JUDICIAL APPROACHES TO STIPULATED JUDGMENTS, ASSIGNMENTS OF RIGHTS, AND COVENANTS NOT TO EXECUTE IN INSURANCE LITIGATION

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I. INTRODUCTION

Insurance is the business of managing risks by which an insured trades the risk of suffering a large unexpected loss for the certainty of a series of small controllable losses in the form of premium payments.[1] The relationship between provider[2] and insured is a unique one. In most instances, the interests of the provider and the insured are aligned when defending against a third-party claim.[3] Sometimes, however, because of an imbalance in the possession of information and the parties' natural self-interests, a dispute develops between the provider

1. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 1-2 (1986).

2. The term "provider" is used instead of the usual judicial selection of "insurer" when referring to an insurance company for the purpose of avoiding confusion.

3. *See* Chris Wood, Note, *Assignments of Rights and Covenants Not to Execute in Insurance Litigation*, 75 TEX. L. REV. 1373, 1374 (1997) (providing a thorough analysis of the competing interests between a plaintiff, an insured, and its provider).

and the insured concerning the terms of the insurance contract.[4] As a result, the relationship between the provider and its insured becomes adversarial. In developing a quasi-contractual[5] foundation of insurance law to resolve these disputes, courts are constantly struggling to maintain a balance between the rights of insurance providers and their insureds.[6]

One of the judiciary's latest attempts at finding an appropriate balance has been through the evaluation of a procedure whereby an insured involved in a coverage dispute with the provider may assign its claims against the provider to the third-party plaintiff in exchange for a covenant not to execute against the insured's assets.[7] This procedure[8] frees the insured from monetary liability and, in turn, allows the plaintiff to step into the shoes of the insured and bring suit against the provider for whatever claims the insured assigned to the plaintiff.[9]

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4. *See* Scott D. Gilbert, *Information Sharing Between Policyholders and Insurers: Pitfalls and Protections*, *in* LITIGATING THE COVERAGE CLAIM II: PRETRIAL PROCEDURES AND STRATEGIES FOR INSURERS, INSUREDS, AND THEIR COUNSEL 1 (Tort & Ins. Practice Section, ABA ed., 1993) (discussing the benefits and dangers of information sharing between providers and insureds).

5. Although the insurance policy is construed generally as a contract between the provider and the insured, judicial rules of construction formulated to balance the interests of the insured with those of the provider, along with the influence of regulatory agencies, have made insurance law in many ways quasi-contractual. *See infra* note 6; *see also* JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 7002 (1981) (providing a thorough discussion of the contractual nature of the insurance policy).

6. For example, the doctrine of *contra proferentum*—construing ambiguities against the drafter—and the practice of honoring the reasonable expectations of the insured are judicial constructs designed to protect the insured from the inherently adhesive nature of the insurance contract. *See* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531, 568 (1996) (advising courts to return to the traditional conception of *contra proferentum*); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 1008 (1992) (examining the justifications for special rules to interpret insurance contracts); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823, 825 (1990) (examining the development of the doctrine of reasonable expectations); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970) ("The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."). *But see* David S. Miller, Note, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849, 1857 (1988) (arguing that *contra proferentum* is improper in at least some contexts); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1475 (1989) (arguing that replacing policy language with the reasonable expectations of the insured is unwarranted).

7. See *infra* Part II and accompanying text for a more detailed discussion of the mechanics of this procedure.

8. Throughout the Note, use of the term "procedure" in this context will refer to a stipulated judgment against the insured, a covenant not to execute given by the plaintiff to the insured, and the assignment of the insured's claims against its provider to the plaintiff.

9. *See infra* Part II and accompanying text.

This Note will analyze the advantages and disadvantages of allowing these assignments of claims. Specifically, this Note will examine the various judicial responses to the use of this procedure and evaluate the methods courts adopt to ensure a balance of the interests of the provider and its insured. Part II takes a detailed look at the mechanics of this procedure and exposes various jurisdictional approaches to each element involved. Part III examines the judicial response that the use of this procedure has garnered in three jurisdictions—Texas, Iowa, and California. Part IV details the various arguments surrounding the use of this procedure and culminates in an argument that, in many cases, the use of this procedure can be a valid device by which an insured can limit or eliminate liability exposure when pressed with a provider's denial of its duty to defend and to indemnify the insured. This Note also points out, however, that where the provider has agreed to defend the insured, assignments of claims, following a stipulated judgment and a covenant not to execute, are fraught with an unjustified risk of fraud and collusion, and should be disallowed to protect the interests of providers.

II. THE PROCEDURE

Suppose you have been hired as counsel to defend a client against a claim in which your client's insurance provider has refused coverage. Your client's insurance provider may or may not agree to pay for your client's defense.[10] Your client is less than thrilled with his provider's denial of coverage, and he is worried about the prospect of paying a substantial judgment out of his pocket. What recourse does your client have to avoid this possibility? In most cases, your client would have little to lose and much to gain by executing an agreement

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10. The duty to defend an insured against a claim is recognized in most, if not all, jurisdictions to be broader than the duty to indemnify under the coverage provisions of an insurance contract. *See* Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. 822, 829 (D.N.M. 1994) ("If the allegations on the face of the complaint are 'potentially' or 'arguably' within the scope of coverage, the insurer is obligated to defend."); Allstate Ins. Co. v. Vavasour, 797 F. Supp. 785, 787 (N.D. Cal. 1992) ("The duties to defend and to indemnify are not co-extensive. The duty to defend is generally broader than the duty to indemnify; where there is any possibility of coverage, the insurer is duty-bound to defend."); Essex Ins. Co. v. Fieldhouse, Inc., 506 N.W.2d 772, 775 (Iowa 1993) (recognizing that the duty to defend is broader than the duty to indemnify); Independent Sch. Dist. No. 697 v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 576, 580 (Minn. 1994) (holding that a provider has a duty to defend if any part of the claim is "arguably" within coverage); Fitzpatrick v. American Honda Motor Co., 575 N.E.2d 90, 92 (N.Y. 1991) (finding that the duty to defend is broader than the duty to indemnify); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 759 (N.D. 1980) (stating that the obligations to defend and to indemnify are "separate and distinct" elements of the insurance contract). *See generally* Karon O. Bowdre, *"Litigation Insurance": Consequences of an Insurance Company's Wrongful Refusal to Defend*, 44 DRAKE L. REV. 743 (1996) (arguing that insureds should be compensated for wrongful refusal to defend under a contractual damages approach).

with the plaintiff involving: (1) a judgment creating liability on behalf of the insured; (2) a covenant not to execute against the insured's assets given by the plaintiff; and (3) an assignment of the insured's claims against its provider to the plaintiff.[11] Each of these components merit consideration in turn.

