The Covenant Judgment Problem

Presenters: Aaron Doynow, *AIG*
Craig Stewart, *White and Williams*
Marjorie Thompson, *Allied World Assurance Company, Ltd.*

I. What is a "Covenant Judgment" and Why is it a Problem?

The term "covenant judgment"[1] refers to a settlement agreement that is reached between an insured defendant and the plaintiff, most often in a tort action, where the potential damages are high, the personal assets of the defendant are small in relation to the alleged damages, and there is an insurance policy that may provide coverage for some or all of the claims alleged. The settlement agreement typically provides that the insured defendant will enter into a consent judgment on liability and damages, and will assign to the plaintiff her rights under the insurance policy and any bad faith claims she has against the insurer. In exchange, the plaintiff gives the insured a covenant not to enforce the consent judgment against her personal assets, with the exception of the insurance policy. Particularly where the insurance policy's limits are not sufficient to satisfy the plaintiff's damages and where the case for establishing liability is weak, plaintiff's counsel has every incentive to enter into a covenant judgment and assert a bad faith claim against the insurer.

To insulate the settlement and the amount of stipulated damages from charges of fraud or collusion, plaintiffs' counsel use different stratagems. Some counsel will have the defendant insured contribute to the settlement with an amount from his personal funds – so as to demonstrate that the insurer's bad faith conduct has caused the insured direct economic loss. This will help blunt any argument that the insured who has entered into the settlement has no damages and therefore, no actionable claim for bad faith that she can assign. The settlement agreement may also provide that the stipulated amount of damages must be subject to a finding of reasonableness by the court, or that the amount of the consent judgment will be determined by the court or by a summary jury trial on damages. Often the hearing or summary trial on damages will be a one-sided affair with the plaintiff putting in testimony and other facts to justify a high damage award, and the insured offering little or no contrary evidence. Since the insured is

[1] The term "covenant judgment" appears to have been coined by Robert J. Franco and Amy C. Novanik in an article published in the Federation of Defense and Corporate Counsel's quarterly journal in 2001. See, R. J. Franco and A. C. Novarik, *Insurance Bad Faith: Assignments, Consent Judgments and Covenants Not to Execute*, FDCC Quarterly, Winter 2001, vol. 1, Issue 2.

protected by the covenant his primary interest is in making sure that the Court approves the consent judgment and damages, so that the deal goes through and his personal assets are no longer at risk. If the insurer has denied coverage or a duty to defend, it's unlikely that the court will permit it to intervene to contest the amount of damages. This is so even where the insurer is defending under a reservation of rights, but has refused to offer policy limits, since the insured can argue that the insurer is seeking to block its advantageous settlement in order to protect its own interests, especially since those interests (i.e. protection against a suit for bad faith) are not direct but merely "contingent." See, *Whitehead v. Lakeside Hosp. Ass'n,* 844 S.W.2d 475, 478-479 (Mo. App. W.D. 1992).

A. Claimed Benefits of Covenant Judgments Which Justify their Enforcement.

For the insured whose carrier has unfairly denied a duty to defend or who has unreasonably refused to accept the plaintiff's policy limit settlement demand, the Covenant Judgment Strategy offers significant advantages. The insured can escape from the hobbesian choice of either having to pay for its own counsel to defend the lawsuit against it with the risk of losing the case, while simultaneously suing it's insurer in coverage litigation with uncertain prospects of success; or paying an inflated amount to settle the case with the plaintiff. Instead, by entering into a covenant judgment with the plaintiff, it can avoid expensive litigation and, although it must admit to liability, it no longer has any financial risk.

Knowing that the courts will enforce a covenant judgment, the insurer has a greater incentive to agree to defend litigation, notwithstanding the likelihood that the facts may demonstrate there is no coverage under the policy; since it will be in a much stronger position to assert its rights under the contract requiring the insured to cooperate in the defense or settlement of the claim.

B. The Problem with Covenant Judgments.

While covenant judgments can be a tool to correct unfair and unreasonable behavior on the part of a small minority of carriers on an even smaller number of occasions, they also can be abused by opportunistic plaintiffs' counsel, in conjunction with claims of bad faith, to bypass the traditional checks and balances of discovery and the adversary system, to compel insurers to pay claims where liability is dubious, damages are inflated, and on occasion where there is no coverage. This is accomplished by both succeeding at enforcing covenant judgments where liability is stipulated and claimed damages are never subjected to cross-examination or opposing expert testimony, and by managing the underlying litigation in order to create a bad faith claim that will survive a motion to dismiss under the laws of the particular jurisdiction where the case is brought.

II. Two Examples of the Covenant Judgment Problem

A. State of Washington.

In *Miller v. Kenney*, 325 P. 3d 278 (Wash. App. Ct. 2014), the Court of Appeals affirmed the jury's bad faith verdict against the defendant Safeco Insurance Company and awarded the Plaintiff $13 million for compensatory and bad faith damages arising out of an automobile accident which severely injured the negligent driver and his three passengers. The award was in addition to the $1.5 million of Safeco's primary auto policy ($500,000) and umbrella policy ($1 million) that Safeco had belatedly tendered two months before trial, and a stipulated covenant judgment between Safeco's insured and the Plaintiff which Safeco had assented to in the amount

of $4.15 million. In total, Safeco was found liable for $18.65 million plus pre and post-judgment interest and attorneys fees, far in excess of its $1.5 million policy limits. The relevant background and Plaintiff's use of a covenant judgment tied to a bad faith claim is summarized as follows:

- In August 2000 Four high school friends were on a road trip when Patrick Kenney rear-ended a cement truck which resulted in a brain injury to Miller and varying degrees of injuries to the other two passengers: Casandra Peterson (the owner of the car insured by Safeco) and Ashley Bethards.
- Safeco defended Kenney without a reservation of rights. Safeco refused to provide Miller with a copy of its insurance policy and Miller filed suit in December 2001.
- Safeco disclosed its policies and Miller made a policy limits demand in July 2002. In addition to Miller's demand of $1.5 million, Cassandra Peterson demanded $350,000. Ashley Bethards demanded $1.25 million, also alleging a head injury.
- In late August 2002, Kenney's defense counsel (appointed by Safeco) demanded that Safeco tender the policy limits into the court's registry in exchange for a release and hold harmless from the three claimants. Safeco refused, saying that it did not see the combined value of the injuries as being in excess of the policy limits. Instead, Safeco tendered $500,000 to settle all claims.
- In November 2002, Kenney's defense counsel wrote to the three claimants on behalf of Kenney offering the $500,000 tendered by Safeco and an assignment of Kenny's bad faith claims against Safeco (if any) in exchange for a covenant not execute or enforce any judgment above the total policy limits. The three claimants refused.
- In March 2003 with trial, two months away, Safeco tendered the remaining limits of $1 million for a release of all claims against its insureds. The tender came too late. With trial approaching, Kenny retained personal counsel to negotiate a global settlement with the three claimants.
- In May 2003 Kenny, Miller and the other two claimants entered into a covenant judgment whereby Kenney agreed to pay $1.8 million (Safeco's $1.5 million and another $300,000 from Kenny's State Farm policy on his own vehicle) to the three claimants and to assign to Miller, Kenny' s bad faith claims against Safeco. The covenant provided that the three would not execute on any judgment which was over the total policy limits in the bad faith action which would be brought against Safeco. They further agreed that the full amount of the consent judgment would be determined by stipulation or arbitration, contingent upon a reasonableness finding by the court. (*Miller v. Kenney*, *supra* at 285).
- Safeco intervened in the underlying action when it was advised that it's insured had entered into the covenant judgment in order to participate in the reasonableness hearing on the amount of the consent judgment. A reasonableness hearing became unnecessary, however, when Safeco stipulated in May 2005 that $4.15 million was a reasonable amount for the remaining unpaid damages of the three claimants, had they pursued their claims to trial. Safeco reserved all of its defenses in the event of future bad faith litigation. (It did not anticipate, however, that the court would rule that the jury could award damages against Safeco in excess of the $4.15 million should they find Safeco to be liable for bad faith. See below.) Miller dismissed his claim against Kenney and as

