2016 CLM Annual Conference
April 6-8, 2016
Orlando, FL

Peeling the Layers of the Consent Judgment Onion

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I. INTRODUCTION

Over the past ten years there has been a dramatic increase in the number of consent settlements arising from insurance claims. Consent judgments typically arise in a situation where a liability insurer allegedly fails to either settle a claim or defend its insured. This allows the insured to proceed to settle the claim with the third party in exchange for the third party agreeing not to execute upon the settlement. In exchange for the covenant not to execute, the insured assigns whatever extra contractual rights and contractual claims the insured has against their own insurer. The parties can then present that stipulation to the court for a finding of a good faith settlement, or request a hearing or trial resulting in a judgment. Often the claimant will then sue the insurer for breach of contract and sometimes bad faith to collect on the judgment. The amount sought commonly exceeds policy limits and includes claims for attorney's fees and interest. *Litigating the Consent Judgment Case—A 50 State Overview*, Catalina J. Sugayan et al., 185-206, 185 (Mar. 2015). Insurers have defenses to the extra-contractual liability premised on a consent judgment. These include: (1) the underlying claim is not covered under the policy; (2) the insured breached its duty to cooperate or violated a policy provision by entering into a settlement without consent or assigning a non-assignable right; (3) the judgment amount is unreasonable or nonbinding; or (4) the judgment is the product of fraud or collusion.

Consent judgments are on the rise because the standard operating procedures for many insurers upon receipt of a construction defect tender is to issue a boiler plate reservation of rights (ROR) letter. In days gone by, the ROR letter served to protect the insurer from uncovered claims and inform the insured about available coverage. For example, in certain jurisdictions providing a defense subject to a ROR letter can serve as a bad faith trigger and result in unintended exposure to the insurer.

The flip side is that consent judgments can be leveraged by insurers to minimize risk in thorny construction defect claims where coverage is tenuous. Creative claim handling of the consent judgments process can result in favorable settlements for insurers and better position for insurers to defend the post judgment/bad faith litigation.

State law varies with respect to whether consent judgments are binding on insurers; many courts will not enforce consent judgments even if the insurer raised a defense that was based on a reservation of rights. Courts also differ with respect to whether an insurer must first be provided with notice of or have the opportunity to participate in settlement discussions. Some courts have also held unenforceable consent judgments against an insurer if the insured is released from liability prior to assigning rights to the claimant, based on policy provisions requiring that the insured is "legally obligated to pay." While all courts recognize that there must be a showing of *actual damage* in order for there to be a finding of liability against the insurer for breach of the insurance contract or bad faith, a majority of courts hold that an entry of judgment alone is sufficient damage to sustain recovery from an insurer ("judgment rule"). A minority of courts hold that if an insured cannot satisfy an excess judgment, the insurer cannot be held responsible for it ("prepayment rule"). Courts also differ with respect to (1) enforcement of cooperation, (2) consent to settle, (3) policy assignment provisions, and (4) whether the amount of a consent judgment is binding on an insurer. State courts differ in their application of the factors, burdens of proof for coverage or bad faith, and presumptions in assessing whether the amount of a consent judgment is reasonable. Most courts allow an insurer to defeat liability if

there is a showing of fraud or collusion.

This article will discuss coverage-triggering events, with a particular focus on consent judgments in Washington and Arizona, two of the most coverage-litigated states. The discussion is not an exhaustive analysis of issues and claims relating to the particular topic. It is intended to provide a general understanding of the issues that accompany both the policyholders' exposure to claims as well as the claims adjuster's responsibilities in handling and adjusting claims as a result of judicial decisions impacting these cases.

II. CONSENT JUDGMENTS UNDER WASHINGTON STATE LAW

GENERAL LEGAL PRINCIPLES ARISING IN CONSENT SETTLEMENTS

The following represents some of the basic legal principles and standard operating procedures that can trigger the invocation of a consent judgment.

A. Insured's Duty to Cooperate

Almost all insurance policies contain language requiring an insured's cooperation. The policies also prohibit a voluntary payment by an insured. This language is often implicated in consent judgments.

Washington courts have repeatedly held that an insured has an express obligation to cooperate with its insurer (this cooperation includes producing records and documents which are considered material to an insurer). In the context of liability insurance, however, the courts have specifically held that a breach of an insured's policy obligations only precludes coverage if there *is actual prejudice to the insurer* (burden of proof to show prejudice is on insurance company). In addition, RCW 48.01.030 specifically places a burden on both an insurer and the insured (also including the insured's representatives) to act in good faith.