A. *The Judgment*

The first component in this procedure, a judgment creating liability on behalf of the insured, can be obtained in at least three ways: (1) a stipulated judgment;[12] (2) a judgment by judge or jury following a trial;[13] or (3) a settlement agreement, which may only be subject to a good-faith determination by the court.[14] The way in which the judgment creating liability was obtained may lend credibility to the result of the process.[15] For example, in most jurisdictions, stipulated judgments are subject to attack from a provider on the grounds that the

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11. *See* State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 715 (Tex. 1996).

12. For articles from opposing spectrums concerning stipulated judgments against insurance providers, see generally Michael J. Brady et al., *Demise of the Stipulated Judgment as Basis for Bad Faith Actions*, 60 DEF. COUNS. J. 59 (1993) (arguing that, under recent decisions, stipulated judgments are increasingly vulnerable to attack by providers); Steven L. Paine & Wynn Heather Sourial, *Recent Developments in California Insurance Law: Enforceability of Stipulated Judgments Against Insurance Carriers*, 22 PEPP. L. REV. 1017 (1995) (suggesting ways by which stipulated judgments can be structured so as to increase their likelihood of being enforced).

13. In at least one jurisdiction, a provider is only bound by a judgment rendered after a fully adversarial trial. In *State Farm Fire & Casualty Co. v. Gandy*, the Texas Supreme Court held that "[i]n no event . . . is a judgment for plaintiff against defendant, rendered without a fully adversarial trial, binding on defendant's [provider] or admissible as evidence of damages in an action against defendant's [provider] by plaintiff as defendant's assignee." State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 714. The court also stated that "if [a provider's] liability is to be litigated in an action by a plaintiff as a defendant's assignee after such a judgment is rendered, it should be done on the strength of plaintiff's claims rather than the generosity of defendant's concessions." *Id.* at 719; *see also infra* Part III.A.

14. *See* Tech-Bilt, Inc. v. Woodward-Clyde & Assoc., 698 P.2d 159, 166-67 (Cal. 1985) (delineating factors for courts to use in considering whether a settlement was made in good faith); *see also infra* note 109.

15. In *Pruyn v. Agricultural Insurance Co.*, a California appellate court stated:

> [I]t is settled that a default judgment hearing in which the injured party was required to present some evidence . . . would bind the [provider] that had denied coverage or refused to provide a defense. The same result flows where the settlement resulted in an uncontested trial rather than a default hearing. However, we do not believe the same can be said where the nature of the judicial participation is limited to the settlement process and simply consists of a good faith determination [under California law]. That determination, however, may well have evidentiary value in the ultimate resolution of the bona fides of the settlement; and that issue must be resolved in plaintiff's favor before she can enforce against the defendant [providers] the judgment which resulted from that settlement.

Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295, 308 (Ct. App. 1995) (citations omitted).

judgment was unreasonable, fraudulent, or collusive.[16] On the other hand, a judgment resulting from an adversarial trial by jury or judge, a default judgment rendered after the plaintiff presents her case, or an uncontested trial may lend more credibility to the judgment, or even serve to bind the provider, should coverage be determined to exist.[17]

B. *The Covenant Not to Execute*

The second component necessary to effect this procedure is a covenant not to execute on the judgment, provided by the plaintiff to the insured/defendant.[18] Practitioners must exercise care, however, when executing this device—improper selection of terms in the instrument may cause the liability on the part of the insured to be extinguished, erasing any liability on the part of the provider as well.[19] Providers have argued that a covenant not to execute against an insured means that the insured is not "legally obligated to pay,"[20] a necessary condition

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16. *See, e.g.*, Continental Cas. Co. v. Westerfield, 961 F. Supp. 1502, 1506-09 (D.N.M.) (holding a settlement agreement and stipulated judgment entered after one-sided presentation before the trial court collusive as a matter of law), *aff'd sub nom.* Continental Cas. Co. v. Hempel, 108 F.3d 274 (10th Cir. 1997). The court in *Westerfield* looked at the settlement and stipulated judgment with "heightened scrutiny" and found guidance from Stephen R. Schmidt's observations on collusion in this situation:

> 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 a material fact. Any negotiated settlement involves cooperation to a degree. It becomes collusive when the purpose is to injure the interests of an absent or nonparticipating party, such as [a provider] or nonsettling defendant. Among the indicators of bad faith and collusion are unreasonableness, misrepresentation, concealment, secretiveness, lack of serious negotiations on damages, attempts to affect the insurance coverage, profit to the insured, and attempts to harm the interests of the [provider]. They have in common unfairness to the [provider], which is probably the bottom line in cases in which collusion is found.

Id. at 1505 (quoting Stephen R. Schmidt, *The Bad Faith Setup*, 29 TORT & INS. L.J. 705, 727-28 (1994) (citation omitted)).

17. *See* Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d at 308.

18. *See* State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 715.

19. *See, e.g.*, Clock v. Larson, 564 N.W.2d 436, 436-38 (Iowa 1997). In *Clock v. Larson*, the device executed by the plaintiff limiting the personal liability of the insured provided that the plaintiff's claim be dismissed with prejudice and that the plaintiff agreed to bring no further legal action against the insured. *Id.* The court held that such an agreement operated as a full and complete release of the plaintiff's claims and "when there is a full release there is no further liability owed by the insurance company to its insured, and therefore the insured has no right to recover against the insurance company which can be assigned to the injured party." *Id.* at 437-38. Under the terms of the insurance policy, the provider was not "legally obligated to pay." *Id.*

20. Most insurance policies contain language limiting the provider's duty to indemnify to situations where the insured is "legally obligated to pay." *See, e.g.*, *infra* notes 82-84 and accompanying text.

under the terms of the insurance contract to implicate the provider's duty to indemnify the insured.[21] The majority rule is that a covenant not to execute is a contract and not a release—tort liability on behalf of the insured still exists and the provider is still obligated to indemnify its insured.[22] The rule in a minority of jurisdictions is that an "insured protected by a covenant not to execute has no compelling obligation to pay any sum to the injured party; thus, the insurance policy imposes no obligation on the [provider]."[23] The trend seems to lean overwhelmingly toward the majority rule, as most recent decisions concerning the use of this procedure do not even address the question of whether the provider is "legally obligated to pay" under the terms of its policy[24] and the

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21. *See infra* notes 22-25 and accompanying text.

