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The Insurer's Hollow Crown: Reservations, Denials and Loss of Control
Or
How to Reserve Your Rights and Lose Your Shirt

Prologue

For God's sake let us sit upon the ground,
And tell sad stories of the death of kings –
How some have been deposed, some slain in war,
Some haunted by the ghosts they have deposed,
Some poisoned by their wives, some sleeping killed;
All murdered – for within the Hollow Crown
That rounds the mortal temples of a king,
Keeps Death his court; . . .and humoured thus,
Comes at last, and with a little pin
Bores through his castle wall, and farewell king![1]

I. Consent Judgments and Stipulated Damages

For those of us who believe that all life's lessons can be learned from a careful reading of Shakespeare, [2] King Richard's lament offers valuable insights about the fragility of political power. The same might well be said about the power held by parties with certain legal rights – for example, the power given to one under contract or common law.

In the insurance world, it is common knowledge that, when issuing a policy to an insured, the insurance company typically retains many important rights and, therefore, significant power. Perhaps chief among these powers is the ability of the insurer control the defense of the claim and to resolve the claim should it so desire. Generally, the insurer's duty to defend includes the right to assume control of the litigation. "The purpose of such right is to allow insurers to protect their financial interest in the outcome of litigation and to minimize unwarranted liability claims. Giving the insurer exclusive control over litigation against the insured safeguards the orderly and proper disbursement of large sums of money involved in the insurance business." [3]

As Richard discovered, however, having the power to control the kingdom and the flow of monies, carries its own dangers, including the threat of ending up in the Tower of London without any power whatsoever.[4] Likewise, the power to control the defense and settlement of lawsuits carries with it the danger of breaching the duties owed to the insured when exercising that control. When, for example, an insurer, in compliance with applicable common and/or statutory law, reserves its rights and advises the insured of the possible limitations of available coverage, some jurisdictions hold that, in many situations, the insurer has thereby created a conflict situation resulting in the loss of the insurer's rights to control the insured's defense.[5] In addition to the obvious issues relating to independent counsel that flow from such a conflict, there are a number of recent cases that highlight a different and more dangerous potentiality – the consent judgment. With the consent judgment, the insurance company king, with all of its contractual right to control defense and settlements, is deposed and, like Richard in the Tower of London, powerless to protect itself in any meaningful way. Insurers need to be aware of this tactic and learn how they can best mitigate its risk.

Elements of Consent Judgments by Insureds

What do we mean by a "consent judgment?" As most commonly understood, a consent judgment involves an insured reaching an agreement with a claimant without involving the insurer. Pursuant to this agreement: (1) the insured consents or stipulates to an adverse judgment for a certain quantum of damages; (2) the claimant executes a covenant not to execute judgment against the insured; and (3) the insured assigns to the claimant all of its rights under the policy for coverage and any and all bad faith or other claims arising thereunder. Significantly, consent judgments do not constitute and do not contain a release of liability for the insured. Indeed, the opposite is typically the case – a judgment against the insured is agreed or stipulated to or, depending on the jurisdiction and the involvement of the overseeing court, not objected to. As such, the potential liability of the insurer to its insured remains (having been assigned to the claimant) and is not extinguished by the consent judgment itself.

The Reasonableness of Trial Court Reasonableness Hearings

Most jurisdictions recognize the risk of collusion or fraud between the claimant and the insured in reaching such agreements. As such, consent judgments will often not be valid unless they are "reasonable" and entered into in good faith.[6] Just how that determination is made, however, can be a considerably murkier question. In Illinois, for example, a reasonable settlement is one in which the insured's decision conformed to a standard of a prudent *uninsured* under the totality of the circumstances.[7] In New York, when an insurer declines coverage, "the insured may settle with third parties without prejudicing its rights against the insurer, so long as the settlement is made 'in good faith.'"[8] To demonstrate good faith, the insured need not show "actual liability to the party with whom it has settled so long as a potential liability on the facts known to the [insured is] shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant's success against the [insured]."[9]

Such standards are fairly common and are relatively easy to articulate. A settlement by an insured must be one that is reasonable with respect both to the question of whether to settle and to its actual amount. The "totality of the circumstances" allows for almost any factor to be introduced and will most likely be viewed from the perspective of a party that does not enjoy the benefit of insurance protection.