B. Reasonableness Hearing (required by RCW 4.22.060)

Reasonableness hearings have become commonplace in Washington cases where a settlement includes an agreed upon judgment with a covenant not to execute on that judgment. Nevertheless, WA courts have noted they "are aware that an insured's incentive to minimize the amount of a judgment will vary depending on whether the insured is personally liable for the amount. Because a covenant not to execute raises the specter of collusive or fraudulent settlements, the limitation on an insurer's liability for settlement amounts is all the more important." *Besel v. Viking Ins. Co.* The Court of Appeals has also cautioned that "an insured may settle for an inflated amount to escape exposure and thus call into question the reasonableness of the settlement. We share this concern about consent judgments coupled with a covenant not to execute. (*Chaussee*)(The Ct. of Appeals stated the following with respect to these kinds of settlement agreements and agreed judgments: "*Besel* recognizes that the reasonableness of a settlement with an insured who is not personally liable for a settlement is open to question because the insured will have no incentive to minimize the amount."

Additionally, courts from other jurisdictions have found that a stipulated judgment involving a covenant not to execute warrants heightened scrutiny.

C. *Chaussee* and *Glover* Factors

Within the context of a reasonableness hearing, the trial court should consider numerous factors when determining the reasonableness of a settlement. Specifically, in *Glover v. Tacoma General Hospital,* the Washington Supreme Court delineated nine factors that a trial court should consider when determining if a settlement is reasonable:

1. The releasing person's damages;
2. The merits of the releasing person's liability theory;
3. The merits of the released person's defense theory;
4. The released person's relative faults;
5. The risks and expenses of continued litigation;
6. The released person's ability to pay;
7. Any evidence of bad faith, collusion, or fraud;
8. The extent of the releasing person's investigation and preparation of the case; and
9. The interests of the parties not being released.

Recently, the Washington Court of Appeals held that not all of these factors apply in construction defect claims. The court has held "[c]onstruction defect cases . . . implicate contractual liability, rather than tort liability. Here, the defendants involved are not joint tortfeasors. Instead, they face liability due to statutory warranty or contractual obligations . . . In [construction defect] cases, protecting the insurer from excessive judgments that are the product of collusion or fraud between the claimant insured, is the main concern." As a result, in the context of a construction defect claim the only relevant facts are bad faith, collusion or fraud.

D. What Constitutes Collusion or Fraud

Washington State courts have not formally defined the parameters of a collusive settlement in a published appellate decision. The Washington Supreme Court has, however, addressed the potential for collusion, in stipulated settlements where there are covenants not to execute. As noted by our Supreme Court:

> [P]ermitting the assignment of legal malpractice claims to an adversary in the same litigation that gave rise to the legal malpractice claim ought to be prohibited because of the opportunity and incentive for collusion in stipulating to damages in exchange for a covenant not to execute judgment in the underlying litigation . . . We merely observe that the opportunity and incentive for collusion were certainly present here.

Courts from other jurisdictions have found that a stipulated judgment involving a covenant not to execute warrants heightened scrutiny. In *Andrade*, the court found substantial evidence of collusion based upon manipulation of the value of the claim and the underlying parties' efforts

to conceal the settlement discussions from the liability insurer.

In *Continental Casualty v. Westerfield,* the parties entered into a settlement agreement insulating the attorney from personal liability in exchange for a $29.46 million stipulated judgment and assignment of claims against the liability insurer. The court identified several indicators of collusion, based on case law and a 'comprehensive article' on the subject. The court specifically found that "collusion and fraud in this context are not necessarily tantamount to the common-law tort of fraud in that there need not be a misrepresentation of material fact."

Among the indicators of collusion listed in *Westerfield* include: (1) the unreasonableness of the settlement amount, (2) concealment, (3) lack of serious negotiation on damages, (4) profit to the insured, and (5) attempts to harm the interest of the insurer. All factors have the common thread of unfairness to the insurer, "which is probably the bottom line in cases in which collusion is found." *Westerfield*. The Court concluded that the settlement was in fact collusive. The Court commented:

> . . . .[S]ettlement agreements such as the one at hand "skew the trial process" by realigning adversarial parties into a posture whereby they both will profit by a maximum judgment against the insured. Moreover, such settlements create conflicting interests that may compromise an attorney's ability to confirm his or her conduct to such ethical obligations as candor towards a tribunal and avoiding unjustified litigation. Most importantly, the point of such agreements is "not to end the litigation but to prolong it" by confusing and distorting the issues rather than resolving the parties' disputes.