22. *See* Freeman v. Schmidt Real Estate & Ins., Inc., 755 F.2d 135, 137-38 (8th Cir. 1985) (explaining the majority rule but ultimately holding the opposite); Red Giant Oil Co. v. Lawlor, 528 N.W.2d 524, 531 (Iowa 1995) (holding a covenant not to execute is not a release and a breach of contract remedy remains); *see also* Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1133 n.7 (D.C. Cir. 1989) (explaining courts have used much of the same reasoning when dealing with covenants not to execute as they do with releases); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 953 (Ariz. Ct. App. 1979) (finding a covenant not to execute is not a release from liability, and if it were to find otherwise, the court would "wholly undermine the purpose of such agreements"); Globe Indem. Co. v. Blomfield, 562 P.2d 1372, 1375 (Ariz. Ct. App. 1977) (stating a covenant not to execute is a contract, and not a release, and thus, insured would have an action for breach of contract should the other party seek a judgement); Miller v. Shugart, 316 N.W.2d 729, 732 (Minn. 1982) (holding when an insured settles directly with the plaintiff, the plaintiff may seek to collect from the provider). *Cf.* Critz v. Farmers Ins. Group, 41 Cal. Rptr. 401, 410 (Dist. Ct. App. 1964) (stating agreement holding tortfeasor harmless as to judgment in excess of tortfeasor's insurance coverage does not foreclose suit against insurer for bad-faith failure to settle). Some courts have ignored the distinction between a release and a covenant and have held that providers are legally obligated to indemnify the insured whenever an insured enters into such an agreement to protect themselves from a provider's denial of coverage and refusal to defend. *See* Metcalf v. Hartford Accident & Indem. Co., 126 N.W.2d 471, 476 (Neb. 1964); *see also* Coblentz v. American Sur. Co., 416 F.2d 1059, 1062-63 (5th Cir. 1969) (stating when a provider has notice and an opportunity to defend, any judgment against the insured is conclusive against the provider); American Family Mut. Ins. Co. v. Kivela, 408 N.E.2d 805, 812-13 (Ind. Ct. App. 1980) (finding that whether the provider appears or not, if the provider is responsible to the insured and is duly notified of the suit, any judgment is conclusive).

23. Freeman v. Schmidt Real Estate & Ins., Inc., 755 F.2d at 138 (citing Bendall v. White, 511 F. Supp. 793, 795 (N.D. Ala. 1981); Huffman v. Peerless Ins. Co., 193 S.E.2d 773, 774 (N.C. Ct. App. 1973); Stubblefield v. St. Paul Fire & Marine Ins. Co., 517 P.2d 262, 264 (Or. 1973) (en banc)) (trying to determine a question of first impression under Iowa law—*Red Giant Oil Co. v. Lawlor*, 528 N.W.2d at 531, is now controlling on this issue); *see* American Cas. Co. v. Griffith, 129 S.E.2d 549, 551-52 (Ga. Ct. App. 1963). Many of these courts were primarily concerned with the possibility of collusion between the insured and the injured plaintiff. *See, e.g.*, Freeman v. Schmidt Real Estate & Ins., Inc., 755 F.2d at 139.

24. *See, e.g.*, State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696 (Tex. 1996); Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295 (Ct. App. 1995).

minority rule has been overturned in some jurisdictions where it formerly controlled.[25]

C. *The Assignment of Claims*

The third component necessary when using this procedure is the assignment of the insured's claims against his provider to the plaintiff.[26] In *State Farm Fire & Casualty Co. v. Gandy*,[27] the Texas Supreme Court, after a lengthy discussion concerning the alienability of choses in action,[28] held that an assignment of claims against a provider is invalid if: (1) it is made prior to adjudication of the plaintiff's claim against the insured in a fully adversarial trial; (2) the provider has tendered a defense to the insured; and (3) the provider has accepted coverage or has made a good-faith effort to adjudicate coverage issues prior to the adjudication of the plaintiff's claim against its insured.[29] A few courts do not allow these assignments at all.[30] Most courts, however, allow both prejudgment and post-judgment assignments of claims.[31]

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25. *See, e.g.*, Lancaster v. Royal Ins. Co. of Am., 726 P.2d 371, 374 (Or. 1986) (distinguishing and having the practical effect of overruling *Stubblefield v. St. Paul Fire & Marine Insurance Co.*, 517 P.2d 262 (Or. 1973), which held that the covenant not to execute releasing the insured from further liability also had the effect of releasing the provider).

26. *See* State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 715.

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

28. A chose in action is defined as "a personal right not reduced into possession, but recoverable by a suit at law." BLACK'S LAW DICTIONARY 241 (6th ed. 1990).

29. State Farm & Cas. Co. v. Gandy, 925 S.W.2d at 714. The court refused to address whether such an assignment would be invalid when any of the elements were lacking, specifically noting when a provider fails to defend its insured. *Id.* at 719; *see also infra* Part III.A.

30. *See* American Cas. Co. v. Griffith, 129 S.E.2d 549, 552 (Ga. Ct. App. 1963); Huffman v. Peerless Ins. Co., 193 S.E.2d 773, 774 (N.C. Ct. App. 1973).

31. *See* United Servs. Auto. Ass'n v. Morris, 741 P.2d 246, 251 (Ariz. 1987); Samson v. Transamerica Ins. Co., 636 P.2d 32, 45 (Cal. 1981); Shook v. Allstate Ins. Co., 498 So. 2d 498, 500 (Fla. Dist. Ct. App. 1986); Bishop v. Crowther, 428 N.E.2d 1021, 1024-25 (Ill. App. Ct. 1981); American Family Mut. Ins. Co. v. Kivela, 408 N.E.2d 805, 813 (Ind. Ct. App. 1980); Red Giant Oil Co. v. Lawlor, 528 N.W.2d 524, 531-34 (Iowa 1995); Glenn v. Fleming, 799 P.2d 79, 90-91 (Kan. 1990); Miller v. Shughart, 316 N.W.2d 729, 736 n.7 (Minn. 1982); Metcalf v. Hartford Accident & Indem. Co., 126 N.W.2d 471, 476 (Neb. 1964); Griggs v. Bertram, 443 A.2d 163, 174 (N.J. 1982); Lancaster v. Royal Ins. Co. of Am., 726 P.2d at 374; Kobbeman v. Oleson, 574 N.W.2d 633, 638-39 (S.D. 1998); First Nat'l Indem. Co. v. Mercado, 511 S.W.2d 354, 358 (Tex. Civ. App. 1974); Ammerman v. Farmers Ins. Exch., 450 P.2d 460, 462 (Utah 1969); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1251 (Wash. 1987). "[S]o long as one ultimately obtains a judgment in the underlying action to establish the loss before proceeding to trial on the assigned claim, it is not crucial whether the judgment precedes or follows the assignment." Kobbeman v. Oleson, 574 N.W.2d at 639. The court in *Kobbeman* would not allow the tortfeasor, defendants' insured, to waive the statute of limitations, "which in effect extend[ed] only another's exposure to liability, invit[ing] future mischief and collusion." *Id.* at 640.

