 Or App 609, 612, 759 P2d 1111 (1988) (finding failure to properly install windows is not physical injury to the building).

The concept that defective workmanship is not "property damage" goes hand-in-hand with the "your work" exclusion, which operates to preclude coverage for property which was the insured's work. *Schneider Equip., Inc. v. Travelers Indem. Co. of Ill.*, 2006 WL 2850465 (D Or). In *Schneider*, the insured performed work on a portion of the well that rendered the well unusable. The underlying claimant sought payment for drilling a new well. Because the only damage to the well as to the portions of which the insured had worked, the damages were excluded. *Id.* at *5.

Whether the damage to Sideco's work is precluded from coverage because it is not "property damage" or is excluded by the "your work" exclusion, Oregon law dictates that the American Family policy does not indemnify these repairs.

3. "Property Damage" Must Occur During the Policy Period

The coverage grant is limited to "property damage" caused by an "occurrence" that takes place during the American Family policy period. The American Family policy defines "property damage" to mean "[p]hysical injury to tangible property." Oregon follows the "injury-in-fact" trigger rule, where actual injury to property must occur during the policy period in order to trigger a policy's coverage. *St. Paul Fire & Marine Ins. Co. v. McCormick & Baxter Creosoting Co.*, 324 Or 184, 923 P2d 1200, 1213 (1996); *Silver Eagle Co. v. Nat'l Union Fire Ins. Co.*, 246 Or 398, 406, 423 P2d 944 (1967).

The majority of courts across the United States reject joint and several liability allocation and, instead allocate the loss on a pro-rata basis. 15 Couch on Ins. § 220:30. However, in jurisdictions following the actual injury trigger, such as Oregon, pro rata allocation has been determined to be inconsistent with that approach, thereby only holding an insurer liable for those damages actually occurring within its policy period. *Id.*, citing *N. States Power Corp. v. Fid. & Cas. Co. of NY*, 523 NW2d 657 (Minn. 1994).

As explained by Judge Hubel in *Valley Forge Ins. Co. v. Am. Safety Risk Retention Group, Inc.*, 2006 WL 314455, *6, "[a] defect, however, by

itself does not necessarily constitute physical injury to tangible property or create the loss of use of tangible property. Nor does this record establish that property damage immediately follows the manifestation of a defect. Thus, a defect is not equated with property damage." Similar to this case, the *Valley Forge* case also involved hundreds of construction defects to a condominium project causing different types of property damage that occurred over a number of years. *Id.* at *8.

As Judge Hubel illustrated by the following hypothetical, what particular parts of the buildings suffered actual damage during a particular policy period are questions of fact:

> If a particular defect has allowed water to leak into the structure, it may first begin to damage a stud. Property damage to that stud has obviously commenced. With time, more and more of the stud suffers damage from the continued water exposure. Next, building material in contact with the stud may begin to suffer damage. This could, for instance, be drywall or insulation or both. As with the stud, over time, more and more of the drywall or insulation suffers damage from the continued water exposure. After some period of time, interior material in contact with drywall, such as the floor or carpet or wall covering, may begin to suffer damage. As with the stud and the drywall, more and more of the carpet, floor, or wall covering may then become damaged over time.

As noted by Judge Hubel, the policy in *Valley Forge*, which is identical to the language in the American Family policy, defined property damage as "[p]hysical injury to tangible property, including all resulting loss of use of **that** property," *Id.* at *9.

It was FountainCourt's burden to prove, based on facts in evidence at the trial, the amount of damages for actual injury to **that** property other than Sideco's work occurred between May 1, 2004 and May 1, 2006. As stated above in the Material Facts section, factual testimony was taken at the Show Cause hearing (in contravention of American Family's right to a jury trial) that damage to the buildings began before American Family's policy incepted and damage would continue to occur until the defective conditions were repaired.

That is, despite damage occurring over at least a six year time period – from the completion of the first building in 2003 until the 2009 trial date at which time the buildings had not been repaired – American Family only had 2 years' exposure over that 6 year time period. The length of time that it took for initial water intrusion to damage which specific property other than Sideco's work and the extent of that damage as it progressed over the years necessarily involve questions of fact.

The lower courts erred by holding that because it was impossible to prove how the jury came up with their verdict, American Family had to pay for the entire award while at the same time also denying American Family's right to a jury trial to have that factual determination made.