One Texas court has cast doubt on the viability of this kind of solution, noting:

> It is one thing to say that a defendant's liability must be determined as if he had not settled with the plaintiff; it is quite another thing to do it. We think [*Pruyn v. Agricultural Ins. Co*.],'s[10] listing of factors to be considered in the process of assessing a defendant's liability after he has settled shows that the undertaking is virtually impossible. Once the parties have changed positions, their views are altered, and it is very difficult to determine what might have been.[11]

If the court's observation is true, the courts called upon to determine the validity of a consent settlement, whether as an overseeing court or a declaratory judgment venue, face a difficult task and the parties are therefore placed in an even more difficult position in trying to predict an uncertain result.

II. Insurance Policy Clauses and How They Impact Consent Judgments

Any analysis of the propriety of consent settlements from the standpoint of the insurance company should begin with and be grounded in the language of the insurance policy itself. A typical insurance policy contains a number of clauses that are implicated by a consent judgment against an insured. Among these are the cooperation clause, the provision prohibiting voluntary payments, the anti-assignment clause and the insurer's right to control the defense and effect settlements.

Policy language that puts coverage at risk in the event the insured makes any admissions or enters into voluntary settlements would seem, at first blush, to offer the strongest basis for an insurer to avoid being bound by a consent settlement. However, as Shakespeare again teaches, "All that glisters is not gold"[12] and a number of courts have rejected that argument. For example, the Pennsylvania Supreme Court recently held that an insurance company, even while defending under a reservation of rights, cannot avoid an insured's settlement of a claim against if that settlement is reasonable and noncollusive. The court observed that policyholders should be allowed to control settlements of claims against them when they face a risk of no coverage so long as the settlement is objectively "fair and reasonable."[13] The opinion indicates that the insurer refused to consent to the settlement prior to the insured agreeing to it. While the opinion extended the insurer's liability for such settlements beyond those of earlier cases finding liability when the insurer was found to be in bad faith in rejecting settlement or where it had refused to defend the insured at all, it would appear to still leave open the question in Pennsylvania whether the result would be different if the insurer had never been given the opportunity to accept or reject the settlement proposal.

This issue has been addressed in Illinois, further eroding an insurer's ability to rely on the cooperation or no voluntary payment language of the policy. An Illinois appellate court has ruled that, where a settlement did not compromise the insurer's ability to contest indemnification of its insured because it had reserved its rights and where the insurer had relinquished its control of the insured's defense due to a potential conflict of interest, the insured was under no obligation under the policy to obtain the insurer's consent to settlement.[14]

This line of cases would suggest that, as long as an insurer properly reserves its rights under the policy, thereby ensuring that its coverage defenses can be litigated at some future date, the subsequent relinquishment of its control of the insured's defense will also prevent it from standing in the way of an insured's consent judgment, whether with or without notice. One might, based on this logic, ask whether the relinquishment of defense without a proper reservation of rights would then give the insurer standing to object to a consent judgment but it is difficult to see how a court would come to grant this advantage to an insurer for *failing* to properly reserve its rights. What is apparent is that an insurer hoping to rely on the cooperation or no voluntary payments language of its policies may well find indeed that, "wishes were ever fools."[15]

Similarly, anti-assignment provisions in policies would not seem to disqualify an insured from seeking indemnity from its insurer for amounts owed pursuant to a consent judgment. While there is little doubt but that an insured can assign a claim to a third party when the claim arises after the loss, there is now also authority suggesting that, even if the assignment is made prior to the claim being asserted, it may still be valid under the anti-assignment clause. For example, a New Jersey appellate court has held that an assignee was permitted to pursue coverage on policies written for a different insured where the policies provided coverage for occurrences. The court noted that the peril insured was the occurrence itself so that, once the occurrence took place, coverage attached, even if the claim itself were not make until sometime thereafter. The court noted the difference between the assignment of a policy and the assignment of a claim under the policy, which could be valid even where no claim had been made.[16]

Given that consent settlement are, by necessity, dealing with claims already asserted at the time of assignment, there would appear to be little hope of strengthening the anti-assignment provisions of an insurance policy to restrict the assignability of claims at a time when courts are expanding an insured's right to assign claims even before they are asserted.