In sum, when correctly maintained, a judgment creating liability on the part of the insured, coupled with a covenant not to execute against the insured and the insured's assignment of its claims creates the procedure necessary for the plaintiff to step into the shoes of the insured and bring suit directly against the provider in most jurisdictions.[32]

III. THE RESPONSE

The various underlying claims by plaintiffs against insureds and the variety of claims assigned to plaintiffs by insureds against providers make the judicial opinions so fact specific that sweeping generalizations are difficult, if possible at all. Therefore, this Note will focus on the judicial responses to the use of this procedure in three jurisdictions which provide somewhat differing views on the topic—Texas, Iowa, and California. Generally, the Texas and Iowa Supreme Courts have fashioned competing approaches, while both leave some issues unresolved.[33] California's appellate courts, while awaiting a pronouncement from the California Supreme Court regarding the use of this procedure, appear to have decided upon a standard amongst themselves.[34]

A. *Texas*

The controlling case on the use of the procedure described in Part II in Texas is *State Farm Fire & Casualty Co. v. Gandy*.[35] A detailed look at the facts in this case is necessary to fully appreciate the considerations under which the Texas Supreme Court contemplated its regulation of the procedure.

In *Gandy*, the plaintiff, Julie Gandy, sued her mother and her former stepfather, Ted Pearce, alleging that Pearce had negligently[36] and intentionally sexually abused her and that her mother was negligent in failing to prevent the acts of sexual abuse.[37] Gandy claimed actual damages of at least $1 million and punitive damages of four times that amount.[38] Pearce took the papers served on

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32. *See supra* Part II.

33. *Compare* State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 715 (holding assignment of claims against provider invalid), *with* Red Giant Oil Co. v. Lawlor, 528 N.W.2d at 531-35 (upholding assignment of claims against provider).

34. *See* Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295, 312-14 (Ct. App. 1995).

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

36. Is it possible to *negligently* sexually abuse someone? *See* Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721, 1722 (1997) (describing the practice of "underlitigating" by plaintiffs seeking to recover under an insurance policy, which excludes coverage of intentional acts, by pursuing only causes of action founded in negligence).

37. State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 698.

38. *Id.*

him to the attorney who was also representing him in criminal charges and a divorce stemming from the same incidents.[39] Upon notification of the claims against its insured, State Farm (which provided homeowners' insurance to the Pearces) investigated the claims and concluded that while Pearce's acts might not be covered under its policy, it should nevertheless provide a defense to the Pearces under its broader duty to defend.[40] In a subsequent meeting with an agent of State Farm, Pearce absolutely denied all of the allegations.[41] In a letter sent to Pearce's attorney, State Farm further advised Pearce that it would defend him against Gandy's claims, but reserved the right to litigate coverage issues after the trial.[42] Some time later, Pearce and Gandy's mother obtained new counsel without notifying State Farm.[43]

During discovery, Gandy's attorney offered to provide Pearce with a covenant not to execute on the judgment if Pearce would assign his claims against State Farm to Gandy and stipulate to a judgment.[44] Despite State Farm's provision of defense, Pearce accepted Gandy's offer without notifying State Farm.[45] Pearce then pled nolo contendere to the criminal charges arising out of the alleged events of sexual abuse.[46] Subsequently, Pearce assigned all his claims against State Farm, including a claim for failure to defend, to Gandy in return for

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39. *Id.*

40. *Id.* In the letter reserving its right to dispute coverage while providing a defense, State Farm noted that (1) there was a question as to whether the homeowners' policy was in force on the date of the loss because the alleged acts occurred sometime between 1983 and 1988 and the policy was not initiated until September of 1997, and (2) the lawsuit contained allegations of intentional acts which would exclude coverage under the policy. *Id.* at 699. The intentional acts exclusion is a common provision in insurance policies that has spawned much litigation. *See* James A. Fischer, *The Exclusion from Insurance Coverage of Losses Caused by the Intentional Acts of the Insured: A Policy in Search of a Justification*, 30 SANTA CLARA L. REV. 95, 99 (1990); Gary L. Fontana & Anthony J. Barron, *Insurance Coverage for Intentional Acts*, 658 P.L.I./COMM. 203, 203 (1993); James L. Rigelhaupt, Jr., Annotation, *Construction and Application of Provision of Liability Insurance Policy Expressly Excluding Injuries Intended or Expected by Insured*, 31 A.L.R.4th 957, 982 (1984).

The letter reserving the rights of the provider and denying coverage is an important document that providers must exercise care when drafting and that insureds should carefully consider. *See generally* Thomas W. Johnson, Jr., *Ramifications of Failing to Include All Potential Defenses in Reservation of Rights and Denial Letters*, *in* LITIGATING THE COVERAGE CLAIM II: PRETRIAL PROCEDURES AND STRATEGIES FOR INSURERS, INSUREDS, AND THEIR COUNSEL 149, 152-53 (Tort & Ins. Practice Section, ABA ed.,1993) (describing the necessity of providing clear and thorough reservation of rights and denials of coverage).

41. State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 699.

42. *Id.*

43. *Id.* at 700.

44. *Id.*

45. *Id.*

46. *Id.*

a covenant not to execute upon the judgment.[47] The district court then signed a stipulated judgment in which damages were set at $4,062,500 in actual damages and $2 million in exemplary damages.[48] Upon learning of the judgment, State Farm contacted Pearce's attorney, asked him to move to set aside the judgment, and, after being refused, offered to continue to defend Pearce under a reservation of rights, which Pearce's counsel also refused.[49]

Pursuant to the assignment of rights, Gandy sued State Farm, not only alleging that the provider owed her more than $6 million from the judgment, but also bringing claims that State Farm had failed to defend Pearce, failed to settle, was negligent and grossly negligent, had acted in bad faith, had breached its contract with Pearce, and had violated Texas law regarding deceptive trade practices.[50] Gandy also claimed that Pearce's first attorney, as an agent of State Farm, was negligent in conducting Pearce's defense.[51]

Upon receiving summary judgment motions from both Gandy and State Farm, the district court partially granted State Farm's motion—holding that it had no duty to defend and it was not required to indemnify Pearce for the stipulated judgment against him.[52] The court also held, however, that because State Farm had agreed to defend Pearce, Gandy would be permitted to try her claim that State Farm negligently represented Pearce.[53]

Gandy's case consisted primarily of the testimonial evidence of Pearce,[54] the attorney hired by State Farm to represent Pearce,[55] and an attorney expert

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47. *Id.* at 700-02.