4. American Family Presented Undisputed Evidence that 5 out of the 8 Buildings Sideco Worked On were Excluded

The lower courts further erred by holding that because American Family could not prove whether or how the jury apportioned damages among the FountainCourt buildings, it was liable for the entire amount of the judgment against Sideco. *FountainCourt*, 264 Or App at 477.

American Family introduced undisputed evidence at the Show Cause hearing that its policy did not cover damages to 5 of the 8 buildings that Sideco worked on. The following table indicates when the certificates of occupancy were issued for each of the 11 buildings along with the number of units in each building and whether Sideco worked on each building. The highlighted entries are those that Sideco worked on with greater than 8 units and were therefore excluded from coverage:

BUILDING	CERTIFICATE OF OCCUPANCY	NUMBER OF UNITS	SIDECO WORKED ON
A	02-24-2003	6	Yes
B	11-19-2003	14	Yes
C	03-09-2004	12	Yes
D	04-14-2004	5	Yes
E-1	07-15-2004	8	No
E-2	07-19-2004	4	No
F	05-18-2004	10	No
G	02-12-2004	11	Yes
H	08-29-2003	10	Yes
J	05-15-2003	10	Yes
K	06-11-2003	6	Yes

Exs. 17, 18 and 123; Tr. 5282.

After proving that there was no coverage for damages to 5 of the 8 buildings that its insured worked based on the multi-unit exclusion, the trial court erred by not setting the matter for a jury trial to determine what damages claimed in the underlying trial were for the only 3 buildings covered under the American Family policy.

As explained above, American Family is not required to prove how the jury allocated its verdict. The jury's verdict is simply a cap on damages that may be recovered under the policy. The subsequent coverage action is where facts material to whether certain items of damage are covered under the policy are adjudicated in the context of the conditions and provisions in the policy at issue.

D. An Insurer is Entitled to a Jury Trial to Resolve Questions of Fact Material to the Coverage Determination

The trial court and the Court of Appeals erred by denying American Family's right to a jury trial and instead proceeding with a Show Cause hearing. To resolve the conflict of interest with its insured, American Family's counterclaim should have been determined first because unless and until the coverage dispute was adjudicated with the full panoply of discovery and a jury trial, the liability, if any, due and owing under the

American Family policy was only a contingent liability and therefore not garnishable.

1. Constitutional Right to a Jury Trial

American Family was entitled to a jury trial under the garnishment statute, the declaratory judgment statute and the Oregon Constitution. Not only were questions of fact at issue in the garnishment hearing – despite both the trial court and Court of Appeals denying any such factual issues – even facts generally undisputed are subject to more than one interpretation, which is made by the trier of fact.

Fountaincourt sought, and was awarded, a monetary judgment against American Family. Article I, section 17, provides that the right to a jury trial shall remain inviolate in "*in all civil cases*," and Article VII (Amended), section 3 provides a right to jury trial in "*actions at law, where the value in controversy shall exceed $750.*" (Emphasis added).

As stated by this Court almost 50 years ago, "[w]hile a garnishment is a statutory proceeding, it is legal and not equitable in nature, and if tried as any normal issue between a plaintiff and a defendant, as required by the statute, all fact issues must be tried as in an action at law. (citations omitted). This necessarily means such issues are tried with a jury unless the parties waive a jury trial." *Argonaut Ins. Co. v. Ketchen*, 243 Or 376, 413 P2d 613 (1966).

Accordingly, because a garnishment proceeding is legal in nature and Fountaincourt sought a monetary judgment, American Family had a constitutional right to a jury trial. *See M.K.F. v. Miramontes*, 352 Or 401, 87 P3d 1045 (2012); *see also Molodyh v. Truck Ins. Exch.*, 304 Or 290, 295-97, 744 P2d 992 (1987) (recounting the kind of cases in which a jury trial has been required in Oregon for over a century).

American Family also had a right to jury trial under the declaratory judgment statute, ORS § 28.090:

> When a proceeding under this chapter [on declaratory judgments] involves the determination of an issue of fact, such issues may be tried and determined in the same manner as issues of fact are tried and determined in other actions at law or suits in equity in the court in which the proceeding is pending.

