IN THE SUPREME COURT OF THE STATE OF OREGON

FOUNTAINCOURT HOMEOWNERS' ASSOCIATION and FOUNTAINCOURT CONDOMINIUM OWNERS' ASSOCIATION

Plaintiff,

v.

FOUNTAINCOURT DEVELOPMENT, LLC, et al.,

Defendants,

and

FOUNTAINCOURT DEVELOPMENT, LLC., et al.,

Third-Party Plaintiffs,

v.

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

Third-Party Defendants.

and

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

and

FOUNTAINCOURT HOMEOWNERS' ASSOCIATION and FOUNTAINCOURT CONDOMINIUM OWNERS' ASSOCIATION,

Garnishors—Respondents—Respondents on Review,

v.

AMERICAN FAMILY MUTUAL INSURANCE COMPANY,

Garnishee—Petitioner—Petitioners on Review.

Brief of Oregon Association of Defense Counsel, as *Amicus Curiae*

SC No. S062691
CA No. A147420
TC No. C075333CV

Petition for Review of a Decision of the Court of Appeals
on Appeal from a Judgment of the Circuit Court of Washington County,
by the Honorable Judge Marco A. Hernandez

Decision Filed:	August 6, 2014
Author:	Armstrong, P.J.
Concurring:	Duncan, J., and Brewer, J., pro tempore,

Thomas M. Christ, OSB No. 834064
tchrist@cosgravelaw.com
Cosgrave Vergeer Kester LLP
888 S.W. 5th Ave., Suite 500
Portland, OR 97204
(503) 323-9000

For Oregon Association Defense Counsel, as Amicus Curiae

June 2015

L. Kathleen Chaney, *pro hac vice*
kchaney@lclaw.net
Lambdin & Chaney, LLP
4949 S. Syracuse St., Suite 600
Denver, CO 80237
(303) 799-8889

and

John R. Barhoum, OSB No. 045150
john.barhoum@chockbarhoum.com
Chock Barhoum LLP
121 S.W. Morrison St., Suite 415
Portland, OR 97204
(503) 223-3000

Attorneys for Garnishee-Petitioner on Review

Anthony L. Rafel, OSB No. 066472
arafel@rafellawgroup.com
Rafel Law Group PLLC
1100 S.W. 6th Ave., Suite 1600
Portland, OR 97204
(503) 808-9960

Robert L. O'Halloran, OSB No. 823577
roberto@mcewengisvold.com
Katie Jo Johnson, OSB No. 063823
katiejo@mcewengisvold.com
McEwen Gisvold, LLP
1100 S.W. 6th Ave., Suite 1600
Portland, OR 97204
(503) 412-3507

Attorneys for Garnishors-Respondents on Review

CONTENTS

AUTHORITIES

Cases

AUTHORITIES (cont.)

Cases (cont.)

Statutes

Other Authorities

AUTHORITIES (cont.)

Other Authorities (cont.)

I. INTRODUCTION

The Oregon Association of Defense Counsel (OADC) – a professional organization of lawyers who mostly represent defendants in civil cases, often hired by the defendant's insurer – submits this friend-of-the-court brief on the first question presented on review: when an insurer defends a claim against its insured under a "reservation of rights," is a verdict for the claimant binding on the insurer in a later action between the insurer and insured (or the insurer and the claimant) to determine coverage for the damages awarded? The question is important to OADC members, because a "yes" answer would present insurer-retained defense counsel with an un-waivable conflict of interest in reservation-of-rights cases, and that would probably mean the end of insurance-defense practice as we know it in this state. Fortunately, the answer to the question is "no." This brief explains why.[1]

II. BACKGROUND: INSURER DUTIES

The relationship between insured and insurer – and, by extension, between them and insurer-retained counsel – depends on the terms of the insurance policy and the duties it imposes. (The Insurance Code imposes

[1] OADC takes no position on the other questions presented on review in this case.

some duties too, but none relevant here.) For insurers, the standard policy imposes two main duties. One is a duty to pay, also known as a duty to indemnify. The other is a duty to defend. The policy's "insuring agreement" says that the insurer "will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies." (The exclusions section of the policy describes the bodily injury and property damage to which "this insurance" does *not* apply.) The agreement then says that the insurer has the "right and duty" to defend any suit seeking "those damages," meaning the "damages for 'bodily injury' or 'property damage' to which this insurance applies."