48. *Id.* at 703. The damages were based upon an estimated 325 occurrences of sexual abuse, where Gandy testified that her damages were $50,000 per occurrence. *Id.*

> However, Gandy's lawyer thought the total "was beyond what a court or jury in Dallas County would award" and more than could be justified to the court. So based upon his "personal evaluation" of the case, he arrived at the figure of $12,500 per occurrence, which he testified was "a fair evaluation of what the scope and extent of her injuries were."

Id.

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.* at 704.

53. *Id.*

54. *Id.* Pearce denied the allegations of abuse, testified that he had not understood he could hire the attorney of his choice, and stated that he complained several times to State Farm, to no avail, regarding his attorney's handling of his case. *Id.* State Farm denied ever receiving the calls and had no record of them. *Id.*

55. *Id.* Pearce's original attorney was initially a defendant along with State Farm and testified in his deposition that he represented Pearce in his divorce case and was qualified to represent Pearce in Gandy's lawsuit. *Id.* Right before the trial, Gandy dropped her claims against the attorney, and he testified at trial that he had *not* represented Pearce in his divorce and that he was *not* qualified to represent Pearce against Gandy's claims. *Id.*

witness.[56] The jury found that State Farm was negligent and had unknowingly violated Texas's Deceptive Trade Practices Act, and returned a verdict of $200,000 plus fifteen percent of the judgment as a reasonable attorney fee.[57] The court of appeals affirmed.[58]

Laboring under these particularly egregious facts, the Texas Supreme Court first conducted a brief examination of the alienability of choses in action,[59] and outlined the exceptions it had formulated to the general rule that choses in action are alienable.[60] The court concluded this section of its opinion by stating it had never upheld the assignment of claims in situations that tended to increase and distort litigation.[61]

With an eye toward the evils of increased and distorted litigation, the court turned to the assignment in the case before it.[62] Unsurprisingly, given the nature of the facts it was analyzing, the court found that Gandy's use of the procedure tended to both increase and distort subsequent litigation.[63] As a result of this finding, the court held Gandy's use of the procedure to be invalid.[64]

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56. *Id.* Gandy's expert testified that the negligent representation of Pearce caused an excessive judgment to be rendered against him, in an amount $4 million in excess of the value of Gandy's claims. *Id.* Contrast this with Gandy's attorney's earlier statement to the court. *See supra* note 48 and accompanying text.

57. State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 704.

58. *Id.*

59. The court noted that at early common law, choses in action were not alienable because allowing the practice would increase litigation, and because the common law regarded the right to a chose in action as personal, dependent on the identity of the particular individuals involved and their transactions or circumstances. *Id.* at 705-06 (citing James B. Ames, *The Alienability of Choses in Action*, *in* LECTURES ON LEGAL HISTORY 210, 210-11 (1913); OLIVER W. HOLMES, JR., THE COMMON LAW 340-409 (1881)). But, the court found the "[p]racticalities of the modern world have made free alienation of choses in action the general rule." *Id.* at 707.

60. *Id.* at 705-11. The inalienable choses in action discussed by the court concerned: (1) the assignment of legal malpractice claims; (2) assignments of claims pursuant to Mary Carter agreements; (3) claims in which a tortfeasor takes an assignment of a plaintiff's claim as part of a settlement agreement and then prosecutes that claim against a joint tortfeasor; and (4) the assignment of interests in an estate. *Id.* at 707-11.

61. *Id.* at 711 (citing Trevino v. Turcotte, 564 S.W.2d 682 (Tex. 1978)).

62. *Id.*

63. *Id.* at 711-13. "First, Pearce's settlement with Gandy did not end the litigation, nor could there have been any reasonable contemplation that it would. Once Gandy attempted to enforce against State Farm a $6 million agreed judgment . . . the likelihood of a negotiated end to the litigation was virtually nil." *Id.* at 711-12. The court also found that Pearce's settlement with Gandy "greatly distorted" the litigation, especially because of Gandy's attorney's extremely inconsistent arguments to the different courts involved. *Id.* at 712. "The court of appeals did not exaggerate when it called Gandy's agreed judgment against Pearce 'a sham,' or when it stated that the judgment 'perpetrates a fraud' and 'an untruth.'" *Id.* at 713.

64. *Id.* at 714.

The court was careful, however, to instruct that not every use of this procedure perpetrates the evils of increased and distorted litigation upon society.[65] Where the use of this procedure follows an adversarial trial, which eliminates the problem of objectively evaluating the plaintiff's claim, the court found that it need not worry about the possibilities of fraud or collusion by the parties.[66] The court refused to "invalidate a settlement . . . free from [the difficulty of evaluating the plaintiff's claim] simply because it is structured like one that is not."[67]

After balancing the interests of the plaintiff, the insured, and the provider, the court held an assignment invalid if:

> (1) it is made prior to an adjudication of plaintiff's claim against [the insured] in a fully adversarial trial, (2) [the insured's provider] has tendered a defense, and (3) either (a) [the insured's provider] has accepted coverage, or (b) [the insured's provider] has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim.[68]

The court explicitly refused to address situations where any of these elements were lacking, but did state that in no event would a judgment for the plaintiff, absent a fully adversarial trial against an insured, be binding on a provider or admissible as evidence of damages, in a later action by an insured's assignee.[69]

The court also specifically addressed the approaches taken by other jurisdictions that had considered the use of this procedure, including California and Iowa.[70] Among the justifications for its approach to regulating this procedure, the court found that jurisdictions upholding the prejudgment use of this procedure have based their approaches upon the belief that it is possible, absent a fully adversarial process, to determine what the result of the plaintiff's claim against the insured would have been.[71] The Texas Supreme Court did not believe it possible, and stated "[i]t is one thing to say that [an insured's] liability must be

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65. *Id.*
66. *Id.*
67. *Id.*
68. *Id.* Despite this language, Texas law did not allow a provider to seek a declaratory judgment to determine whether it had a duty to indemnify its insured before a judgment had been rendered against its insured until 1997. *See* Farmers Tex. County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 83-84 (Tex. 1997). Prior to the *Griffin* decision, which cited *Gandy* in support of this change, the Texas Supreme Court had held that a declaratory action on the duty to indemnify would be premature, and a ruling on the issue would constitute an improper advisory opinion, until after a judgment had been rendered against the insured. *See id.*; Firemen's Ins. Co. v. Burch, 442 S.W.2d 331, 333-35 (Tex. 1968).
69. State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d at 714.
70. *Id.* at 715-19.
71. *Id.* at 719.

determined as if he had not settled with the plaintiff; it is quite another thing to do it."[72]