Kenney's assignee he amended his Complaint to allege bad faith against Safeco, along with claims for breach of contract, consumer protection violations and negligence. Miller alleged that Safeco "had damaged Kenney by refusing to disclose the liability policy limits, thereby forcing the initiation of Miller's lawsuit against Kenney and by its subsequent actions in handling the case." *Id.*

- After the denial of Safeco's motion for summary judgment and a trip to the Appeals Court on an issue of contract interpretation, the bad faith trial against Safeco finally began in December of 2011. After a ten day trial the jury returned a plaintiff's verdict of $13 million. With pre and post judgment interest, attorneys fees and treble damages under Washington's Consumer Protection Act the total judgment was $21, 837, 286.73.

Lessons Learned from *Miller v. Kenney*

Over the years, the State of Washington has earned its reputation as being among the most, if not the most, friendly jurisdictions in the United States for a plaintiff seeking to use a covenant judgment and an assignment of bad faith rights to secure a total damage award substantially exceeding the insurer's policy limits. The use of covenant judgments in Washington by plaintiffs has become common for several reasons. Among those reasons are the following four, which were responsible in substantial part for the excess judgment rendered against Safeco.

First, is the relatively low standard applied in Washington to determine whether an insurer is acting in bad faith, and the availability of a statutory multiple damage award. Under Washington law, in a first-party action for bad faith (which is what Miller received by the assignment from Kenney of his bad faith rights) the insured is required to show that the breach of the insurer's duty of good faith and fair dealing was either ***unreasonable***, frivolous or unfounded. *St. Paul Fire and Marine Ins. Co. v. Onvia, Inc.*, 196 P. 3d 664, 668 (Wash. 2008) (emphasis supplied). In addition, an insured may bring an action under the Insurance Fair Conduct Act ("IFCA") against an insurer who has unreasonably denied a claim for coverage or payment of benefits, Wash. Admin. Code. §48.30.01, where the insured may be awarded costs, attorneys fees and treble damages. Further, the IFCA sets forth a litany of unfair claims handling and settlement practices whose violation can result in the imposition of treble damages. Finally, an insured can also bring a claim under the Washington Consumer Protection Act (Wash. Rev. Code Ann. §19.86.010).

Both Washington's common law and its statutory scheme set a low threshold for a judge or jury to find bad faith. This is illustrated in the *Kenney* case where Safeco's bad faith conduct consisted of not providing a copy of its policy to Miller when his lawyers requested it (despite the absence of any requirement that it do so), and Safeco's initial refusal to tender its policy limits because it believed the value of the plaintiffs' claims did not exceed $500,000. Notwithstanding that Safeco immediately provided Kenney with a copy of its policy after he filed suit, and that Safeco tendered its policy limits to the plaintiffs three months prior to the start of the trial, a jury was permitted to find, that Safeco's initial refusals and delay constituted bad faith.

Second, even though Washington courts have consistently held that an insured has an express duty to cooperate with its insurer in the defense of the case, (*See, e.g. Downie v. State Farm Fire & Cas. Co.*, 929 P.2d 484 (Wash. App. 1979)), and even though Safeco's primary

automobile policy contained the usual and customary "consent" and "cooperation" obligations[2], under Washington law, "[w]hen an insured defendant believes its insurer is refusing to settle a plaintiff's claims in bad faith, the insured can negotiate an independent pretrial settlement with the plaintiff." *Best Plumbing Group LLC v. Contractors Bonding Insurance Company,* 287 P.3d 551, 553 (Wash. 2012) (hereafter, "*Best Plumbing*"). It is also clear under Washington Law that an insured can enter into a consent judgment and assign his bad faith claims against his insurer to the plaintiff, even where the insurer is defending without a reservation of rights, and where it has put at risk substantial policy limits to protect the insured. *Id.* 762-763. Therefore, given the relatively low threshold for establishing bad faith, and the Washington Supreme's court explicit endorsement of plaintiff's use of covenant judgment s (*Id.* at 556), Safeco could hardly count on the trial court finding that Kenney's entering into a covenant judgment without Safeco's consent voided coverage under the policy. It is probably for that reason that there is nothing in the Court of Appeals decision that references any attempt by Safeco to defend against the covenant judgment on the basis that Kenney's breach of his obligations under the policy forfeited coverage.[3]

Third, plaintiffs and insureds in Washington, pursuant to RCW 4.22.60 ("the Statute" or "Reasonableness Statute) as well as to custom and practice, have routinely submitted their proposed covenant judgments to a "reasonableness hearing" before the Court.[4] These hearings pursuant statute, while providing protection to insurers from the most egregious fraudulent or wholly unreasonable consent judgments, in fact offer a significant benefit to plaintiffs and their counsel. The Statute provides as follows:

RCW 4.22.060

Effect of settlement agreement.

(1.) A party prior to entering into a release, covenant not to sue, covenant not to enforce judgment, or similar agreement with a claimant shall give five days' written notice of such intent to all other parties and the court. The court may for good cause authorize a shorter notice period. The notice shall contain a copy of the proposed agreement. A hearing shall be held on the issue of the reasonableness of the amount to be paid with all parties afforded an opportunity to present evidence. A determination by the court that the amount to be paid is reasonable must be secured. If an agreement was entered into prior to the filing of the action, a hearing on the issue of the reasonableness of the amount paid at the time it was entered into may be held at any time prior to final judgment upon motion of a party.

---

[2] In the typical Commercial General Liability or Commercial Auto policy the insured must: "Section IV. A. 2. b.(1) Assume no obligation, make no payment or incur no expense without our consent, except at the" insured's" own cost; and (3) Cooperate with us in the investigation or settlement of the claim or defense against the "suit." ISO Properties, Inc. 2000; Commercial Auto CA 00 01 10 01.

[3] In addition, Washington courts have held that breach by an insured of its policy obligations only precludes coverage if the insurer can show actual prejudice. *Griffin v. Allstate Ins. Co.* 108 Wn. App. 133, 140, 29 P. 3d 777 (2001). Given Kenney's assignment of his bad faith rights against his insurer, Safeco might well have been able to successfully argue prejudice.

[4] In *Best Plumbing* the Washington Supreme Court wrote that although heretofore it had not explicitly applied the Reasonableness Statute in the insurance context, it was "tak[ing] this opportunity to explicitly approve the application of RCW 4.22.060 to reasonableness hearings involving covenant judgments." Id. at 556-557.

> The burden of proof regarding the reasonableness of the settlement offer shall be on the party requesting the settlement.