Therefore, to the extent the matter involved factual issues material to the application of the policy terms, American Family was entitled to a jury trial. *Farmers Ins. Co. of Or. v. Munson*, 127 Or App 413, 419, 873 P2d 370 (1994).

In *Munson*, this Court ruled that the trial court erred by denying the parties' request for a jury trial in an insurance coverage case. The court recognized that whether the facts constituted an "insured person" and whether a vehicle was available for regular use were factual inquiries to be determined by a jury.

2. Factual Evidence at the Garnishment Hearing

While the trial court and the Court of Appeals were careful to deny that they were making factual findings in support of their rulings, that is precisely what they did as stated by the Court of Appeals:

> "And FountainCourt's expert established that physical damage due to Sideco's defective work occurred in every one of the buildings during each of the policy periods, thus triggering coverage. Moreover, FountainCourt points out, the evidence at the garnishment hearing establishes that there was sufficient consequential damage to components other than Sideco's own work to constitute the entirety of the damages awarded against Sideco."
>
> * * *
>
> "Jeff Forell, FountainCourt's expert who had inspected the buildings, testified at the garnishment hearing that there was physical damage, due to Sideco's defective work, to underlying materials in all of the FountainCourt buildings. He explained that he had provided to the jury an allocation, by subcontractor, of the total repair estimate; that Sideco's allocation was approximately $1.5 million; and that all of the $485,000 awarded by the jury could have been to repair that resulting damage."
>
> "At the ganishment hearing, Forell testified that the damage to the buildings from the water intrusion occurred after the construction on each building was completed and that the damage would continue to occur, or progress, until it was repaired. He also testified that every building in the project sustained water damage because of defects in Sideco's work while the American Family policies were in effect."

FountainCourt, 264 Or App at 481-82, 484, 486-87.

By any measure, this testimony taken as evidence in the garnishment hearing involved determining questions of fact for the coverage determination.

As noted by this Court in *Argonaut Ins. Co. v. Ketchen*, 243 Or 376, 413 P2d 613 (1966), "[i]t is obvious that the question of whether Mrs. Reed was an employee of the defendant Ketchen at the time of the accident is one of fact and not of law. While there is no serious dispute in the testimony, reasonable men can dispute the proper inferences to be drawn therefrom." *Id.* at 379.

Two years later, this Court in *Heider v. Comm. Ins. Co.*, 248 Or 564, 436 P2d 268 (1968), noted that an action to obtain indemnity from an insurance company was "an independent action against his insurer and **requires its own determination of the facts**." *Id.* at 565. The court went on to note that whether events were an "accident" within the meaning of the insurance policy were issues of fact. *Id.* at 566-67.

And the Oregon Court of Appeals in *Senn v. Am. States Ins. Co.*, 55 Or App 592, 639 P2d 1281 (1982), rejected an attempt to speculate on facts in the underlying case to prove coverage against the insurer in a post-judgment action.

Similarly, this case involved the following factual issues that should have been decided by a jury:

1. Which items of damage claimed in the liability trial were caused by an "occurrence" as defined by the policy;
2. Which items that were caused by an "occurrence" constituted "property damage" as defined by the policy:
3. Which items of "property damage" caused by an "occurrence" in fact occurred between May 1, 2004 and May 1, 2006;
4. Which items of "property damage" caused by an "occurrence" that in fact occurred between May 2004 and May 2006 existed in buildings with 8 or more units;
5. Which items of "property damage" caused by an "occurrence" that in fact occurred between May 2004 and May 2006, were excluded by one or more of the business risk exclusions

American Family was denied the panoply of discovery and due process rights afforded to litigants, and denied its constitutional rights to a jury trial. Accordingly, the judgment against American Family is not supportable as it based on an incorrect analysis and without the necessary factual determinations by the trier of fact in the independent coverage action between FountainCourt and American Family.

CONCLUSION

Judgment against American Family following a Show Cause was improperly entered and affirmed. This Court should remand the case to the trial court to reverse the lower courts' decisions and vacate the judgment against American Family.

Upon remand, this Court should direct the trial court to enter judgment in American Family's favor because FountainCourt did not meet its burden of proof or, alternatively, to set the matter for a jury trial to determine disputes issues of fact relevant to the coverage issues under American Family's policy.

Dated this 7th day of May, 2015

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