B. *Iowa*

The Iowa Supreme Court's approach to regulating this procedure was pronounced in *Red Giant Oil Co. v. Lawlor*.[73] In *Red Giant*, Red Giant Oil Company sued Coyle, an independent contractor, for negligent welding on Red Giant's oil tanks.[74] Coyle notified his provider, LeMars Mutual, who denied coverage and refused to defend Coyle against Red Giant's suit.[75] Lawlor, one of LeMars's agents, had previously told Coyle that his policy would cover the type of damages claimed by Red Giant.[76]

Red Giant, Coyle, and another of Coyle's providers, Union Insurance, reached a settlement, whereby Coyle assigned all of his claims against LeMars and Lawlor to Red Giant.[77] In return, Red Giant obtained a judgment against Coyle in the amount of $58,351.32 (Red Giant's claim for actual damages).[78] Red Giant then brought suit against LeMars and Lawlor for breach of contract and bad faith.[79] Red Giant also claimed that Lawlor intentionally and recklessly misrepresented the extent of the insurance policy to Coyle.[80] The trial court granted LeMars's and Lawlor's motions for summary judgment.[81]

On review, the main issue presented to the Iowa Supreme Court was whether the insured was "legally obligated to pay" as was necessary for indemnification under the insurance policy.[82] The court outlined both lines of authority on this question and held that Coyle was still legally obligated to Red Giant, despite being protected by a covenant not to execute.[83] The court bolstered its

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72. *Id.* (emphasis omitted).
73. Red Giant Oil Co. v. Lawlor, 528 N.W.2d 524 (Iowa 1995).
74. *Id.* at 527.
75. *Id.*
76. *Id.*
77. *Id.* at 527-28.
78. *Id.* at 528. Coyle and Union Insurance also agreed to loan Red Giant $16,500 without interest, which would be satisfied and extinguished in the event Red Giant recovered nothing from LeMars and Lawlor. *Id.*
79. *Id.* at 527.
80. *Id.*
81. *Id.* at 526-27.
82. *Id.* at 528; *see also supra* Part II.B.
83. Red Giant Oil Co. v. Lawlor, 528 N.W.2d at 527-33. One line of authority reasons that covenants not to execute are merely contracts, and not releases, and therefore do not extinguish the underlying tort liability. *See* Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1133 n.7 (D.C. Cir. 1989); Freeman v. Schmidt Real Estate & Ins., Inc., 755 F.2d 135, 137-39 (8th Cir. 1985) (explaining this line of reasoning, but declining to follow); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 953 (Ariz. Ct. App. 1979); Miller v. Shugart, 316 N.W.2d 729, 732 (Minn.

decision by finding the term "legally obligated to pay" ambiguous and construing it in favor of the insured.[84]

Central to the court's holding was its view that "[p]rejudgment assignments—like the one here—in return for covenants not to execute are not inherently collusive or fraudulent."[85] In order to afford some protection to providers, the court required the assignee to "prove by a preponderance of the evidence that (1) the underlying claim was covered by the policy, and (2) the settlement which resulted in the judgment was reasonable and prudent."[86] In addition, the provider may raise as affirmative defenses the claims of fraud or collusion, and bear the burden of proof on these issues.[87]

Two years later, in *Six v. American Family Mutual Insurance Co.*,[88] the Iowa Supreme Court was presented with the opportunity to decide how an assignee may proceed after a jury finding that the amount of the settlement agreement was not reasonable and prudent under the test set forth in *Red Giant*—an issue it had not addressed in that decision.[89] In *Six*, the insured made use of the procedure and stipulated a judgment in the amount of $285,000 for personal injury damages sustained in a motor vehicle collision.[90]

The issue of whether the settlement was reasonable and prudent was submitted to the jury, who returned the special verdict with a "no" answer.[91] The provider argued on appeal that upon a negative finding as to the reasonableness of the settlement amount issued, its liability was extinguished.[92] The Iowa Supreme Court disagreed, holding that if the jury finds the insured was covered for the plaintiff's claim in the underlying action, the jury should determine what portion of the settlement amount was reasonable and prudent.[93]

1982). The other line of authority reasons that in situations in which the insured has no obligation to pay, neither does the provider. *See* Freeman v. Schmidt Real Estate & Ins., Inc., 755 F.2d at 138-39; Bendall v. White, 511 F. Supp. 793, 795 (N.D. Ala. 1981) (mem.); American Cas. Co. v. Griffith, 129 S.E.2d 549, 551-52 (Ga. Ct. App. 1963); Huffman v. Peerless Ins. Co., 193 S.E.2d 773, 774 (N.C. Ct. App. 1973); Stubblefield v. St. Paul Fire & Marine Ins. Co., 517 P.2d 262, 264 (Or. 1973) (in banc); *see also* Steil v. Florida Physicians' Ins. Reciprocal, 448 So. 2d 589, 592 (Fla. Dist. Ct. App. 1984) (holding the use of this procedure invalid because of the court's suspicion of collusion and fraud, but indicating that the procedure may be upheld where free from taint).

84. Red Giant Oil Co. v. Lawlor, 528 N.W.2d at 533; *see also supra* note 6.

85. Red Giant Oil Co. v. Lawlor, 528 N.W.2d at 533 (citing Damron v. Sledge, 460 P.2d 997, 999 (Ariz. 1969); Critz v. Farmers Ins. Group, 41 Cal. Rptr. 401, 409 (Ct. App. 1964)).

86. *Id.* at 535.

87. *Id.*

88. Six v. American Family Mut. Ins. Co., 558 N.W.2d 205 (Iowa 1997).

89. *Id.* at 207.

90. *Id.* at 206.

91. *Id.*

92. *Id.* at 207.

93. *Id.* "We are convinced that, if coverage exists, [a provider] that declines to defend a claim continues to be liable to hold its insured harmless for that portion of the stipulated judgment

In *Clock v. Larson*,[94] the Iowa Supreme Court was again presented with questions arising out of an insured's attempt to use this procedure.[95] In holding that the insured's position in *Clock* was different than the insured in *Red Giant*, the court focused on "two controlling factors" present in *Red Giant* and lacking in *Clock*.[96]

One factor was the nature of the relinquishment provided by the plaintiff to the insured.[97] In *Red Giant*, the plaintiff had provided the insured with a covenant not to execute, which the court construed as leaving the insured still legally obligated to pay the plaintiff's damages.[98] To the contrary, in *Clock*, the plaintiff agreed to dismiss her claim with prejudice, and not bring further suit against the insured, which operated as a full release of the plaintiff's claims against the insured.[99] Thus, the insured was no longer legally obligated to pay according to the terms of the insurance policy.[100]

The other "controlling factor" was that the provider in *Clock* had not refused to provide a defense to its insured, unlike the provider in *Red Giant*.[101] From the court's opinion, it is unclear whether the fact that the provider furnished a defense to its insured would have been sufficient to alter the holding in *Red Giant*.[102]

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that represents a reasonable and prudent settlement." *Id.* The court also stated, however, that had the language indicating Six could not recover against the provider if the stipulated damages were not reasonable and proper been submitted on a general verdict, such language would have been binding on the issue. *Id.*

94. Clock v. Larson, 564 N.W.2d 436 (Iowa 1997).

95. *Id.* at 437.