We have previously addressed the significance of an insurer's right to control the defense and effect settlements of claims. However, as noted, this right, too, seems to be subject to significant erosion as the courts consider what is "control" and when is that control relinquished. Clearly, when an insurer abandons its insured by refusing to defend, the courts are going to be ill-disposed to granting that insurer the right to avoid a reasonable settlement entered into by its abandoned insured. In contrast, where an insurance company fulfills its obligations to its insured, recognizes a potential conflict of interest and cedes control of the defense based on that conflict, why is that insurer treated in the same manner as its counterpart that abandoned its insured. Is the mere potential to litigate coverage defenses reason enough to allow an insured to enter into a consent judgment in any amount, checked only by the critical

inquiry of a court into the amount of that judgment? One might well argue that, from a public policy standpoint, there should be a greater difference in the treatment afforded an insurer breaching its duty to defend and that which has not. At this time, however, the trend appears to be otherwise and the insurer's control of the defense becomes the instrument of its later misfortune.

A Statutory Approach to Consent Judgments

In the same vein, one can also look to statute. Of considerable interest in this regard is Section 537.065, R.S.Mo. 2000, a Missouri statute that permits a claimant and a tortfeasor to limit satisfaction of a claim to specified assets, including the tortfeasor's insurance policies. The statute allows the claimant and the insured, in consideration of the payment of a specified amount, to agree that, in the event of a judgment against the insured, the claimant will not execute against any but the specified assets (e.g., the insurance policy). The tortfeasor, knowing that it cannot be held personally liable because of the agreement, then agrees to settle the claim or to refrain from any objections or opposition to the claim at trial. Subsequently, the insurance company, faced with the claimant's garnishment action against the tortfeasor's insurer, is limited to contesting only the coverage questions but is barred from re-litigating the liability of the insured or the damages to which it stipulated. Moreover, no prior notice to the insurer of this agreement is required. In this manner, the insured knows that it has no personal exposure. The claimant does risk recovery if it turns out that the insurer had valid coverage defenses. The insurance company's risk is that, if it does not prevail with its coverage defenses, it will have no opportunity whatsoever to contest the issue of liability or damages.[17]

Defenses to Consent Judgments

In concept, the most easily accepted defense to a consent judgment is likely to be one based on demonstrated fraud or collusion between the claimant and the tortfeasor. However, while a "rose by any other name would smell as sweet,"[18] it is far from clear when a court will view a voluntary agreement between consenting parties as fraudulent or collusive. The same is true, as discussed above, with respect to the "reasonable" settlement. What facts are likely to be persuasive to a court? Who has the burden of proof and how may it be satisfied? What leeway will be given to an insurer to discover these facts, likely as such an inquiry is to implicate attorney-client privilege and subjective frames of mind. One is hard-pressed to imagine that the courts will be enthusiastic about the notion of substituting their own independent judgment, largely limited by the facts known to them, for that of the insured facing the risk of a claim without insurance protection. Nevertheless, this is the landscape currently faced by insurers who either abandon or reserve rights to their insureds and thereby relinquish control of the defense.[19]

Consent judgments have the potential of radically shifting the burdens imposed on the parties to insurance contracts when coverage questions exist. Their use considerably raises the stakes on insurance companies who choose to reserve their rights, particularly when, under the governing state's jurisdiction, that reservation of rights leads to a potential conflict of interest between the insurer and its insured and the relinquishment by the insurer (whether or not voluntary or required by law) of its contractual right to control the defense. As consent judgments become more popular and until such time as there exists a well-developed line of

precedent clarifying the defenses available to these judgments, insurance companies would be well-counseled to devote even more attention and to strategically address their decision whether or not to issue reservations or rights to their insureds. In the face of common law and statutory regimes, the insurer's right to control the defense does become a double-edged sword which, when not used expertly or wisely, may cause it, as Hamlet warned, to be hoist on its own petard.[20]

Epilogue

Things did not end well for Richard II, either in real life or in Shakespeare's "based on the life of" version. Although his insights and reflections into the use and misuse of his powers as king came too late to prevent his deposition or even the loss of his life, they do nevertheless offer guidance for anyone or any entity exercising those powers. Insurance companies, not often guided by the bard, might do well to heed the lessons Richard learned too late. It may be good to be King and it is helpful for insurers to have the contractual right to control the defense and settlement of claims. However, that power and that contractual right is also the source of emerging and developing danger. When the insurer's control of the defense is misused or when it is relinquished by word or deed, insureds can enter into consent judgments, potentially locking in both liability and the amount of damages and setting up further claims of bad faith. In such circumstances, the insurance policy terms and provisions, like the moats of Richard's own castles, offer the insurance company no real protection. It is then, stripped of the rights on which it once relied, that the insurer may soon realize that its crown is indeed hollow and that grave misfortunes may attend those who wear it unwisely.