Because it has the *right* to defend, not just a *duty* to, the insurer is entitled to choose defense counsel, which is one part of the defense, *Radcliffe v. Franklin Nat'l Ins. Co.*, 208 Or 1, 298 P2d 1002 (1956),[2] maybe the most important part. *See Ferguson v. Birmingham Fire Ins.*, 254 Or 496,

[2] The policy at issue in *Radcliffe* provided in its insuring agreement that the insurer would defend covered claims, "but * * * shall have the right to make such investigation, negotiation and settlement of any claim or suit as may be deemed expedient by the company[.]" 208 Or at 7. This language, the court said, "recognized in the insured no privilege of handling the situation himself." *Id.* at 9. Instead, "[h]e was required to entrust his protection to the insurer." *Id.* "If [the insurer] decides to defend, it selects an attorney and the insured must accept the appointee regardless of personal preferences or dislikes." *Id.* at 21.

509, 460 P2d 342 (1969) (noting the "benefits that accrue [to an insurer] from being represented by its own counsel").[3]

The lawyer chosen to conduct the defense finds himself (or herself) in what is sometimes described as a "tripartite" relationship. *See, e.g.*, Marilyn Cohen, *The Tripartite Relationship: Is There Harmony Among Insurer, Insured And Defense Counsel?* 52 Ore St Bar Bulletin 33 (1992). That means he has two clients: the insured for whom he appears in the case, and the insurer who is paying his fee and directing the defense. The relationship, although complicated, works well, so long as the interests of the two clients don't diverge.

But sometimes they do. That's because the insurer's two duties – to defend and to pay – are not always co-extensive, as explained below.

---

[3] The right to defend does not mean that the insurer can defend however it chooses, with no concern for the insured's interests, just its own. This court has held that, when an insurer undertakes to defend the insured, a fiduciary relationship is created, one that imposes on the insurer a duty of care "independent of the contract and without reference to the specific terms of the contract." *Georgetown Realty v. The Home Ins. Co.*, 313 Or 97, 111, 831 P2d 7 (1992). Accordingly, breach of that duty gives rise to an action for negligence, *id.* at 111, often called a "bad faith" action, although this court has warned against use of that term because it "tends to inject an inappropriate subjective element – the insurer's state of mind – into the formula. The insurer's duty is best expressed by an objective test: Did the insurer exercise due care under the circumstances." *Maine Bonding v. Centennial Ins. Co.*, 298 Or 514, 518-19, 693 P2d 1296 (1985). Because the claim is extra-contractual, the potential damages are not limited to what the contract required of the insurer, *i.e.*, the cost of defense and indemnity.

III. INSURED-INSURER CONFLICTS OF INTEREST

Sometimes the insurer owes a duty to defend the insured against a claim that it might not owe a duty to pay, depending on the verdict. *Ledford v. Gutoski*, 319 Or 397, 877 P2d 80 (1994), explains why that is so.

In *Ledford*, this court re-affirmed the long-standing rule that the insurer's duty to defend depends on what the claim *alleges*. If the claim alleges "facts" which, if proved, would result in covered damages, the insurer must defend, even if the insurer knows, from its own investigation, that those "facts" aren't true. 319 Or at 400. Moreover, the insurer must defend even if the claim also alleges "facts" which, if proved, would not result in covered damages – that is, "[e]ven if the complaint alleges some conduct outside the coverage of the policy[.]" *Id.* Thus, for duty-to-defend purposes, all that matters is what is alleged, not what actually happened. *See Ferguson*, 254 Or at 505-06 ("The insurer's knowledge of facts not alleged in the complaint is irrelevant in determining the existence of the duty to defend and consequently the insurer need not speculate as to what the 'actual facts' of the alleged occurrence may be.").

The opposite is true for duty-to-indemnify purposes. As *Ledford* goes on to explain, whether the insurer must indemnify the insured depends not on what *allegedly* happened, but rather on what *actually* happened – whether

the insured is actually liable for "damages because of 'bodily injury' or 'property damage' to which this insurance applies." *Id.* at 403.

Because the duty to defend depends on what is alleged, while the duty to indemnify depends on what actually happened, "[a]n insurer may have a duty to defend its insured, * * * but no duty to indemnify," *ZRZ Realty Co. v. Beneficial Fire & Cas. Ins. Co.*, 351 Or 255, 265, 266 P3d 61 (2011), or at least no duty to indemnify the insured for all of the damages awarded.[4] That situation arises when the claim alleges both covered and uncovered damages, as where the complaint alleges some bodily injury or property damage that is subject to an exclusion, and some that is not.