96. *Id.* at 438.

97. *Id.*

98. *Id.*; *see also supra* notes 82-84 and accompanying text.

99. Clock v. Larson, 564 N.W.2d at 437-38.

100. *Id.* at 438.

101. *Id.*

102. *Id.* The court stated: "It is not necessary for us to decide whether either of these two distinguishing factors, standing alone, would be sufficient to distance our holding here from that in *Red Giant*." *Id.* At first glance, this appears to be an odd statement by the court, because regardless of whether the provider furnished a defense to its insured or not, a plaintiff's full release of its claims against the insured would extinguish any liability on behalf of the provider. However, in a later case, the Iowa Supreme Court determined that an insured's full release of its claims against the tortfeasor did not prevent the insured from later pursuing her provider for underinsured motorist benefits for damages not covered by her settlement with the tortfeasor. *See* Waits v. United Fire & Cas. Co., 572 N.W.2d 565, 573 (Iowa 1997). The court held in *Waits* the "technical distinction between a covenant not to sue and a release has no relevancy" when interpreting the phrase "legally entitled to recover" in the provider's uninsured motorist coverage. *Id.* at 574. Perhaps the same rule would apply in the context of the procedure scrutinized in this Note.

C. *California*

In contrast to the relatively sparse judicial regulation of this procedure in Texas and Iowa, the California appellate courts have been highly active in attempting to sort out an approach to this procedure that balances the interests of the insured and its provider.[103] A recent pronouncement by the California Court of Appeals appears to have somewhat resolved many of the issues under California law, and may fairly be regarded as controlling the use of this procedure in California.[104]

In *Pruyn v. Agricultural Insurance Co.*,[105] Pruyn brought suit against a community association (RHCA) for damages to her property caused by land

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103. *See* Smith v. State Farm Mut. Auto. Ins. Co., 7 Cal. Rptr. 2d 131, 137-38 (Ct. App. 1992) (holding the stipulated judgment between the insured and the plaintiff did not bind the provider, even where the provider refused to defend its insured, absent a judgment or payment of the settlement by the insured); Wright v. Fireman's Fund Ins. Cos., 14 Cal. Rptr. 2d 588, 603-04 (Ct. App. 1992) (holding the stipulated judgment between the insured and the plaintiff did not bind the provider, where the provider furnished a defense to its insured); Xebec Dev. Partners, Ltd. v. National Union Fire Ins. Co., 15 Cal. Rptr. 2d 726, 746-49 (Ct. App. 1993) (holding a stipulated judgment obtained on the basis of an uncontested settlement proceeding in which the provider did not participate was insufficient to bind the provider); Sanchez v. Truck Ins. Exch., 26 Cal. Rptr. 2d 812, 817-19 (Ct. App. 1994) (holding a provider who has wrongly refused to defend its insured is bound by a judgment against the insured pursuant to a settlement agreement, as long as the judgment was taken in good faith and was free from fraud or collusion); Roman v. Unigard Ins. Group, 31 Cal. Rptr. 2d 501, 505 (Ct. App. 1994) (holding a provider will be bound by a stipulated judgment against its insured if a trial court found the judgment to be in good faith pursuant to California procedural rule allowing a hearing to determine if the settlement was reached in good faith); National Union Fire Ins. Co. v. Lynette, 33 Cal. Rptr. 2d 496, 497-98 (Ct. App. 1994) (holding the provider is bound by a stipulated judgment against its insured if the settlement is determined to be made in good faith pursuant to California procedure); Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295, 303 (Ct. App. 1995) (holding when a provider wrongly refused to defend its insured, the insured may negotiate a settlement, including a stipulated judgment accompanied by a covenant not to execute, and delineating a presumptive scheme allowing for enforcement of the settlement against the provider); *see also* Messersmith v. Mid-Century Ins. Co., 43 Cal. Rptr. 2d 871, 895-96 (Ct. App. 1995) (holding a stipulated judgment did not bind a provider where the plaintiff refused to accept the provider's offer of policy limits, when the court was suspicious that the plaintiff and the insured attempted to set up the provider for a bad-faith claim). The California Supreme Court denied review of *Messersmith* and ordered that the opinion not be officially published, leaving it with no precedential value. *See* Messersmith v. Mid-Century Ins. Co., 43 Cal. Rptr. 2d at 871. This case merely illustrates an extreme example from the wide range of factual scenarios the courts must respond to when scrutinizing the use of this procedure.

104. *See* Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d at 305-08. Recent cases cite *Pruyn* as the controlling authority on the use of this procedure under California law. *See, e.g.*, National Steel Corp. v. Golden Eagle Ins. Co., 121 F.3d 496, 501-02 (9th Cir. 1997) (construing California law); Andrade v. Jennings, 62 Cal. Rptr. 2d 787, 796 (Ct. App. 1997); Amato v. Mercury Cas. Co., 61 Cal. Rptr. 2d 909, 917 (Ct. App. 1997).

105. Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295 (Ct. App. 1995).

movements due to RHCA's control and maintenance of surrounding property.[106] After RHCA's provider[107] denied coverage and refused to tender a defense to its insured, RHCA settled with Pruyn in the amount of $650,000 and assigned its rights against its provider in exchange for a covenant not to execute from Pruyn.[108] Subsequently, under a California rule of civil procedure,[109] Pruyn and RHCA filed a motion to the court for a determination that the settlement was made in good faith.[110] The court granted the motion and a stipulated judgment was entered.[111] The case ended up before a California Court of Appeals after the trial judge granted the provider's motion for judgment on the pleadings when Pruyn brought suit as RHCA's assignee.[112] One of the issues presented on appeal was whether a stipulated judgment, accompanied by a covenant not to execute and an assignment of claims, could be enforced against a provider who wrongfully refused to provide a defense to its insured.[113]

The court initially stated that where a provider has furnished a defense to its insured, in fulfillment of its contractual obligations, an insured's settlement of the action without the consent of the provider would violate the standard policy language requiring the insured to cooperate with the provider throughout the defense, giving the provider a defense against the enforcement of a stipulated judgment.[114] Where the provider had wrongfully denied its insured a defense, however, the court found it necessary to look at the degree of judicial participation involved at the point the judgment is rendered against the provider.[115]

The court found that where the judgment was entered at a default hearing held after the settlement, or at an uncontested trial where the insured presented no defense after a settlement, the judgment would be binding on the provider because "significant independent adjudicatory action" mitigated the risk of fraud

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106. *Id.* at 298-99.