A number of other jurisdictions have held that the terms collusion or fraud in the context of a reasonableness hearing are not comparable to establishing common law fraud or collusion. As one court has stated:

> Collusion occurs when plaintiff and insured enter into "a questionable collaboration. . . to impose an uncompromised full balance of a judgment upon the insurer, while the insured incur[s] no real detriment".

For example, collusion may be found where the evidence demonstrates an absence of conflicting interests—the "lack of opposition between a plaintiff and an insured that otherwise would assure that the settlement is the result of hard bargaining."

In *Indiana School District,* the Minnesota Court of Appeals directly addressed the issue of whether or not collusion can be ruled on as a matter of law in the context of a stipulated settlement. The court also specifically pointed out that the issue of fraud and collusion cannot be separated out from determining whether or not a settlement is reasonable. As the court stated, "Reasonableness and collusion, however, are not readily separable issues. Collusion would make a facially reasonable settlement unreasonable in fact."

Of particular concern to the court was the fact that the settlement in the *Indiana Sch. Dist.* was particularly suspect in a situation where a defendant with little to lose could agree to an inflated judgment in order to avoid personal liability. *Indiana Sch. Dist*. citing *Alton M. Johnson*

Company. In conclusion, the court in *Indiana Sch. Dist.* reversed a summary judgment motion wherein the trial court found that there was insufficient evidence of collusion as a matter of law. The court specifically remanded the issue for further adjudication of the factual issues which are inherent in determining whether or not the settlement was reasonable. This included ascertaining whether or not there was collusion.

Moreover, in regard to the term collusion, there are dictionary definitions which make clear that actions undertaken by parties in agreement may be collusive simply if they are not an arm's length transaction. Specifically, the following dictionary definitions apply: "Collusion is . . . a lack of opposition between a plaintiff and an insured that otherwise would assure that the settlement is a result of hard bargaining." *Indiana Sch. Dist. No. 917 v. Accident & Cas. Ins.*

E. Burden of Proof

In a reasonableness hearing, the "burden of proof regarding the reasonableness of the settlement offer shall be on the party requesting the settlement." *See* RCW 4.22.060 (1).

As a result, the party requesting approval of the settlement, has the burden of establishing that the settlement was free of collusion, fraud or bad faith. In other words, the plaintiff, as the party requesting approval of the settlement in this matter, bears the burden of proving reasonableness. Under *Issaquah Ridge*, reasonableness of a settlement in a contract action, the elements to consider are the existence of bad faith, collusion and fraud.

F. If Settlement is Unreasonable, the Reasonable Amount of the Insured's Liability Must Be Set by the Judge

RCW 4.22.060(1) states, in part, that a "determination by the court that the amount to be paid is reasonable must be secured." Moreover, the Court of Appeals in *Meadow Valley Owners Association v. St. Paul Fire & Marine Insurance Company* stated "if the court determines the settlement amount is unreasonable . . . the statute requires the court to then determine a reasonable amount." Thus a court will determine what the reasonable settlement amount is if the court determines the settlement was unreasonable as a result of fraud, collusion or bad faith.

As a result, the new settlement value will not be set by a jury. Rather, the court at the conclusion of the reasonableness hearing or in a separate proceeding will make an award. The due process and constitutional concerns associated with the courts determination of damages was recently addressed by the Washington State Supreme Court in *Bird v. Best Plumbing Group, LLC*. The *Bird* court held that that RCW 4.22.060 creates an equitable proceeding to which there is no right to a jury trial. Specifically, the Court relied upon the plain language of the statute which states that the reasonableness of the settlement is a determination to be made by the court. The court held that an insurer's due process rights are satisfied by the fact that they are given notice of the hearing and permitted to intervene.