It also arises when the complaint contains alternative claims, one for covered damages, the other, not. An example of that situation is a lawsuit arising out of a brawl in a tavern. One claim of the complaint is for assault and battery. It alleges that the insured deliberately stuck the plaintiff, injuring him. An alternative claim sounds in negligence. It alleges that the insured carelessly struck the plaintiff, not intending to cause harm, but causing it anyway. The first claim falls within standard exclusions for intentionally caused injury. *See Ledford*, 319 Or at 401-02 (discussing those

[4] The converse is also true: the insurer can be obligated to pay a claim that it is not obligated to defend, because, again, what actually happened turns out to be different than what allegedly happened.

exclusions). The second claim is not excluded. Under the rules discussed in *Ledford*, the insurer would owe a duty to defend the entire lawsuit but not necessarily to pay any damages awarded, depending on whether the jury found for the plaintiff on the first claim or the second – that is, on whether it found that the injury was deliberate or accidental.

In this type of situation, where the insurer is obligated to defend, but not necessarily to pay, the insurer will undertake to defend under a "reservation rights," meaning it will defend the insured while reserving its right not to pay any judgment the claimant recovers. That reservation creates a conflict of interest between the insurer and the insured. Both hope, of course, for a defense verdict. But, in the event of an adverse verdict, the insured hopes that it will award covered damages, payable by the insurer. The insurer, on the other hand, hopes for an award of uncovered damages. Thus, in the example given above, the insured hopes for a verdict on the negligence claim, and the insurer for one on the assault and battery claim.

IV. ETHICAL CONCERNS FOR DEFENSE COUNSEL

If the insured and the insurer have different interests in the verdict, they will likewise have different interests in how the case is defended, since the way the case is defended can, and usually does, affect the verdict. And

that, in turn, creates an ethical problem for the lawyer hired by the insurer to conduct the defense. As noted above, that lawyer has two clients, the insured and the insurer, and owes each of them a duty of loyalty and zealous representation. But how the lawyer handles the defense – the defenses raised or not, the motions filed or forgone, the evidence offered or objected to, the instructions requested and opposed, all of those things, and many more – can affect the verdict and thus determine which of the two clients, insured or insurer, must pay the damages awarded. Accordingly, the lawyer in that situation would have a conflict of interest, probably unwaivable,[5] and could not undertake the representation.

Or could not undertake it *but for* this court's decision fifty-plus years ago in *Ferguson*. In that case, the court took note of the conflict-of-interest that arises in reservation-of-rights cases and came up with a solution for it.

---

[5] Paragraph (a) of Rule 1.7 of the Rules of Professional Conduct provides that, "[e]xcept as provided in paragraph (b), a lawyer shall not represent a client if the representation of that client involves a current client conflict of interest," which "exists if * * * the representation of [the] client will be directly adverse to another client." Paragraph (b) provides that the prohibition in paragraph (a) is waivable only if "the representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client." In a reservation-of-rights cases, insurer-retained counsel are often called upon to contend for something that might affect the verdict to the benefit of one client (the insured) and the detriment of the other (the insurer), and vice versa.

V. THE *FERGUSON* NO-PRECLUSION RULE

The insured in *Ferguson* was covered by a homeowner's policy that, as usual, excluded "property damage caused intentionally by or at the direction of the insured." 254 Or at 499. While the policy was in force, the insured hired a laborer to clean brush off the back of his lot. *Id.* at 500. In doing so, the laborer cleared beyond the unmarked property line and cut down some trees of the insured's neighbors, who then sued him for damages. Their complaint alleged that the insured "without the consent or permission of the plaintiffs, and without any legal authority whatsoever, willfully, intentionally, and unlawfully trespassed upon [the plaintiffs'] premises." *Id.* at 506. Relying on that allegation and the intentional-harm exclusion, the insurer offered to defend the insured under a "reservation-of-rights agreement," but the insured refused to accept it and thus defended himself. *Id.* at 500-01. The jury returned a verdict for the neighbors and awarded damages to them, and in a special interrogatory found that the trespass was not committed "willfully and intentionally." *Id.* at 501. The insured paid the judgment and then sued the insurer to recover their payment and their defense costs. *Id.*