The benefits which the Statute confers on plaintiffs and insureds who are looking to obtain an enforceable covenant judgment where liability may be thin, coverage uncertain and damages potentially huge are at least two. First, the Statute and the Supreme Court's application of the Statue to Covenant Judgments, make crystal clear that the Court has endorsed covenant judgments as a mechanism to protect insured defendants against insurers who independently evaluate claims lower than the plaintiffs who bring them and the insureds who worry about excess verdicts, and to cause insurers to settle dubious claims because of the fear of being saddled with a bad faith judgment far in excess of the their policy limits.

Second, the Statute itself allows plaintiff's counsel to take weeks, months or even years to prepare a damage case on behalf of his client and against the insured, and then provide "all other parties and the court" with five days written notice before an evidentiary hearing held is to determine the reasonableness of those damages – unless of course the Court for good cause authorizes a shorter period. The prejudice to the insurer in such a situation, who until being served with notice of the hearing thought it had contractual rights as well obligations to provide a defense, is obvious. The plaintiff has – or should have – all of the documents, expert testimony, and demonstrative evidence it needs to put on an effective damage case. The insurer, unless it has anticipated and acted upon the possibility of becoming a defendant in a bad faith case, may have far less information and, depending on the case management order, may not have prepared a damage case if the notice comes relatively early in the litigation. In defending the case, retained defense counsel may not have focused on damages as the first order of business in conducting discovery where liability is questionable, and the objective is to focus on the insured defendant's absence of liability in preparing a motion for summary judgment which will eliminate the need for a damage case altogether. Or, the insurer's retained counsel may have asked for detailed damage information in discovery but may been met with opposition from plaintiff's counsel.

In these ways and a variety of others, the insurer will inevitably be at a substantial disadvantage in defending a damage case – especially where it has five days or less to properly prepare. Further, in such a situation the insurer is likely to have little assistance from its defendant insured, either on the issue of damages or on the strength of the insured's liability defenses, which should obviously play a substantial part in determining the reasonable value of any settlement. Once it has entered into a covenant judgment, the insured has little or no incentive to argue against the lack of evidence of negligence, proximate causation, or to vigorously contest the amount of damages. The insured's interest, understandably, is to have the Court find the consent judgment to be reasonable so that 100% of the liability falls on the insurer.

Fourth , and the reason that *Miller v. Kenney* is so often cited: the court found that the covenant judgment of $4.15 million did not cap the damages that could be awarded by the jury if it found Safeco had committed bad faith, rather the $4.15 million was a floor. *Id.* 284 and 293-294. Safeco argued based on its interpretation of Washington law that "an insured should be put to an election. It must either prove all of its damages or it may choose to confine any bad faith

recovery to the covenant judgment settlement amount." *Id.* at 293. The *Miller* court disagreed and explained that " a covenant judgment, when found reasonable in a proceeding in equity, is the presumed measure of damage only for the insured's liability to third parties" (i.e. Ryan Miller and the other three passengers). Id. at 294. However, the damages "personal to the insured" (i.e. Patrick Kenney), are determined by a finder of fact. Consequently, because the $13 million the jury awarded was based on Kenney's bad faith claims that he had assigned to Miller, Miller was entitled to both the jury's award of $13 million, and his share of the $4.15 million covenant judgment.

If there had been no covenant judgment or bad faith action it's impossible to know whether a jury would have returned a $13 million verdict against Kenny, especially if it had been told that Miller had already received $4.15 million from an earlier agreement with Kenney, or whether the jury might have returned some lesser number based on the evidence, or even found that Kenney wasn't liable. From the plaintiff's perspective, the beauty of the covenant judgment strategy is that the plaintiff doesn't have to risk a trial on the merits with a possibly sympathetic defendant who can explain his actions and argue why he was not to blame, and why plaintiff's damages are excessive. Instead the injured plaintiff can plead his case against a large, faceless insurance company, on a claim of bad faith settlement practices. While some members of the jury may not fully grasp the concept of the defendant "assigning" his bad faith claims to the plaintiff, it is likely that everyone on the jury can be made to understand that the seriously injured plaintiff is claiming that the insurance company unreasonably refused to pay the plaintiff the amount demanded, even though it had the money within its policy to do so.

B. <u>Missouri.</u>

In Missouri, the plaintiff's task of demonstrating that the insurer has committed bad faith so as to enable the insured to enter into a covenant judgment without breaching his duty of cooperation and theregby waiving his right to coverage, has been made much easier by the Missouri legislature. Section 537.065 of the Missouri Revised Statutes specifically approves and authorizes the plaintiff and the insured in an action for bodily injury or death to enter into a covenant judgment, so that the plaintiff can bring suit against the insurer to recover the policy limits. Under Section 537.065 a plaintiff having a claim for bodily injury or death may enter into a contract whereby the plaintiff agrees that in the event of a judgment against the tort feasor, neither he "nor any person, firm or corporation claiming by or through him will levy execution, by garnishment or as otherwise provided by law, except against specific assets listed in the contract [i.e. the insurance policy] and except any insurer which insures the legal liability of the tort-feasor for such damage and which insurer is not excepted from execution, garnishment or other legal procedure by such contract." *Id.*

With the force and authority of Section 537.065, a plaintiff can enter into a consent judgment in which the insured stipulates to liability and damages, in consideration of an assignment by the insured of its bad faith claims and the typical covenant not to execute on any assets of the insured except for the insurance policy, knowing that the covenant judgment will be enforced so long as the *insurer* can prove that it is unreasonable. *Gulf Insurance Co. v. Noble Broadcast,* 936 S.W. 2d 810, 815-817 (Mo. 1997). Under the decisions of the Minnesota Appellate Courts, the covenant judgment will be enforced, not only where the insurer has denied a duty to defend or indemnity thereby leaving the insured "to fend for himself," but also where

the insurer defends under a reservation of rights and files an action for declaratory judgment to establish that there is no coverage. *Truck Ins. Exchange v. Prairie Framing, LLC, et al.,* 162 S.W.3d 64, 89 (Mo. Court of Appeals, W.D. 2005).

In *Truck Insurance Exchange*, the underlying tort case was brought by the estate of Eugene Rolf who died after his vehicle was rear-ended by a truck being driven by the defendant Robert Winger. Winger was the employee of Prairie Framing, LLC, also a named defendant, a framing subcontractor who was insured by TIE under a $1 million policy which included CGL coverage and commercial auto. Prior to the accident Winger had been drinking with his fellow employees and a supervisor, and was carrying tools for his co-workers in his personal truck at the time of the accident. The coverage issues in the case turned on whether Winger was within the scope of his employment when he struck Rolf, plaintiff's claim of *respondeat superior* liability against Prairie, and whether the policy's "Auto Exclusion" [5] applied, and whether there may have been coverage for a claim of negligent hiring, training and supervision. The relevant course of the litigation and TIE's conduct which the trial court found to be in bad faith as a matter of law, [6] are summarized as follows:

- TIE originally retained counsel and defended Prairie Framing without a reservation of rights. Approximately seven months after the litigation began, in April 2000, TIE sent a reservation of rights letter advising Prairie that "additional facts and information have been developed" which caused it to now subject its defense to a "full Reservation of rights." The letter further advised Prairie of its right to retain personal counsel who could associate with retained counsel. *Id.* 70. Prairie accepted TIE's defense under a reservation of rights.
- In August 2000, Prairie demanded that TIE settle the case against it for the policy limits.
- In November 2000, TIE filed a declaratory judgment action asking the court to confirm that it owed neither a duty to defend or indemnify.
- In mid-June 2001 Prairie's independently retained counsel, wrote a letter saying the TIE's reservation of rights letter was not acceptable, demanded that TIE admit coverage within ten days and if it did not, Prairie would defend its own interests in the matter. TIE did not immediately respond. In late June plaintiffs demanded $ 1million to settle Prairie's liability.
- In July 2001, Prairie terminated counsel retained by TIE, and again demanded that TIE settle the case by paying its policy limits.
- In early August 2001 Prairie entered into a covenant judgment agreement pursuant to Section 537.065, but without explicitly admitting liability or agreeing on the amount of any consent judgment. There followed a period in which TIE tried to negotiate an agreement whereby TIE would agree to provide coverage without reservation if Prairie would back out of its Section 537.065 agreement. Prairie refused.