G. Damages in Bad Faith Actions Arising from Consent Judgments

There was a fundamental change in 2014 regarding how the Courts interpreted the presumption of damages in bad faith litigation arising out of consent judgments. In *Miller v. Kenny*, the Washington Court of Appeals held that a consent judgment sets the floor, not the

ceiling, for damages that can be awarded in bad faith litigation. Prior to the decision in *Kenny*, it had been a widely accepted principle that the Washington Supreme Court decision in *Besel v. Viking Ins. Co. of Wisc.*, established that the value of a consent judgment was the ceiling for future damages in a bad faith litigation. In *Besel*, the Supreme Court held: "the amount of a covenant judgment is the presumptive measure of an insured's harm caused by an insurer's tortious bad faith if the covenant judgment is reasonable under the *Chaussee* criteria."

This approach promotes reasonable settlements and discourages fraud and collusion. Furthermore, using the amount of a covenant judgment to measure tort damages in this context makes sense in light of our long-standing requirement that such settlements be reasonable. If a reasonable and good faith settlement amount of a covenant judgment does not measure an insured's harm, our requirements that such settlements be reasonable is meaningless. Finally, the *Chaussee* criteria protect insurers from excessive judgments especially where, as here, the insurer has notice of the reasonableness hearing and has an opportunity to argue against the settlement's reasonableness.

The Court of Appeals in *Kenny*, however, read the reference to "presumptive" measure of harm not as a limitation, but as a starting point. The *Kenny* Court held:

> "It does not appear that Besel claimed Viking's bad faith conduct caused the driver any damages other than liability for the judgment, so there was no reason for the court to announce a rule barring Besel, as the driver's assignee, from recovering additional damages personal to the driver. When *Besel* is read in context with the Court of Appeals decision that it reversed, the proper interpretation of the above-quoted paragraph is that harm to the insured is presumptively worth *at least* the amount of the covenant judgment—not less."

The Supreme Court implicitly confirmed this interpretation by explaining in a recent case that "in the insurance setting, the presumptive amount is added to *any other* damages found by the jury." The holding of *Bird* is that a reasonableness hearing is an equitable procedure. The court stated, "Here, there is no factual determination to be made on damages in the later bad faith claim, *at least not with respect to the covenant judgment*." This sentence indicates the way is open for a jury to make a factual determination of an insured's bad faith damages *other than* and *in addition* to the covenant judgment."

[The proposition regarding the presumption of damages for consent judgments in WA is summed up by the first sentence of the *Kenny* decision: "In an insurance bad faith case, the amount of a reasonable covenant judgment sets a floor, not a ceiling, on the damages a jury may award."]

III. CONSENT JUDGMENTS UNDER ARIZONA LAW

In Arizona, consent judgments are known as "Damron" or "Morris" Agreements. *Damron v. Sledge*; *USAA v. Morris*. Consent judgments typically arise in a situation where a liability insurer allegedly fails to defend its insured, defends under a reservation of rights or refuses to settle. This allows the insured to proceed to settle a claim with the third party in exchange for the third party agreeing not to execute upon the settlement. However, Arizona courts have

cautioned the potential for inflated damages, which often pose a significant threat and exposure to insurers. In the wake of its *Damron* and *Morris* decisions, Arizona courts have struggled in applying their principles consistently. As a result, and in an effort to protect the expectations of all parties, subsequent decisions have been issued that test the boundaries of *Damron* and *Morris*.

Today, the Arizona debate continues to surround the issue of whether any stipulated judgment—regardless of its reasonableness—binds an insurer as a consequence of its failure to defend. The Arizona Court of Appeals cautions in *Leflet v. Redwood Fire & Cas. Ins. Co.*, that *Morris* agreements are fraught with risk of abuse and any settlement will be unenforceable absent any legal and economic support. It is therefore essential that insurers be weary of what is transpiring in potential lawsuits and remain prepared to take the necessary steps to cut-off any attempts by the insured and opposing parties to create an optimal consent judgment climate.

[The following represents some of the foundational principles of *Morris* and its progeny.]

A. Insured's Duty to Cooperate

Arizona has consistently upheld the cooperation clause and found that an insured does have a duty to cooperate with its insurer. The duty to cooperate requires that the insured aid the insurer in its defense. "He may not settle with the claimant without breaching the cooperation clause unless the insurer first breaches one of its contractual duties." *USAA v. Morris.* As long as the insurer meets its contractual obligations, the duty to cooperate remains in force and any settlement by the insured constitutes a breach of the policy. *Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme*.