ENDNOTES

[1] William Shakespeare, *Richard II*, Act III, Scene 2.

[2] *See, e.g., "Everything I Need to Know, I Learned from Shakespeare: 50 Lessons from the Bard," http://newvictorytheater.blogspot.com/2013/03/everything-i-need-to-know-i-learned.html (March 1, 2013).*

[3] *Parker v. Agricultural Insurance Co.* (1981), 109 Misc.2d 678,681, 440 N.Y.S.2d 964, 967; 7C Appleman, Insurance Law & Practice sec. 4681, at 2-5 (1979).

[4] *See* William Shakespeare, *Richard II*, Act IV, Scene 1.

[5] *See, e.g., San Diego Navy Federal Credit Union, et al. v. Cumis Insurance Society, Inc,* 162 Cal.App.3d 358 (1984); *Maryland Cas.Co. v. Peppers*, 64 Ill.2d 187 (1976); Florida Statutes §627.426(2).

[6] See, e.g., *Steil v. Fla. Physicians Ins. Reciprocal*, 448 So. 2d 589 (Fla. 2d DCA 1984).

[7] *Guillen v. Potomac Ins. Co.*, 203 Ill.2d 141, 149 (2003).

[8] *Amalgamet, Inc. v. Underwriters at Lloyd's,* 724 F. Supp. 1132, 1142 (S.D.N.Y. 1989).

[9] *Luria Bros. & Co. v. Alliance Assurance Co.,* 780 F.2d 1082, 1091 (2d Cir. 1986).

[10] 42 Cal. Reptr. 2d 295 (Ct. App. Cal. 1995).

[11] *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996).

[12] William Shakespeare, *Merchant of Venice*, Act II, Scene 7.

[13] *Babcock & Wilcox Company v. America Nuclear insurers, No.* 2 WAP 2014, 2015 WL 4430352 (Pa. Jul. 21, 2015).

[14] *Commonwealth Edison Co. v. National Union Fire Insurance Co.*, 323 Ill.App.3d 970 (2001).

[15] William Shakespeare, *Antony and Cleopatra,* Act IV, Scene 15.

[16] *Givaudan Frangrances Corporation v. Aetna Casualty & Surety Co.,* Docket No. A-2270-12T4 (N.J. App.Div, August 12, 2015).

[17] *Butters v. City of Independence,* 513 S.W.2d 418 (Mo. 1974).

[18] William Shakespeare, *Romeo & Juliet,* Act II, Scene 2.

[19] In a very interesting opinion, *Hartford Casualty Insurance Co. v. J.R. Marketing, LLC*, __ Cal. __ (August 10, 2015), the California Supreme Court found Hartford may seek reimbursement directly from its insured's chosen defense counsel for overbilled amounts because a court ordered Hartford to pay each bill as presented but stated Hartford could later seek reimbursement. While not dealing with consent judgments, this opinion raises important issues relating to the rights of an insurer that has ceded control of the defense of a claim that would likely impact future judicial analysis of consent judgments. In deciding the matter, the Court limited the opinion to the particular facts of the litigation and, thus did not decide several other broad questions, including whether an insurer that breached its defense obligations has a right to recover excessive fees paid to *Cumis* counsel. Justice Liu's concurrence reiterates the unique facts underlying the opinion and notes Hartford still bears the burden of proving the fees were not objectively reasonable at the time they were incurred and were not incurred primarily for JR Marketing's benefit and advocated for a rebuttable presumption that fees were incurred for the policyholder's benefit.

While the case is limited to the "circumstances of this case" and may not have a direct, significant impact generally, it will likely lead to further disputes between insurers and insured-appointed defense counsel and especially, with respect to consent judgments, bear significantly on the question of "what is reasonable."

[20] William Shakespeare, *Hamlet,* Act III, Scene 4.