This court held, first, that the insurer owed a duty to defend despite the express allegations of intentional trespass, because, under the

circumstances, the complaint should have been construed to have implicitly included an alternative claim for un-intentional trespass – a sort of "'lessor included offense' by analogy to the criminal law." *Id.* at 507. The court then turned to the insurer's attempt to defend the case while reserving "its right to later raise the question of coverage" – that is, to argue in a subsequent proceeding between the insurer and the insured that the insured's trespass was intentional and, therefore, that it owed no duty to pay the judgment. The court noted that "[i]t is generally held that the insurer, when tendered the defense of an action, cannot, as a condition of its assumption of the defense, reserve the right to later question coverage." *Id.* at 509.[6] If the insured refuses to accede to the insurer's request for a reservation of rights, and if the insurer undertakes to defend anyway, the insurer is deemed to have "waived," or to be "estopped" to assert, any defense to coverage in a later action on the judgment. *Id.* And that created a dilemma for the insurer:

> "[I]f the insurer, in order to avoid the loss of its right to question coverage, rejects the tender of the defense, it loses the benefits that accrue from being represented by its own counsel

[6] *But cf. Clark Motor Co. v. United Pac. Ins. Co.*, 172 Or 145, 155, 139 P2d 570 (1943) ("The general rule is well established that an indemnity insurer will not be estopped to set up the defense of nonliability by reason of having participated in defense of the action against the insured if it has given timely notice to the assured that it does not waive the benefit of such defense.").

> who ordinarily is experienced in the defense of such actions. And if it guesses wrong on the question of coverage, it will be required to pay the judgment and the costs of defense. Thus the insurer is forced to choose between two alternatives either of which exposes it to a possible detriment or loss."

Id.

The court then asked itself, rhetorically, "What is the justification for imposing this dilemma upon the insurer?" *Id.* One reason, the court surmised, is concern that the insurer's control of the defense will enable it to "adversely affect the insured," at least "[w]here there is a conflict of interest between the insurer and insured and the judgment in the action against the insured can be relied upon as an estoppel by judgment in a subsequent action on the issue of coverage." *Id.* To alleviate that concern, the court held that, in conflict-of-interest situations, a judgment against the insured will not be binding on the insurer or insured in a later action to determine coverage:

> "[W]e see no reason for applying the rule of estoppel by judgment in such cases. 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 could gain any advantage in the original action which would accrue to it in a subsequent action in which coverage is in issue."

Id. at 509-10 (footnotes omitted).

The relevant terminology has changed since *Ferguson*. The phrase "estoppel by judgment" has been replaced by "preclusion by former adjudication," one aspect of which is "issue preclusion," formerly known as "collateral estoppel." *See Drews v. EBI Companies*, 310 Or 134, 139, 795 P2d 531 (1990) (discussing the evolving nomenclature). Issue preclusion prevents parties from re-litigating issues that were actually litigated and determined by the judgment in a prior action. *Nelson v. Emerald Peoples Utility Dist.*, 318 Or 99, 103-04, 862 P2d 1293 (1993). Thus, under *Ferguson*'s no-"estoppel" rule – or, to use the modern lexicon, its no-preclusion rule – neither the insurer nor the insured is precluded from re-litigating coverage-related issues that were decided by a judgment against the insured in an action defended by the insurer under a reservation of rights. To put it another way, any findings that inhere in the judgment – *e.g.*, whether the insured intended to cause injury – are not preclusive in a later action to determine coverage for the judgment.

Which is just what this court said in *Ferguson* after announcing the no-preclusion rule. It said that on retrial of the coverage action – required because of the trial court's misinterpretation of another exclusion – the insurer would not be bound by the jury's finding that the trespass was not

willful or intentional, but would be free to re-litigate that issue. *Ferguson*, 254 Or at 511-12.