B. *Damron* and *Morris* Agreements

There are two main types of consent agreements in Arizona; *Damron* agreements and *Morris* agreements. A *Damron* agreement arises when the insurer refuses to defend the insured in a claim that may or may not fall under policy coverage. *Damron v. Sledge*. When plaintiff and the insured enter into this agreement, the insurer may not contest the reasonableness of the agreement and is limited to contesting the judgment on coverage issues or on the basis that the judgment was collusive or fraudulent. The court stated that "if the [insurer] refuses to defend at all, it must accept the risk that an unduly large verdict may result from lack of cross-examination and rebuttal."

Damron agreements can also arise in circumstances where the insurer chooses to defend and does not reserve any rights. *State Farm Mut. Auto Ins. Co. v. Peaton*, The court in *Peaton* ruled that insurers owe their insureds three duties, the duty to indemnify; the duty to defend; and the duty to treat settlement proposals with equal consideration, and that the breach of any of these duties generally frees the insured from his obligations under the cooperation clause. Therefore, if an insurer defended its insured with no reservations, the insured could still enter into a *Damron* agreement if the insurer failed to treat settlement proposals with equal consideration.
Factors to be considered by the trier of fact in determining whether the insurer failed to meet this duty include: (1)the strength of the injured claimant's case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to a settlement; (3) failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; (4)the insurer's rejection of advice of its own attorney or agent; (5) failure of the insurer to inform the insured of a compromise offer; (6) the amount of financial risk to which each party is exposed in the event of a refusal to settle; (7) the fault of the insured in inducing the

insurer's rejection of the compromise offer by misleading it as to the facts; and (8) any other factors tending to establish or negate bad faith on the part of the insurer. *Clearwater v. State Farm Mut. Auto. Ins. Co.*

Morris agreements arise when the insurer defends its insured under reservation of rights. The court in *Morris* dealt with two main issues: 1) whether this type of agreement violated the insured's duty to cooperate, and 2) whether the insurer was bound by the settlement. The court ruled that "the cooperation clause prohibition against settling without the insurer's consent forbids an insured from settling only claims for which the insurer unconditionally assumes liability under the policy." The insured is not prohibited from entering into these settlements when the insurer defends under a reservation of rights but the insurer must be given notice of the agreement so it has the opportunity to withdraw its reservation of rights. Finally, the court found that the settlement will only bind an insurer if the plaintiff can show that the amount of the settlement was reasonable and that it was neither fraudulent nor collusive.

1. Limiting Exposure

When an insurance carrier receives notification that its insured is contemplating a *Morris* agreement, the insurance carrier can limit its exposure and solidify its coverage defenses by sending the insured a *Munzer* letter.

In *Munzer v. Feola*, the AZ Court of Appeals held that a *Morris* agreement is only limited to those claims and damages for which the insurer reserved its rights. *Munzer v. Feola*. A *Munzer* letter is a letter sent to the insured by the insurer which specifically states which of plaintiff's claims will be defended without a reservation of rights, and those as to which it will reserve its rights. *Id.* More specifically, the letter outlines which alleged damages are covered under the policy and which alleged damages are not. This letter prevents plaintiff and the insured from entering into a *Morris* agreement that settles any claim the insurer agreed to defend without reservation. Any such *Morris* agreement will be deemed a breach of the cooperation clause, voiding the policy.

C. Reasonableness Hearing

When parties enter into a *Morris* agreement, an insurance carrier must be allowed to contest the reasonableness of the settlement between the plaintiff and its insured. *Anderson v. Martinez*; *Monterey Homes Arizona, Inc. v. Federated Mut. Ins. Co*. In this type of reasonableness hearing, the finder of fact is charged with determining the following issues: (1) the reasonableness of the settlement between the plaintiff and the insured; (2) whether or not the settlement was fraudulent or collusive; and (3) whether the insurance carrier received proper notice of the settlement. "The primary purpose of a reasonableness hearing is to attempt to re-create the same result that would have occurred if there were an arm's length negotiation on the merits of the case between interested parties." *Waddell v. Titan Ins. Co.*,(quoting *Himes v. Safeway Ins. Co.*). Notably, "reasonableness" does not mean the full value of a claim if it were to be presented to a jury. Rather, it means what a reasonable arm's length transaction/settlement between the parties would have been had it taken place. In other words, the court must view the claim as if the parties were negotiating a settlement, taking into account all of the pros and cons of the case and all of the factors typically considered by

parties and their attorneys when entering into a settlement.