---

[5] "Auto Exclusion: The policy excludes coverage of "'Bodily injury' or 'property damage' arising out of the ownership, maintenance, use or entrustment to others of any… "auto"… owned or operated by or rented or loaned to any insured." *Id.* at 81.

[6] This finding was reversed by the Court of Appeals and the bad faith claim was remanded for a trial on the factual allegations. *Id.* at 96.

- By late September 2001, no agreement had been reached and TIE pursued a motion for summary judgment in its declaratory judgment action. Prairie stipulated to liability, the plaintiff, Winger (the tort-feasor) and Prairie waived their rights to a jury trial, and the court conducted a bench trial on damages. The trial resulted in a judgment against Prairie of $4 million, $3 million in excess of TIE's policy limits.
- TIE litigated and lost its coverage issues before both the trial court and the Court of Appeals.

With regard to the Section 537.065 agreement, TIE argued that it owed no coverage because TIE had defended Prairie under a reservation of rights and properly brought a declaratory judgment action to confirm the correctness of its position that there was no coverage for the claims asserted. On the other hand, Prairie had breached its obligation to cooperate with TIE in its defense by entering into the 537.065 agreement and by stipulating to liability. The court rejected TIE's argument that it had "defended" Prairie and explained as follows:

> So as of July 2001 [one month before Prairie entered into the Section 537 agreement] the posture of the case was this: TIE was defending under a reservation of rights and actively pursuing a declaratory judgment action against Prairie Framing wherein it denied coverage of all of the claims alleged by the [plaintiffs] against Prairie Framing. Prairie Framing unequivocally rejected TIE'S continued defense under the reservation of rights and chose instead to assume responsibility for its own defense. TIE's continued pursuance of the declaratory judgment and its refusal to remove its reservation of rights at Prairie Framing's insistence ***constituted a refusal to defend***. [citing Balmer v. Balmer, 923 S.W. 2d 365, 369 (Mo. App. W.D. 1996)].
>
> *Id.* at 89. (emphasis added).

The court concluded that, "Having breached the contract, TIE 'is treated as if it waived any control of the defense of the underlying tort action. [citation omitted]," and TIE's breach also relieved Prairie from its contractual obligation not to settle, so that it was "free to go its own way, and to 'make a reasonable settlement or compromise without losing [the]right to recover on the policy.'[citing, *Cologna v. Farmers & Merchants Insurance Co.*, 785 S.W.2d 691 at 701]."

From the foregoing, it can be seen that in Missouri an insurer who wants to have its coverage defenses adjudicated without risking becoming liable for a consent judgment substantially in excess of policy limits is in a difficult spot. When even an insurer's defense under a reservation of rights can be found to be a "denial" of the duty to defend, which then allows the insured to ignore its contractual obligations, it's hard to see what else could have been done.

The one option that TIE might have pursued (in addition to all of its other efforts) was to pay its limits to settle the underlying case while preserving its right to recoup the payment from its insured if its coverage position was vindicated by the court in its declaratory judgment action. Depending on the financial health of its insured, this might not have done it much good even if had succeeded in convincing the court there was no coverage under the policy. But at least TIE would have been saved from having to pay an excess judgment.

III. Key Elements that Determine if and When Plaintiffs Will Use a Covenant Judgment

Whether a covenant judgment is likely to be used by a plaintiff and an insured to by-pass an insurer's decision to reject a policy limits demand, or otherwise circumscribe the insurer's right to control the defense, and whether it is likely to be successful, is highly dependent on the law of the jurisdiction which will control the case. Consequently, in order for an insurer to assess whether a particular claim has the potential of being settled by a covenant judgment, and if so the degree to which it might subject the insurer to extra-contractual damages , the insurer must know the applicable state law regarding the elements that determine whether a covenant judgment will turn the routine adjustment of a claim into a financial debacle. With that admonition in mind, here are the key elements that need to be researched in order to determine whether a plaintiff is likely to offer the insured defendant a covenant judgment which will get him off the financial hook; and replace him with the insurer.

A. Whether the Covenant Judgment is Enforceable.

In some states, courts have held that a covenant judgment cannot be enforced because the insured is not "legally obligated to pay" anything and because the insured has not sustained "Loss" within the terms of the insurance policy. See, e.g. *Lida Mfg. Co. v. U.S. Fire Ins. Co.*, 448 S.E. 2d 854, 856-57 (1984) ("…When an insurance policy contains language such as 'legally obligated to pay,' an insurer has no obligation to an injured party where the insured is protected by a covenant not to execute."); *Bendall v. White,* 511 F. Supp. 793,795 (N.D.Ala. 1981); and *U.S. Bank Nat'l Assoc. v. Federal Ins. Co.*, 664 F.3d 693, 696-699 (8th Cir. 2011) (Where the "policy excludes from the definition of Loss amounts 'not indemnified by the Insured Organization for which the Insured Person is absolved from payment by any agreement' the $56 million judgment is not a 'Loss' as required by the plain language of the policy").

In many other states, however, courts have found that the covenant not to execute is not a release of liability, but merely an agreement between the insured and the plaintiff; and therefore the insured's underlying tort liability remains. Consequently, the covenant judgment against the insured triggers coverage because the insured remains "legally obligated to pay." *Red Giant Oil Company v. Lawlor, et al,* 528 NW. 2d 524, 532-533 (Iowa 2011). See also, *Metcalf v. Hartford Accident and Indemnity Co.*, 126 N.W. 2D 471 (Neb. 1964), *State Farm Mut. Auto. Ins. Co. v. Paynter,* 593 P.2d 948, 953 (Ariz. Ct. App. 1979); *Safeco Ins. Co. of Am. v. Butler 823 P. 2d 499* (Wash.1992).

For obvious reasons it is critically important to an insurer in assessing the risk posed by a potential covenant judgment to know whether the covenant judgment will be enforced under the law of the applicable jurisdiction.