Two things are worth mentioning about the *Ferguson* no-preclusion rule. First, the rule is neither pro-insurer nor pro-insured. Instead, it cuts both ways. Just as the insured cannot use the judgment in the underlying case to prove the claim is within coverage, the insurer cannot use it to prove the claim is without coverage. *See Paxon-Mitchell v. Royal Indemnity Co.*, 279 Or 607, 569 P2d 581 (1977).[7] Thus, in the bar-brawl example above, if the jury found the insured liable on the assault and battery claim, the insurer could not rely on the verdict to argue that the damages fell within the intentional-injury exclusion and, therefore, that it owed no duty to pay them. In that situation, the *insured* would be free to re-litigate the intent-to-injure issue – and the insurer's duty to indemnify – in a later coverage action. Likewise, the *insurer* would be free to retry the intent-to-injure issue – and

[7] *Paxton* was an action by an insured against its insurer to recover the cost of satisfying a judgment against the insured in an earlier action. The insurer argued that, under the doctrine of collateral estoppel, the insured was bound by the trial court's findings of fact in the earlier action. This court rejected that argument, because the interests of the insurer and insured "were not identical" in the earlier action, and because "there was at least a potential conflict of interest between [them]." 279 Or at 613, n 2 (citing *Ferguson*).

whether it owed a duty to indemnify – if the jury found the insured liable on the negligence claim only.[8]

Second, the rule applies not only to disputes between the insurer and the insured about payment of a judgment against the insured, but also to disputes between the insurer and the claimant about payment. Those disputes can proceed several ways. The claimant can bring a direct action against the insurer, after obtaining a judgment against the insured for certain types of tort claims, ORS 742.031; or, as in this case, can bring a garnishment proceeding against the insurer, ORS 18.352; *see generally State Farm Fire & Cas. Co. v. Reuter*, 299 Or 155, 164, 700 P2d 236 (1985) (discussing the claimant's collection options). But, in either event, the claimant's rights against the insurer are no greater than the rights of the insured. *Reuter*, 299 Or at 164-66. The same would be true, of course, if the

[8] For an example of that, see *State Farm Fire & Cas. Co. v. Paget*, 123 Or App 558, 860 P2d 864 (1993), *rev den*, 319 Or 36 (1994). In that case, the insured went to a party where he drank beer and took LSD. Later, he got into a fight with Colvin and stabbed him with a pocket knife. Colvin sued the insured, alleging that he was negligent in causing Colvin's injuries. The insurer defended the lawsuit under a reservation of rights because it believed the claim fell within an exclusion for intentional injury. The jury found that the insured was negligent, meaning he acted carelessly, but not intentionally. Relying on *Ferguson*, the Court of Appeals said that finding was not binding on the insurer for coverage purposes. The insurer was free to prove in a later action – and did in fact prove – that the insured intended to injure Colvin after all, which meant it was not obligated to pay Colvin's judgment.

claimant tried to collect the judgment another way – by taking an assignment of the insured's rights against the insurer for nonpayment of the judgment. In that situation, too, the claimant, standing in the insured's shoes, has no greater rights than the insured himself. Accordingly, the no-preclusion rule applies in claimant-insurer disputes to the same extent as in insured-insurer disputes.

VI. *FERGUSON* IS STILL GOOD LAW

For several reasons, OADC believes that the court should re-affirm *Ferguson's* no-preclusion holding. First, *Ferguson* is well-reasoned; there is, indeed, no justification for imposing on an insurer the "dilemma" of choosing between its right, under the policy, to conduct the defense of a potentially-covered claim and its right, also under the policy, not to have to pay uncovered damages. Likewise, there is no justification for binding the insurer and the insured to the judgment in an action in which the one defended the other despite a disagreement between them about who is ultimately liable for paying an adverse verdict. A contrary rule would give

insurers and insureds an incentive to try to manipulate the defense of the claim for coverage purposes.[9]

Second, *Ferguson's* no-preclusion rule is consistent with preclusion rules generally, as they apply to someone who, like the insurer in this action, was not a party to the judgment sought to be enforced. This court, like others nationwide, has long held that issue and claim preclusion can be invoked not only against parties to a prior adjudication, but also against

---

[9] It often happens that an insured, perhaps unaware of *Ferguson*, tells defense counsel not to move against a claim that is subject to dismissal but covered, if that will leave only a claim that is not subject to dismissal but uncovered. The Oregon State Bar has published a formal ethics opinion on that very scenario. *See* Ore State Bar Formal Ethics Op. No. 2005-121. The opinion suggests that the lawyer treat the insured as the "primary" or "dominant" client and, therefore, that the lawyer should follow the insured's instructions, never mind what the insurer wants. That advice is dubious. The "primary"-secondary, "dominant"-subordinate distinction does not appear in Rules of Professional Conduct or in this court's disciplinary rulings. In the event a conflict arises between two concurrent clients, the lawyer is supposed to withdraw from representing both, not continue to represent the interests of one against the other.