The test to determine the reasonableness of a settlement is "what a reasonably prudent person in the insured's position would have settled for on the merits of the claimant's case." *Himes*. A "reasonably prudent person" is a person who is making the decision as though the money is coming out of his or her pocket, not with someone else's money, based on the merits of the case. There are several factors that a court must consider in evaluating the reasonableness of a settlement: (1) the extent of claimant's damages; (2) the merits of claimant's liability theory; (3) the merits of the insured's defense theory; (4) the insured's relative fault; (5) the risks and expenses of continued litigation on the merits; (6) evidence of bad faith, fraud, or collusion; (7) the extent of claimant's investigation and preparation of the case; and (8) the interests of the parties not being released. (citing *Chaussee v. Md. Cas. Co* (1991)).

Parties are required to present witnesses and testimony at reasonableness hearings to better evaluate each of the above-listed factors. Attorneys for the insured have been compelled to testify and to produce documents related to the settlement in Arizona courts.

D. Burden of Proof

In a reasonableness hearing, the plaintiff bears the burden of proving the reasonableness of the settlement amount by a preponderance of the evidence. A court cannot simply rubber stamp a stipulated judgment amount for it to stand as a reasonable settlement. There is no presumption of reasonableness and the burden of proof does not shift to the carrier. Rather, there is an affirmative duty on the plaintiff's part to establish reasonableness for each element of the stipulated judgment.

Finally, the trial court, in the reasonableness hearing, cannot consider non-financial consequences that the insured may face as a result of an adverse judgment when determining whether the settlement or stipulated judgment amount is reasonable. *Parking Concepts, Inc. v. Tenney*, (Ariz. 2004). The carrier does not have a contractual obligation to consider its insured's non-financial consequences under the insurance policy.

E. Unreasonable Settlements

Courts have a duty to determine a reasonable settlement amount if the plaintiff cannot meet his burden. "If [claimant] cannot show that the entire amount of the stipulated judgment was reasonable, he may recover only the portion that he proves was reasonable. If he is unable to prove the reasonableness of any portion of the judgment, [the insurer] will not be bound by the settlement." *Morris*. After hearing all of the witness testimony and reviewing all of the evidence, the court must then determine what a reasonable settlement would have been, or should have been, based on the merits and circumstances of the case. This requires the court to determine a specific dollar amount as reasonable. *Himes*.

For example, in *Cosgrove v. WTM Construction Inc. et al.* (Ariz. Super. 2010), following a *Morris* hearing, an Arizona trial court significantly reduced the stipulated judgment of $443,690 to a net reasonable settlement of $254,373. In *Cosgrove*, a home owner filed a lawsuit against WTM Construction after discovering several defects and asserted numerous legal theories including fraud and negligent misrepresentation. Before trial both parties entered into a *Damron/Morris* agreement, which provided that a

stipulated judgment would be entered against WTM in the amount of $443,690. The court determined a reasonable settlement by examining the plaintiff's claims and assigning settlement values to various claims based on chances of prevailing on these claims. The court also looked at settlement as a whole and found that a reasonable defendant would pay, and a reasonable plaintiff would accept, $304,373 in full settlement of this case based on the merits in an arm's length transaction considering all the factors required by *Morris* and its progeny. The court held that the defendant's insurer was only bound to pay the reasonable settlement of $254,373.

F. Recent Developments

The Arizona Court of Appeals recently clarified the permitted parameters of *Morris* agreements in construction defect cases. In *Leflet v. Redwood Fire & Cas. Ins. Co.*, the developer of a project and its direct insurers attempted to enter into a *Morris* agreement with the plaintiff homeowners, stipulating to an $8.475 million judgment against them and paying plaintiffs $375,000 in addition to assigning plaintiffs their rights against all subcontractors and subcontractors' insurers in exchange for a covenant not to execute on the judgment. The court ruled that such an agreement is invalid when it exposes the excess insurer to liability in excess of their policy limits and its clear intent is to favor the primary insurers and burden the excess insurer.

In *Colo. Cas. Ins. Co. v. Safety Control Co.*, the Arizona Court of Appeals ruled that an insured and its excess insurer can enter into a *Damron/Morris* agreement when the primary insurers have refused coverage. The court stated that an agreement in this setting puts the liability where it should have been in the first place—on the primary insurer. For the judgment to be enforceable, it must prove to be a liability that is within the scope of the subcontractor's insurer's coverage.