B. Whether it Will be Relatively Easy or Difficult for the Plaintiff to Bring a Bad Faith Claim.

As a practical matter, the plaintiff's ability to bring a bad faith claim against the insurer, with enough heft to withstand dismissal on summary judgment, is essential to the plaintiff being able to use the covenant judgment to force the insurer to pay more than the claim is worth, or to pay anything at all. Without a facially plausible bad faith claim the plaintiff and the insured will be taking a chance that the insurer may be able to convince a court in the particular jurisdiction that by entering into a consent judgment, the insured has breached his duty of cooperation and thereby excused the insurer from its duty to provide coverage under the policy. It doesn't matter

how much fear of an excess verdict a plaintiff is able to instill in the heart of the defendant. If as a result of the insured entering into a covenant judgment to protect its personal assets, it is found to have breached its obligations to the insurer , the plaintiff will get nothing. Further, since it is the insurer's alleged bad faith that permits a plaintiff to sue the insurer for damages in excess of the policy limits and recover the amount of the covenant judgment or more, a finding of no bad faith by the jury or an appellate court will mean that the most an insurer will have to pay is the policy limits. In most cases this will constitute a big loss of time and money to the plaintiff's counsel because either the policy limits will already have been paid (assuming the insurer hasn't denied coverage), or the amount of the policy limits will be minimal in comparison to the claimed damages.

Consequently, whether the bad faith law of the jurisdiction is "plaintiff friendly" or unfriendly matters a great deal. In a state like Florida, for example, "the question of whether an insurer has acted in bad faith in handling claims against the insured is determined under the 'totality of circumstances' standard." *Berges v. Infinity Insurance Co.*, 896 So. 2d 665, 680 (Fla. 2004). In practice, this means that a jury is invited to apply its own definition of what is or is not "reasonable" conduct by the insurer, with little guidance as to what constitutes objectively "reasonable" conduct.

An example of the latitude that juries have to find bad faith under the "totality of circumstances" standard is found in *Goheagan v. Am. Vehicle Ins. Co.*, 107 So. 3d 433, 439 (Fla. App. 2013). In *Goheagan* , the insurer's adjuster repeatedly attempted to contact the mother of the seriously injured driver who was hospitalized and in a coma after being struck by the insured drunk driver, in order to find out the name of her daughter's lawyer so she could tender the policy limits. Over a two month period the mother would not return the adjuster's phone calls and when she finally responded to the adjuster she refused to disclose the lawyer' s name and contact information. The adjuster then learned that suit had been filed against her insured. When she called plaintiff's counsel to tender the policy limits, she was told that she was too late and the tender was rejected. After trial on the merits a judgment of $2.8 million was entered against the insured and a bad faith action against the carrier followed. The trial court granted the insurer's motion for summary judgment because the claimant was in a coma, no guardianship had been set up prior to her death, and there was no one to whom the adjuster could tender the policy limits. Further, because the step-father had advised the adjuster that counsel had been retained, under Florida law the adjuster was prohibited from effecting a settlement directly with a claimant represented by counsel.

The Court of Appeals reversed the trial court finding there were "genuine issues of material fact which precluded summary judgment," and that "[a]ny delay in making an offer under the circumstances of this case even where there was no assurance that the claim could be settled could be viewed by a trier of fact as evidence of bad faith." *Id.* 438-439.

With such a loose standard for determining bad faith, one might think that Florida would be a good state for plaintiffs' counsel to employ a covenant judgment - and it is. In contrast, consider the bad faith standards of New York, Massachusetts and Iowa. While New York recognizes a claim for bad faith refusal by an insurer to settle a claim against it within policy limits, New York employs a gross negligence standard rather than negligence or "reasonableness." In New York, in order to prevail on a bad faith settlement claim, the insured

must prove that the insured's conduct "constituted a gross disregard of the insured's interests – that is, a deliberate or reckless failure to place on an equal footing the interests of the insured with its own interests when considering a settlement offer." *Pavia v. State Farm Mut. Auto Ins. Co*. 626 N.E.2d 24, 27-28 (N.Y. 1993). Further, although bad faith can be established in New York "where the liability is clear and the potential recovery far exceeds the insurance coverage . . . it does not follow that whenever an injury is severe and the policy limits are significantly lower than a potential recovery the insurer is obliged to accept a settlement offer." *Id.* In Massachusetts an insurer can be liable for bad faith refusal to settle but, "The test is not whether a reasonable insurer might have settled the case within policy limits, but rather whether *no reasonable insurer* would have failed to settle the case within policy limits." *Hartford Cas. Ins. Co. v. N.H. Ins. Co.* 628 N.E. 2d 14, 18 (Mass. 1994) (emphasis supplied). And in Iowa, the Supreme Court has held:

> "If the insurer has exercised good faith in its dealings with the insured and if the settlement proposal has been fully and fairly considered and decided against, based upon an honest belief that the action could be defeated or the judgment held within the policy limits, and in which respect . . . counsel have honestly expressed their conclusion, the insurer cannot be held liable [for an excess verdict] even though there is a mistake of judgment in arriving at its conclusion." *Johnson v. Am. Family Mut. Ins. Co.,* 674 N.W.2d 88, 90 (Iowa 2004).

The standard used to establish bad faith can be a useful predictor as to whether it will be more or less difficult for a plaintiff to bring a bad faith claim against an insurer as part of his covenant judgment strategy, and therefore whether the particular jurisdiction poses a greater or lesser risk that a covenant judgment can be successfully employed. In any specific case, however, it is important to examine and attempt to discern how the standard is applied by the courts of the jurisdiction to the conduct in question.

C. Whether, Under the Facts Presented, the Insured has the Right to Settle the Case Despite its Duty to Cooperate.

Courts in many jurisdictions have held that an insured has a duty to cooperate with its insurer and that when there has been a material breach of that duty, the insurer may be excused from having to provide coverage if it can show prejudice. See, e.g., *Griffin v. Allstate Ins. Co.*, 29 P. 3d 777, (Wash. 2001); *United Services Automobile Ass'n v. Morris,* 741 P. 2d 246, 254, 741 P. 2d 246, 250 (Ariz. 1987) (hereafter, "*Morris*") (Insured may not settle with claimant without breaching the cooperation clause "unless insurer first breaches one of his contractual duties."); *Elliott v. Metropolitan Cas. Ins. Co.,* 250 F.2d 680 (10th Cir. 1957); *Span Inc. v. Associated Int'l Ins. Co.*, 277 Cal. Rptr. 828 (Ct. App. 1991). There is authority specifically finding that an insured who has entered into a covenant judgment without the consent of the insurer has breached its duty of cooperation. See, *Warren v. American National Fire Insurance Co*. 826 S.W.2d 185 (Tex. Ct. App. 1992) ; *Wolff v. Royal Ins. Co.,* 472 N.W. 2d 233 (S.D. 1991).

Many other courts have found, however, that "an insured defendant may independently negotiate a pre-trial settlement. when an insurer refuses in bad faith to settle the plaintiff's claims." *Besel v. Viking Ins. Co.* 49 P. 3d 887 (Wash. 2002). See also, *Damron v. Sledge*, 460 P. 2d 997 (Ariz. 1969), *Hospital Underwriting Group, Inc. v. Summit Health Ltd.* 63 F.3d 486 (6th Cir. 1995). The Minnesota Supreme Court has found that even in the absence of bad faith, where

the insurer has provided independent counsel to defend its insured while it pursued a declaratory judgment action to determine coverage, and otherwise "never abandoned its insureds" nor "repudiated its obligations," the insureds did not breach their duty to cooperate by entering into a pre-trial covenant judgment, while the insurer was contesting coverage. *Miller v. Shugart and Millbank Mut. Ins. Co.*, 316 N.W. 2d 729, 734 (Minn. 1982). The court reasoned that while the insurer "did not abandon its insureds neither did it accept responsibility for the insureds' liability exposure;" the insureds "had a right to protect themselves against plaintiff's claim;" and that the insurer who is disputing coverage cannot "compel the insureds to forego a settlement which is in their best interests." *Id.* at 733 -734.