Following the insured's wishes could backfire on the insured. Insurance policies usually provide, as a condition of coverage, that the insured cooperate in the defense of a covered claim. That provision aside, the law imposes a duty of good faith and fair dealing on all parties to a contract. An insured that declines to move against a covered-but-vulnerable claim, solely to expose the insurer to continued liability, is not cooperating in the defense of the lawsuit, and not acting in good faith. The insurer, in response, may be justified in declaring a forfeiture of coverage and withdrawing from the case. Thus, a lawyer who advises an insured, for coverage reasons only, to refrain from filing what would otherwise be a well-taken motion may be jeopardizing coverage altogether.

persons in "privity" with those parties. *See, e.g.*, *Wolff v. Dupuis*, 233 Or 317, 320-21, 378 P2d 707 (1963). In this context, however, "privity" is "a chameleon-like term" that has not been well-defined, even by the authors of the first *Restatement of Judgments* (1942), who coined it. *Reuter*, 299 Or at 161. In practice, privity "is neither a rule nor doctrine; it describes a result." *Id.* at 162. More precisely, it describes the conclusion that the relationship between the parties to a judgment and a third party is "close enough" that "it is realistic to say that the third party was fully protected in the first trial." *Wolff*, 233 Or at 322. The relationship between insurer and insured is not that close – at least not when the insurer is defending the insured under a reservation of rights. In that situation, the insurer's duty to protect the insured's interests prevent it from fully protecting its own on issues where those interests diverge – that is, on coverage-related issues. In the end, privity will not be found "unless the result can be defended on principles of fundamental fairness in the due process sense." *Id.*; *see also Bloomfield v. Weakland*, 399 Or 50, 510, 123 P3d 275 (2005). When it comes to coverage issues, it would be fundamentally unfair to bind the insurer – or the insured – to a judgment in an action where the insurer defended the insured. To that extent, *Ferguson* is consistent with the usual rules of preclusion.

Third, *Ferguson* has been on the books for nearly fifty years. For all of that time, defense counsel have relied on it when accepting appointment by insurers in reservation-of-rights cases. It would substantially change insurance-defense practice if this court were to upend that ruling now. It would also frustrate the long-standing expectations of insurers. Avoiding disruptions of that sort is a relevant concern in deciding whether to disavow a prior ruling. *See Farmers Ins. Co. v. Mowry*, 350 Or 686, 698, 261 P3d 1 (2011) ("In the area of commercial transactions, we have noted that stability and predictability strongly support adherence to precedent.").

OADC believes that the no-preclusion rule has been, and still is, a workable solution to the conflict-of-interest problem that arises in reservation-of-rights cases and that this court should adhere to it.[10]

---

[10] In some states, the insured is allowed to choose defense counsel, at the insurer's expense, when the insurer defends under a reservation of rights. These lawyers are often called "*Cumis* counsel," after the California case in which the practice was announced: *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc.*, 162 Cal App 3d 358, 208 Cal Rptr 494 (1984). But appointing *Cumis* counsel doesn't eliminate the conflict between the insurer and the insured and thus doesn't avoid the lawyer's conflict-of-interest problem. The lawyer still has two clients – the one he represents in court, and the one who is paying his fee – and their interests are still in conflict when it comes to coverage. The court in *Cumis* suggested that an unscrupulous lawyer, retained by the insured to defend the insured, might be tempted to manipulate the defense to the insurer's benefit on coverage issues. Of course, an unscrupulous lawyer retained by the insured at the insurer's expense might be tempted to manipulate it the other way. In the end, *Cumis* isn't a solution to the problem.

VII. *FERGUSON* AND THIS CASE

When the FountainCourt homeowners brought this construction defect action against American Family's insured, Sideco, among others, American Family decided to defend under a "full reservation of rights" because it thought that some of the alleged property damage did not occur while the policy was in force and that some of it fell within one or more exclusions. *FountainCourt Homeowners' Ass'n v. FountainCourt Dev., LLC*, 264 Or App 468, 474, 334 P3d 973, *rev allowed*, 357 Or 111 (2014). American Family re-asserted those coverage defenses after the homeowners obtained a judgment against Sideco and then brought this garnishment proceeding.