In *Quihuis v. State Farm Mut. Auto. Ins. Co.*, the United States Court of Appeals for the 9th Circuit certified a question to the Arizona Supreme Court to decide whether an insurer who declines to defend its insured can be estopped from raising a coverage defense in a subsequent action based on a default judgment entered pursuant to a *Damron* agreement that included a stipulation between the third-party plaintiffs and the insured. On June 3, 2014 the Arizona Supreme Court heard oral arguments for the *Quihuis* case, which may have significant consequences for insurers in cases where the insured has entered into a *Damron* agreement with the injured plaintiff.

In *Quihuis*, a couple insured their vehicle under a State Farm automobile insurance policy and later sold it (but did not transfer title) to the plaintiff. The plaintiff lent the vehicle to her daughter to drive, who was later in a vehicle accident with the plaintiff. The couple did not cancel their State Farm policy until after this accident occurred. The plaintiff sued the daughter for negligence and the couple for negligent entrustment. Plaintiff entered into a *Damron* agreement with both parties in which they stipulated that the couple legally owned the vehicle at the time of the accident, establishing the couples' liability for negligent entrustment. The couple assigned their rights under the State Farm policy to the plaintiff, and a default judgment was entered for the plaintiff against both parties for $350,000. Based on the undisputed facts and policy language, the federal court granted State Farm's summary judgment, since the vehicle no

longer qualified as an insured vehicle on the date of the accident because it was previously sold. In agreement with the district court, the Circuit Court held that the default judgment did not preclude the insurer from litigating who owned the vehicle for purposes of coverage, but the outcome depends on whether the stipulation between the parties that the couple owned the vehicle prevents State Farm from contesting coverage under the policy.

This issue required the Court to resolve the inconsistencies between *Morris* and the narrower holding in *Assoc. Aviation Underwriters v. Wood*, applying collateral estoppel to preclude insurers from relitigating facts necessary to both liability and coverage. In its decision, the Arizona Supreme Court took the middle ground and affirmed the validity of consent judgment agreements and delineated under what circumstances the insurer can contest consent judgments on coverage grounds. The Court held that the stipulated judgment in the underlying action does not preclude the insurer(s) from contesting coverage in a subsequent action and the insurance carrier is not bound by stipulated facts essential to establishing coverage. The Court further found that the prudent practice is for an insurer to defend its insured under a reservation of rights and expeditiously pursue a determination on coverage. The Court also cautions insurers against refusal to defend: "We take this opportunity, however, to emphasize our prior admonition that when an insurer refuses to defend, as State Farm did here, it does so at its peril, and if a court later finds coverage, the insurer must pay the damages awarded in the default judgment."

1. *Post Consent Judgment Litigation: Hidden Costs of Consent Judgments*

Inherent in post judgment/bad faith litigation often lies costly discovery battles including production of claims files, coverage attorney's evaluation letters, production of defense counsel's evaluation letters, depositions of claims representatives and coverage counsel, and waiver of attorney client privilege.

For example, in *Lexington Ins. Co. v. Scott Homes Multifamily, Inc.*, Lexington Insurance sued seeking a determination that it was not liable to pay Silverbell, assignee of Lexington's Insured, in satisfaction of a consent judgment Silverbell obtained in prior litigation against Lexington's insured, Scott Homes Multifamily, Inc. ("Scott Homes"). After an order was issued denying Lexington's motion for summary judgment, Lexington then moved to reopen discovery to compel Silverbell to produce additional documents that Silverbell allegedly improperly refused to produce and Lexington's motion for summary judgment on its claim that it is not liable to Silverbell under the terms of the Lexington Excess Policy and on Silverbell's counterclaim for bad faith.

In the underlying lawsuit, several discovery disputes arose over the alleged privileged documents, which were necessary to prove the reasonableness of the stipulated judgment. The discovery disputes were referred to a special master who recommended, and court ultimately adopted, a finding that Silverbell and Scott Homes had impliedly waived the attorney-client privilege with respect to the privileged documents by entering into the Settlement Agreement, because Silverbell had to prove both that (1) Scott Homes diligently defended the lawsuit and (2) there was no collusion between Silverbell and Scott Homes in entering into the Settlement Agreement and stipulated judgment.