In sum, while there will be cases where the insured may forfeit coverage by entering into a settlement without its insurer's consent, in those cases where the insurer has reserved its rights and is contesting coverage – even in the absence of any bad faith, the court may find no breach of the insured's duty of cooperation and enforce the consent judgment.

D. Whether the Insurer Will be Able to Contest the Reasonableness of the Settlement Including the Amount and the Insured's Liability to the Plaintiff.

Virtually all courts have recognized the potential for fraud and collusion inherent in a covenant judgment and there are multiple opinions that that state in one form or another that a fraudulent or collusive judgment which imposes a settlement amount having no reasonable basis will not be enforced. *See, e.g. Continental Casualty v. Westerfield,* 961 F. Supp. 1502 (D.N.M. 1997), *Andrade v. Jennings,* 54 Cal. App. 4th 307 (1997). *See also*, *Miller v. Shugart, supra* at 734. Where fraud or egregious collusion is apparent, insurers can make their objections known, with a reasonable likelihood that the court will conduct an inquiry to see whether the objections have merit. More problematic, however, is what protection does an insurer have from a covenant judgment that is merely unreasonable? Can an insurer who, in good faith, denies coverage and a duty to defend, or defends under a reservation of rights (with or without filing a declaratory judgment action), contest the reasonableness of the covenant judgment? If so, how does the insurer make his objections known and who has the burden of proof? Could an insurer who agreed to provide a defense without a reservation of rights, still be bound by a consent judgment? The answers to these questions depend on the applicable law of the relevant jurisdiction. The following are some examples of what an insurer can expect from these jurisdictions.

Arizona. In Arizona, as well as in many other jurisdictions, an insurer who denies coverage or who denies a duty to defend will be bound by the terms of the consent judgment, and will not be able to challenge the reasonableness of the agreement . It will be limited to contesting the judgment on coverage issues or that the judgment was fraudulent or collusive. *Damron v. Sledge*, 460 P2d 997 (Ariz. 1969, 1002) ("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." *Id.*). On the other hand, under *Morris*, 741 P. 2d at 250 *supra*, when an insurer defends under a reservation of rights and the insured enters into a covenant judgment, the insurer must be given notice of the agreement so it has the opportunity to withdraw its reservation of rights, since the cooperation clause prohibition against settling without the insurer's consent forbids the insurer from settling only those claims for which the insurer unconditionally assumes liability under the policy. *Id* at 252. In addition, the insurer must be allowed to contest the

reasonableness of the settlement at a reasonableness hearing, at which the parties are required to present witnesses, testimony and documents which are subject to subpoena. *Anderson v. Martinez,* 762 P.2d 645, 650 (Ariz. App. 1988). At the hearing the plaintiff has the burden of proving reasonableness for each element of the stipulated judgment. *Himes v. Safeway Ins. Co.* 66 P.32d 74, 79-83. (Ariz. App. 2003). What the insurer will not be permitted to do, is to try the liability case which it claims it would have won. The court in *Morris* rejected the insurer's argument that it should not be bound by the consent judgment since it would have won the case on liability and would have owed nothing. But the Court agreed that "neither the fact nor amount of liability to the claimant is binding on the insurer unless the insured can show that the settlement was reasonable and prudent." *Id.* 120. Thus the insurer would be allowed to contest the liability of its insured as part of its proof that the settlement was not reasonable or prudent.

Washington. In *Truck Ins. Exch v. Vanport Homes, Inc*., 58 P.3d 276 (Wash. 2002), the Supreme Court of Washington held that an insurer who failed to defend in bad faith was estopped to deny coverage and forfeited any right to protect itself from the stipulated judgment.

California. In *Wright v. Fireman's Fund Ins. Co.*, 14 Cal. Rptr. 2d 588, 595-96 (Ct. App. 1992), the court refused to enforce a consent judgment when the insurer had defended the insured without a reservation of rights. The court held that "when an insurer provided a defense… in the underlying litigation and the insured, without the participation or consent of the insurer, stipulated to a judgment without evidentiary support and with no potential for loss, such judgment is insufficient to impose liability in a later action on the insurer." *Id.* at 1024. Courts in *Ohio, Minnesota and Texas* reached similar conclusions.

IV. Jurisdictions Where the Covenant Judgment is Most Problematic for Insurers

For the reasons summarized below, insurers should be particularly aware of the risks posed by covenant judgments in the following jurisdictions.

A. <u>State of Washington.</u>

1. Covenant Judgment is Enforceable.

2. Exceptionally friendly jurisdiction for bad faith claims, including a low threshold for finding bad faith. For first-party bad faith, insured must show that the insurer's breach of duty was "***unreasonable***, frivolous or unfounded." *St. Paul Fire and Marine Ins. Co. v. Onvia, Inc.* , *supra.* 196 P. 3d 664, 668 (Wash. 2008). For third-party bad faith, insured must show that insurer has breached its duty by "***negligently*** or in bad faith failing to settle a claim against the insured within its policy limits." *Smith v. Safeco Ins. Co.* 50 P.3d 277, 281 (Wash. Ct. App. 2002) (rev'd on other grounds by 78 P.3d 1274 (Wash. 2003).

3. Washington explicitly recognizes an insured's right to negotiate a pre-trial settlement when an insurer refuses in bad faith to settle the plaintiff's claims, regardless of whether the insurer acknowledges coverage, defends without a reservation of rights, and the insured has a duty to cooperate in the defense and settlement of the claim. *Besel v. Viking Ins. Co., supra*.

4. Both as a matter of common law and the Revised Code of Washington 4.22.60, there must be "reasonableness hearing" before the court. Because under Section 4.22.60 the hearing may be ordered on five days notice, the insurer may be prejudiced by not having sufficient time to prepare a full-dress damages case, in addition to having to contest reasonableness without the cooperation of the insured, whose only interest is to have the settlement that relieves it of all liability confirmed. In addition, the amount of damages stipulated between the insured and the plaintiff becomes the "presumptive measure of damages" in a later bad faith case against the insurer by the plaintiff who has taken an assignment of the insured's bad faith rights. Finally, in determining the total amount of damages to which the plaintiff is entitled if there is a finding of bad faith, the trier of fact may award an amount that is higher than the covenant judgment agreed to by the parties. *Bird v. Best Plumbing Group, Inc. supra*.

B. Florida.

1. Covenant judgment (or "Coblentz Agreement") is enforceable. *Steil v. Florida Physicians' Insurance Reciprocal*, 448 So.2d. 589, 591 (Fla.2d D.Ct. App.), citing *Coblentz v. American Surety Company of New York,* 416 F.2d 1059 (5th Cir. 1969).
2. Exceptionally friendly bad faith jurisdiction. Bad faith is to be determined on the "totality of circumstances" surrounding the insurers alleged bad faith conduct. *Berges v. Infinity Ins. Co., supra.*
3. The wrongful denial of a duty to defend, precludes the carrier from relying on the "no action" or "cooperation" clause of the policy. *Steil v. Florida Physicians*' at 591.
4. On the issue of reasonableness, the party seeking to enforce the covenant judgment has the burden of initially producing evidence "to make a prima facie showing or reasonableness and lack of bad faith." The ultimate burden of proof, however, will rest upon the carrier to show "the settlement is unreasonable in amount or tainted by bad faith." *Id*. 592.