At that hearing, the court held that the homeowners had the burden to prove that some of the damages contained in the judgment were covered by the policy's insuring agreement and that, in the event of that proof, the burden would shift to American Family to prove that the damages fell within some exclusion to the policy. The court then held that the homeowners had carried their burden, but that American Family had not carried its burden. According to the court, the homeowners proved that at least some of the damages in the judgment were for property damage that occurred during the policy period, but that American Family had not proved that the damages

were excluded. *FountainCourt*, 264 Or App at 477. Accordingly, the court held that American Family was obligated to pay the judgment. *Id.* at 478.

On appeal, American Family did not challenge the trial court's allocation of the burden of proof, which the Court of Appeals described this way: the homeowners were required "to prove that the judgment represented damages that came within the insuring agreement of the American Family policy (the *prima facie* case for coverage), at which point the burden shifted to American Family to prove, if it could, that an exclusion in the insurance policy applied." *Id.* at 480. What American Family argued was that the homeowners had not carried their *prima facie* burden to prove damages within the insuring agreement, which, as usual, covered liability for "property damage" that occurs during the policy period.[11] Specifically,

---

[11] As noted above, this policy, like most, covers liability for bodily injury and property damage "to which this insurance applies." And, like most, this policy goes on to say that "this insurance applies" only if the bodily injury or property damage is "caused by an 'occurrence," defined as "an accident," and "occurs during the policy period." Under these provisions, the trigger of coverage is injury or damage while the policy is force. *See* Scott Turner, *Insurance Coverage of Construction Disputes*, vol I, § 6:42, p 6-147 (Thompson Reuters 2013); Jeffrey E. Thomas and Francis J. Mootz, *New Appleman on Insurance Law Library Edition*, vol III, § 16.07[3][c] (2014).

In many cases, the trigger of coverage is not an issue, because there is no delay between the "occurrence," or accident, and the resulting bodily injury or property damage and its discovery. They all happen at the same time and, hence, during the same policy period. In an auto case, for

American Family argued that the homeowners had not proven that the damages in the judgment were awarded for "property damage," which the policy defined, as usual, as "physical injury to tangible property." *Id.*

The Court of Appeals rejected that argument. It noted that the underlying case "went to the jury on the sole theory of negligence causing physical property damage" and that the trial court in that case had instructed the jury that the homeowners "must allege and prove physical damage to [their] property." *Id.* at 484 (emphasis in original). The court also noted that the homeowners had called an expert in the garnishment proceedings to testify that some – indeed, all – of the damages assessed against Sideco could have been for physical injury to tangible property other than Sideco's own work. *Id.* at 484-85. That evidence was sufficient, the Court of

---

example, the accident and injury are contemporaneous, and the injured party knows immediately that he has been injured. Not so in construction defect cases. In those cases, the accident is the shoddy workmanship that (in many cases) allows rainwater to get in, and the property damage is the resulting mold or dry rot. It takes time, sometimes months, often years, for that to play out – for the water to work its way to where it doesn't belong and to begin the process of mold or rot. And the molding or rotting itself occurs gradually, not suddenly, and often out of sight. That's why, in construction-defect cases, it usually takes years to notice the problem. It's also why, in such cases, the relevant policies for liability purposes are the policies the contractor held *after* the work was performed and *before* the defects were discovered. That is the period of time when the property damage occurred and, therefore, the policies that were in force *then* are the policies that cover any claim arising out of that property damage.

Appeals said, to satisfy the homeowners' *prima facie* burden to prove that the judgment includes damages covered by the insuring agreement. The burden then shifted, the court continued, to American Family to prove that "any portion" of the damages was not covered "by reason of an exclusion," including the exclusion for damages to property damage to "your work." In other words, the burden then fell to American Family to prove that some portion of the damages were for the cost of fixing Sideco's own work. But, the court said, American Family didn't carry that burden. That's what the trial court found, and American Family didn't "contend otherwise on appeal." *Id.* at 485.

The Court of Appeals reached the same conclusion with respect to American Family's back-up argument, which was that the homeowners had failed to meet their initial burden to prove that the judgment included damages for property damage that occurred during the policy period – in other words, while American Family was "on the risk." The court noted that, in the garnishment proceedings, the homeowners' expert testified that all of the buildings in the project suffered property damage from the end of construction until repair, which include the period covered by American Family, and, therefore, that "every building in the project sustained water damage because of defects in Sideco's work while the American Family

policies were in effect." *Id.* at 486-87. To be sure, the trial court also found that the homeowners had proven some property damage during a later insurer's coverage. But, the court explained, that did not necessarily mean that the damages in the judgment included damages for some later – and thus uncovered – property damage, because

> "In the case of continuing and progressive water damage, the award of damages is not tied to discrete instances of property damage along a time continuum; instead the liability for property damage may be the same in every triggered policy period. That is so because the scope of repair – to replace the damaged structural components and eliminate the water intrusion – does not necessarily change depending on the year in which the damage occurred. Accordingly, given the nature of the injury, it is possible that both Clarendon and American Family could be liable for the same damage."