Lexington alleged that the settlement agreement and resulting stipulated judgment between Silverbell and Scott Homes are products of collusion since the two entities share common ownership. The court previously granted several discovery extensions at the parties' requests. On its motion to reopen discovery, Lexington argued that the court should reopen discovery to permit Lexington to discover evidence that could defeat Silverbell's motion for summary judgment on Lexington's claims of fraud and collusion because Lexington learned only after the close of discovery that Silverbell did not comply with Lexington's requests for production. The court denied the motion to reopen discovery, holding that Lexington did not meet its burden of proving that it diligently pursued its previous discovery opportunities since it knew of the existence of privileged documents after the cutoff of discovery in this case. Courts will not permit a party to gain a tactical advantage from reading fully briefed cross-motions before deciding whether to pursue use of privileged documents; such dilatory tactics are not "diligence."

IV. GENERAL PRACTICE TIPS REGARDING CONSENT JUDGMENTS

Depending on the facts and legal issues presented in any particular potential consent judgment, there are a number of appropriate suggestions outlined below:

- Make sure all negotiations are done in an arm's length manner.

Settlement agreements should be reached through a meaningful process. A collusive settlement will not be upheld. For this reason it is important that the settlement is appropriately negotiated and documented.

- Be careful of what you put in writing.

As set forth above, the process requires the settlement to be done in an arm's length manner. Correspondence, e-mails, even phone communications should be done in a manner which avoids any appearance of collusiveness or impropriety.

- Consider mediation or other alternate dispute resolution.

One way to insure that a settlement is reached in a fair and impartial manner is to have the settlement take place in the format of a mediation or through another alternate dispute process. Having a mediator's proposal which matches the eventual settlement or having a mediator approve the settlement can be helpful in establishing that the settlement was reasonable. Obviously mediation discussions or exchanges of offers and compromise may be precluded under ethical rules. Regardless of the constraints of certain ethical rules, however, the process in which a settlement is arrived at may be introduced in a subsequent bad faith claim. It may also become part of the record in regard to a reasonableness hearing.

- Is the number reasonable?

Many times a greedy plaintiff will overestimate the value of their claim which results in settlement being deemed unreasonable by the court. Any settlement should be reflective of real

exposures and appropriate damages.

- <u>Be prepared to support an objection to reasonableness.</u>

Though an insurer may not have much time to intervene and object to a settlement, any objection to settlement should be accompanied by supporting evidence as to why the settlement is not reasonable. A reasonable settlement will likely have been worked up by the parties such that the appropriate experts were retained, the exposures are reviewed, liability issues were analyzed, and damages are, in some fashion, established. If the parties have failed to work up their cases, this absence of evidence can be used to support the claim that the settlement is unreasonable and likely will be received by the court better than an unsupported objection. Another avenue to support an objection to reasonableness would be to examine jury verdicts from similar cases.

- <u>Give all sides an opportunity to settle prior to exercising the stipulated settlement</u>.

Liability insurers have express requirements under state administrative codes to take reasonable actions to settle a case once liability becomes reasonably clear. *See. e.g*., WAC 284-30-330(6). An insurer that is not given an opportunity to attempt to settle the case may use this in defense of any attempted bad faith claim. The insurer should be given an opportunity to participate in the settlement whenever possible.

- <u>Consider having the insured contribute their own funds</u>.

To the extent an insured defendant is willing to contribute their own funds, having that defendant participate by funding part of the settlement will go a long way to establish if the settlement is a fair representation of actual exposures and not the result of collusive or fraudulent behavior.

V. CONCLUSION

Early defense and careful evaluation of coverage disputes on behalf of insureds can go a long way toward militating against consent judgments which most often result in more headaches and expense for carriers. It is important to keep in mind that settlement agreements should be reached through a meaningful process; a collusive settlement will not be upheld. For this reason, it is vital for insurers to be aware of how a consent judgment may impact its exposure when deciding whether to deny a defense or reserve rights to the insurer before participating in settlement discussions, which may have irremediable and damaging results.

It is important to understand the applicable state law when determining whether the amount of a consent judgment (or *any* consent judgment in some states) may be binding on an insurer, under which circumstances an insurer may be liable for breach of the insurance contract or bad faith, as well as any applicable defenses the insurer may use to defeat liability in such circumstances.