C. Colorado.

1. Covenant Judgment (or "Bashor Agreement") is enforceable. *Northland v. Bashor*, 494 P.2d 1292 (Colo. 1972) (post-trial agreement following judgment against the insured); *Nunn v. Mid-Century Insurance,* 244 P.3d 116, 121-124 (Colo.2010) (pre-trial consent judgment between insured and plaintiff).
2. Moderately friendly bad faith jurisdiction. For a first-party claim there are several formulations for finding bad faith: "In addition to proving that the insurer acted unreasonably under the circumstances, a first party claimant must prove that the insurer either knowingly or recklessly disregarded the viability of the insured's claim," *Goodson v. Am. Standard Ins. Co. of Wis*., 89 P.3d 409,415 (Colo. 2004); "insurer may challenge claims that are fairly debatable and will be found to have acted in bad faith only if it has intentionally denied (or failed to process or pay) a claim without a reasonable basis," *Fincher ex.rel. Fincher v. Prudential Prop. & Cas. Ins. Co.*, 374 Fed. Appx. 833 (10th Cir. 2010). For third- party bad faith the

insurer must show that a reasonable insurer would have paid or otherwise settled the third-party claim." *Goodson, supra* at 415.

3. If an insurer refuses in bad faith to accept a policy limits demand, the insured may enter into its own settlement agreement and assign to the plaintiff it's bad faith claims against the insurer to the plaintiff. *Nunn, supra*. Further, even in the absence of bad faith, an insurer who is defending a claim under a reservation of rights can still be liable to pay a covenant judgment. Where the insured gives notice of the settlement agreement with the plaintiff after it has settled, there is a rebuttable presumption of prejudice to the insurer. If the insured meets its burden of coming forward with evidence to rebut the presumption of prejudice, including for example evidence that: (a) the insured's liability was reasonably clear; (b) the insured obtained all material information necessary to analyze the claim the claim; and (c) the settlement represented an arm's length transaction after negotiations, the settlement was reasonable, and the insurer would not have achieved a settlement that was materially better, the insurer then has the burden of proving to the trier of fact that it has been prejudiced. *Stresscon Corporation v. Travelers Prop. Cas. Co. of America, 2013 WL 4874352d, pp.* 4 - 13(Colo. App. 2013), citing *Friedland v. Travelers Indemnity Co.* 105 P. 3d 639, 643 .
4. A covenant judgment will not be binding on the insurer until after there has been "an adversarial proceeding before a neutral factfinder , providing the insurer with an opportunity to advance its defense." *Old Republic Ins. Co. v. Ross,* 180 P.3d 427, 431 (Colo. 2008).

D. <u>Missouri.</u>

1. Not only is the covenant judgment enforceable as a matter of common law, *See, e.g.* , *Truck Ins. Exchange v. Prairie Framing, LLC, et al,* 162 S.W.3d 64 (Mo. Court of Appeals, W.D. 2005), it is explicitly authorized by statute. Section 537.065 R.S. Mo. 2000.
2. Bad faith friendly jurisdiction. The cause of action for first-party bad faith is set forth in Section 375.296, R.S. Mo. 2000: "If the insurer has failed or refused for a period of thirty days after due demand therefor prior to the institution of the action, suit or proceeding, to make payment under and in accordance with the terms and provisions of the contract of insurance, and it shall appear from the evidence that the refusal was vexatious and without reasonable cause, the court or jury may, in addition to the amount due under the provisions of the contract of insurance and interest thereon, allow the plaintiff damages for vexatious refusal to pay and attorneys fees as provided in section 375.420." See also Section 375.420, R.S. Mo. 2000. To sustain a cause of action under sections 375.296 and 375.420, "the plaintiff must show that the insurer's failure to pay the loss was willful and without reasonable cause, as the facts would appear to a reasonable and prudent person before trial." *DeWitt v. Am. Family Mut. Ins. Co.* 667 S.W.2D 700, 710 (Mo. 1984). See also *Dhyne v. State Farm Fire and Cas. Co.* 188 S.W. 3d 45,457 (Mo. 2006), modified (Apr. 11, 2006). ("The existence of a litigable issue, either factual or legal , does not preclude a vexatious penalty where there is evidence the

insurer's attitude was vexatious and recalcitrant. Direct and specific evidence to show vexatious refusal is not required. The jury can base a finding of vexatious delay *upon its consideration of all the facts and circumstances in the case.*" *Id.* at 710) (emphasis supplied).

Missouri recognizes a common law bad faith cause of action for a third party claim by the insured, *and* an action by "the judgment creditor"… "upon the recovery of a final judgment against any person firm or corporation by any person… for loss or damage on account of bodily injury or death, or damage to property if the defendant in such action was insured against said loss or damage at the time the cause of action arose." Section 379.200, R.S. Mo. 2000. Thus an action can be brought either by the insured, or by the third-party plaintiff. However, "a judgment creditor has no standing to sue the liability insurer for excess monies over and above policy limits, based on the alleged bad faith of the insurer to the insured in failing to defend or settle," *Haynes v. Hawkeye Sec., Ins.* Co. 579 S.W. 2d 693,699 (Mo. Ct. App. 1979). For bad faith actions arising out of third party claims, the claimant must show that the insurer acted in bad faith , rather than negligently. *Ganaway v. Shelter Mut. Ins. Co.*, 795 S.W. 2d 554, 556 (Mo. Ct. App. 1990). See also, Johnson v. Allstate Ins. Co. 262 S.W.3d 655, 662 (Mo. Ct. App. 2009) ("An insurer's bad faith in refusing to settle is a state of mind, which is indicated by the insurer's acts and circumstances …[including] not fully investigating and evaluating a third-party claimant's injuries, not recognizing the severity of a third party's injuries and the probability that a verdict would exceed policy limits, and refusing to consider a settlement offer.")

3. Section 537.065 R.S. Mo. 2000 specifically allows an insured to enter into an agreement for a covenant judgment with the plaintiff, which provides that the plaintiff "or any persons, firm or corporation claiming by or through him," shall not "levy execution, by garnishment or as otherwise provided by law except for the specific assets listed in the contract" (i.e. the insurance policy) and "except any insurer which insures the legal liability of the tort-feasor for such damage which insurer is not excepted from execution, garnishment or other legal procedure by such contract." *Id.* The appellate courts of Missouri have interpreted the statute to mean that it applies to an insurer who denies a duty to defend, denies a duty to indemnify and even to an insurer who has agreed to defend and indemnify under a reservation of rights. Where an insurer takes any action except to admit to coverage and waive its coverage defenses, the Missouri courts have held that the insurer is deemed to have denied coverage and is liable for the consequences of that denial, including waiver of its contractual rights under the policy. *See, Whitehead v. Lakeside Hosp. Ass'n*, 844 S. W. 2d 475, 480-481 (Mo. App. W.D. 1992). ("That the refusal of the insurer to defend on the ground that the claim is outside the policy is an honest mistake, nevertheless constitutes an unjustified refusal and renders the insurer liable to the insured for all resultant damages from that breach of contract [citation omitted]. The legal consequences to the insurer from the breach of contract for unjustified refusal to

defend on the ground of non-coverage include the loss of its contractual right to demand that the insured comply with certain prohibitory as well as affirmative policy provisions.") See also, *Cologna v. Farmers & Merchants Ins. Co.*, 785 S.W. 2d 691, 700 (Mo. App. S.D. 1990).