Id. at 487-88.

The court held, again, that the homeowners' evidence satisfied their burden to prove that at least some of the damages were for property damage within the policy period and, therefore, within the insuring agreement, and that the burden then shifted, again, to American Family to prove the contrary – to prove some portion of the damages were not for property damage within the policy period. But, the court said, American Family had failed, again, to carry that burden. That is what the trial court found, and American Family did not challenge that finding on appeal. *Id.* at 488.

For purposes of this review, it's important to note that the Court of Appeals did *not* hold that American Family was precluded by the judgment in the underlying case from raising coverage defenses in the garnishment proceedings. In particular, it did not hold that the judgment conclusively established that all of the damages were for property damage during the policy period. What it held, instead, is that American Family had failed to carry its burden of proof on the coverage issues, including the timing of the damage. American Family lost in the Court of Appeals because it failed to prove its side of the case, not because it was somehow precluded from putting on a case. Indeed, the court expressly held that it was not deciding the case based on issue preclusion, even though the homeowners and their *amici* argued that American Family was bound by the jury's factual determinations in the underlying case, *id.* at 488-89, and even though American Family argued "that the trial court had relied on the judgment as *preclusive*." *Id.* at 490 (emphasis in original).

To be sure, some parts of the Court of Appeals opinion sound preclusion-like – for example, where the court is discussing whether the homeowner's had established a *prima facie* case that the damages included in the judgment came within the American Family insuring agreement. *See id.* at 489-90. But, even then, the court took care not to suggest that the

judgment itself precluded American Family from contending otherwise. In the end, then, the Court of Appeals decision does not contravene the *Ferguson* no-preclusion rule. It is an opinion about burdens of proof, not preclusion.

VIII. CONCLUSION

An insurer is not bound by whatever coverage-relevant facts are determined by the judgment in a case defended by the insurer under a reservation of rights. The insured isn't bound either. That's been the rule for nearly a half-century, since this court decided *Ferguson*. Insureds, insurers, and defense counsel have come to rely on that decision in their many interactions. If the Court of Appeals opinion casts any doubt on *Ferguson's* continued vitality, this court should correct it.

Respectfully submitted,

s/ Thomas M. Christ

Thomas M. Christ
Cosgrave Vergeer Kester LLP

For Oregon Association of Defense Counsel

Certificate of Compliance with ORAP 5.05(2)

Brief length

I certify that this brief complies with the 14,000 word-count limitation in ORAP 5.05(2)(b)(i) and that the word count of this brief, as described in ORAP 5.05(2)(a), is 6,104 words.

Type size

I further certify that the size of the type in this brief is not smaller than 14 point for both the text of the brief and footnotes as required by ORAP 5.05(4)(f).

s/ Thomas M. Christ

Thomas M. Christ

Certificate of Filing and Service

I certify that I filed the attached Brief by electronic filing on June 18, 2015. I further certify that on the same date, I served a copy on the following lawyer(s) by the electronic service function of the eFiling system (for registered eFilers) and by first-class mail, with postage prepaid (for non-eFilers):

L. Kathleen Chaney
Lambdin & Chaney, LLP
4949 S. Syracuse St., Suite 600
Denver, CO 80237

John R. Barhoum
121 S.W. Morrison St., Suite 415
Portland, OR 97204

Attorneys for Garnishee-Petitioner on Review

Anthony L. Rafel, OSB No. 066472
Rafel Law Group PLLC
1100 S.W. 6th Ave., Suite 1600
Portland, OR 97204

Robert L. O'Halloran, OSB No. 823577
Katie Jo Johnson, OSB No. 063823
McEwen Gisvold, LLP
1100 S.W. 6th Ave., Suite 1600
Portland, OR 97204

Attorneys for Garnishors-Respondents on Review

s/ Thomas M. Christ

Thomas M. Christ