4. Fraud and Collusion/ Reasonableness. An insurer may challenge a Section 537.065 agreement on the grounds of fraud and collusion and on lack of reasonableness. Because the statute authorizes the plaintiff to enter into a covenant judgment with the insured, however, any attack on the basis of "fraud and collusion" stands little chance of success, no matter how egregious the conduct. See, *U.S. Fidelity & Guar. Co. v. Safeco Ins. Co. of Am.* 522. S.W.2d 809, 820 (Mo. 1975). While the validity of the Section 537.065 agreement is subject to a test of reasonableness, the burden is on the insurer – not the insured who better knows the "circumstances surrounding the settlement " (See, *Steil v. Florida Physicians*, supra) - to demonstrate that it is ***unreasonable***. *Gulf Insurance Co. v. Noble Broadcast,* 936 S.W. 2d 810, 815-817 (Mo. 1997). In fashioning its test for "reasonableness" the Missouri Supreme Court borrowed the Minnesota Supreme Court's formulation: "The test is … what a reasonably prudent person in the position of the defendant would have settled for on the merits of the plaintiff's claim. [citation omitted] The determination involves a consideration of the facts bearing on the liability and damage aspects of the plaintiff's claim, as well as the risks of going to trial." Citing, *Miller v. Shugart,* 316 N.W. 2d 729, 735 (Minn. 1982).

V. How to Avoid or Lessen the Covenant Judgment Problem.

A. Make Sure Claims Handling is Reasoned and Reasonable.

The old adage of an "ounce of prevention is worth a pound of cure" is applicable to insurers who are faced every day with having to make difficult coverage decisions which, if not made correctly and with an eye to potential litigation, can lead to bad faith liability. Claims investigations need to be conducted promptly and thoroughly. The decision of whether to approve or deny a claim , or what is a reasonable settlement of a first-party or third- party claim, needs to be made with all of the information that can be obtained within a reasonable amount of time , both from the insured, the claim investigation, and where the circumstances are complex, from legal analysis of competent in-house or outside counsel. Where this is done systematically and routinely the insurer can eliminate the mistakes that will be touted, usually unfairly, as instances of bad faith conduct which can permit the insured, despite its policy obligations, to enter into a covenant judgment.

B. Know Your Jurisdiction.

In order for an insurer to know whether its insured has the ability to enter into a covenant judgment on a particular claim, and to assess the practical likelihood that it is likely to do so, the insurer must know the applicable law of the jurisdiction which will govern the adjustment of the claim. This is particularly true for the four elements that will determine whether a covenant judgment is merely a theoretical technique or a problem which will substantially increase the risk of an enforceable extra-contractual judgment. Those elements are:

1. Whether as a matter of state law the covenant judgment is enforceable;

2. The bad faith climate of the jurisdiction: whether it will be relatively easy or difficult for the insured to bring a bad faith claim in the jurisdiction;

3. Whether the insured has the right to settle the underlying case with the plaintiff, without the insurer's consent and despite its duty of cooperation;

4. Whether and how effectively will the insurer be able to contest the reasonableness of the covenant judgment, including the amount and the insured's liability to the underlying plaintiff.

C. <u>Communicate, work with and listen to your insureds.</u>

By definition, an insured enters into a covenant judgment with the plaintiff when it stops communicating with its insurer. To prevent a covenant judgment, therefore, the insurer needs to do everything possible to keep the lines of communication open and listen to its insured. If the insurer isn't communicating with its insured, the first time it's going to learn that the insured migh enter into a covenant judgment is usually just after insured has signed the agreement with the plaintiff - and by then it's too late. With some advance notice, the insurer will be able to lay out the arguments why the insured should not enter into a covenant judgment. For example: (a) the liability case against the insured is very weak and the settlement value of the case is well-within the policy limits; (b) if it should ever become necessary the insurer will settle the case for the full limits of the policy; (c) settling with the plaintiff means that the insured will have to admit to liability, something that probably isn't true and may hurt the insured's chances of getting reasonably priced insurance in the future; and (d) the insured doesn't want to breach its consent or cooperation obligations under the policy because if it does, it may have no coverage for the claims asserted against it.

D. <u>Deny there is a duty to defend the insured, only if you can defeat the ensuing bad faith claim by a motion to dismiss or judgment on the pleadings.</u>

Given the breathtaking scope of the duty to defend in virtually every jurisdiction, no insurer faced with a sizeable claim should deny an insured a defense unless it is confident that it can defeat a claim for breach of contract or bad faith denial of coverage by a motion to dismiss or motion for judgment on the pleadings. See, e.g. *Expedia, Inc. v. Steadfast Insurance Company,* 329 P.3d 59, 64-65 (Wash. 2014) ("The duty to defend arises when a complaint against the insured, construed liberally, alleges facts which could, if proven, impose liability upon the insured within the policy's coverage [citation omitted];" and "[I]f coverage is not clear from the face of the complaint but coverage could exist, the insured must investigate and give the insured the benefit of the doubt on the duty to defend. [citation omitted]; .. and [I]f the allegations in the complaint conflict with facts known to the insurer or if the allegations are ambiguous, facts outside the complaint may be considered [citation omitted;" but only to trigger the duty to defend).

The adverse consequences to an insurer who wrongfully refuses a duty to defend are significant, and will vary in severity, even when the refusal is based on an "honest mistake," ranging from losing its contractual right to demand that the insured comply with policy provisions which would preclude the insured from entering into a covenant judgment, *Whitehead v. Lakeside Hosp. Ass'n, supra* at 481, to being estopped from contesting the reasonableness of the consent judgment or from asserting coverage defenses. See, e.g. *Damron v. Sledge,* 460 P. 2d 997 (Ariz. 1969) ("[I]f 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." *Id.* at 1002). If the insurer's refusal is found to be in bad faith, it may be estopped to deny coverage and forfeit any right to protect itself from the stipulated judgment *Truck Ins. Exch v. Vanport Homes, Inc*., *supra*.

The significantly safer course will be to defend under a reservation of rights and press for a declaratory judgment on coverage as soon as possible – unless, of course, adjustment of the claim happens to be subject to Missouri law. *See*, *Truck Insurance Exchange, Inc. v. Prairie Framing, supra*. In that unfortunate situation, for the reasons discussed above, the only safe course for the insurer may be to settle the case within the policy limits and then seek recoupment from the insured after there has been a declaration of no coverage.

E. Be ready to file a DJ action to determine coverage and a motion to intervene to contest reasonableness.

Finally, especially in those jurisdictions which permit an insured to first accept and later reject the insurer's defense under a reservation of rights as the litigation develops, the insurer must be ready – if it hasn't done so already – to file a declaratory judgment action on in its coverage defenses. In extreme cases, an insurer may also need to file a motion to intervene in the underlying tort case in order to contest the reasonableness of the covenant judgment, not only with regard to the amount of damages, but also with regard to the liability of the insured, which the insured will have had to admit in order to make its deal with the plaintiff.