107. RHCA actually was insured by a number of primary and excess providers over the period covered by Pruyn's lawsuit. *Id.* at 299-300. For purposes of this discussion, the providers will be collectively referred to as one provider.

108. *Id.* at 300.

109. CAL. CIV. PROC. CODE § 877.6 (West 1999). Section 877.6 allows settling parties to file for a hearing to determine whether a settlement was made in good faith, where joint tortfeasors or co-obligors are involved. *Id.* § 877.6(a)(1). "A determination by the court that the settlement was made in good faith shall bar any other joint tortfeasor or co-obligor from any further claims against the settling tortfeasor or co-obligor for equitable comparative contribution, or partial or comparative indemnity, based on comparative negligence or comparative fault." *Id.* § 877.6(c).

110. Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d at 300.

111. *Id.* at 301.

112. *Id.*

113. *Id.*

114. *Id.* at 303.

115. *Id.* at 304-05.

or collusion between the insured and the plaintiff.[116] The court was unwilling to come to the same conclusion regarding a stipulated judgment subject only to a good-faith determination under California civil procedure.[117]

Due to the limited nature of judicial participation during the hearing where a good-faith determination is made, the court formulated an approach whereby a settlement by the abandoned insured would give rise to an evidentiary presumption as to the insured's liability and the amount of damages.[118] To rely upon the presumption, the insured must establish: (1) that the provider wrongfully refused to furnish coverage or a defense; (2) the insured entered into a settlement with the plaintiff; and (3) that settlement was reasonable and in good faith.[119] A good-faith determination under California civil procedure would be considered substantial evidence of reasonableness sufficient to satisfy the third prong of the insured's showing of entitlement to the presumption.[120]

Once the presumption lies, the burden of proof is shifted to the provider "to persuade the trier of fact, by a preponderance of the evidence, that . . . [the] settlement did not represent a reasonable resolution of plaintiff's claim or that the settlement was the product of fraud or collusion."[121] If the provider does not meet this burden of proof, the stipulated judgment will be binding.[122] The court, like the Iowa Supreme Court in *Red Giant*, did not state the result that would follow a finding that the settlement was not reasonable.[123]

IV. In Search of a Balanced Approach

A. *Comparing the Responses*

The Texas approach did not give an example of a situation where the use of the procedure would be binding on the provider. It refused to enforce an assignment given prior to trial when the provider has tendered a defense and has either accepted coverage or is seeking a declaratory judgment as to the coverage issue. This approach leaves situations where any of these elements are lacking open for future review, but will not allow providers to be bound by a settlement or judgment rendered absent a fully adversarial trial. It also precludes assignees from using the settlement or non-adversarial judgment as evidence in later actions. The Texas approach is founded upon the belief that it is never really

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116. *Id.* at 304.
117. *Id.* at 304-05, 308.
118. *Id.* at 311-12.
119. *Id.* at 312.
120. *Id.*
121. *Id.* at 314.
122. *Id.*
123. *See supra* notes 88-93 and accompanying text.

possible to know the result of the plaintiff's claim against the insured without an adversarial trial—a belief that distinguishes the Texas approach from the Iowa and California approaches.

The Iowa approach requires the assignee to bear the burden of proof that the settlement reached through the use of this procedure was reasonable and prudent by a preponderance of the evidence. It also allows the provider to raise as an affirmative defense the fact that the settlement was the product of fraud or collusion between the plaintiff and the insured. Upon a special verdict finding that the settlement was not reasonable and prudent, the assignee is entitled to that portion of the settlement that was determined to be reasonable and prudent.

California's approach distinguishes between judgments rendered under circumstances involving "significant independent adjudicatory action by the court," those in which the courts are not as involved—such as judgments following a good-faith determination hearing—and those in which the courts have yet to be involved, such as the enforcement of a settlement agreement. In the former situation, the provider will be bound by its insured's settlement without further determination of the reasonableness of the settlement. In the latter situation, the court requires the assignee to present a basic foundational showing that the settlement was reasonable and in good faith, which will then shift the burden to the provider to persuade the trier of fact that the settlement was not reasonable or was the product of fraud or collusion. In the middle situation, where an assignee has obtained a good-faith determination, that determination by itself is sufficient to satisfy the assignee's prima facie burden and justifies a shift of the burden of proof to the provider.

B. *Interests and Duties Relating to the Insurance Contract*

Insurance providers and their insureds enter into mutually beneficial contracts to serve their own interests. The provider's primary interest is to profit by accurately calculating the risk that certain events will occur and then accepting premiums from insureds to adequately cover that risk. The provider also collects some excess portion of premium, beyond what it expects to pay out to insureds for occurrences of the calculated events, to serve as a return on its investment. Naturally, then, the provider attempts to limit the amount it pays out for these occurrences by paying only for those risks it included in its calculations.

The insured's primary interest is to protect herself from the risk that an unknown event will occur, creating liability on her part, which will be greater than she can afford to pay. The insured trades the risk of suffering a large unexpected loss for the certainty of a series of small, somewhat controllable losses in the form of premium payments to the provider.

The liability insurance contract obligates each party to perform certain duties whenever a plaintiff makes a claim against an insured. The provider's

duties are generally: (1) to defend the insured against the plaintiff's claim;[124] (2) to indemnify the insured against any judgment against the insured up to the limits of the policy;[125] (3) to deal fairly and in good faith with the insured;[126] and (4) to accept a reasonable settlement offer proposed by a plaintiff in order to protect the insured from possible liability.[127] The insured's primary duties are to cooperate with the provider during the investigation, litigation, and settlement of the plaintiff's claims,[128] and not to take independent action to settle the plaintiff's claims without the consent of the provider.[129]

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124. *See* JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 4682, at 16 (1979) (explaining that the provider must "defend the insured against suits alleging facts and circumstances covered by the policy, even though such suits are groundless, false or fraudulent"). The duty to defend is broader than the duty to indemnify. *See supra* note 10 and accompanying text.

125. *See, e.g.*, Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 759 (N.D. 1980) (stating that the obligations to defend and to indemnify are "separate and distinct" elements of the insurance contract).

126. The breach of this duty leads to damages for bad faith in those jurisdictions recognizing the implied covenant of good faith and fair dealing in insurance contracts.

127. *See* APPLEMAN & APPLEMAN, *supra* note 124, § 4711, at 381.

> The [provider's] obligation [to] honestly and fairly . . . negotiate settlements, like the obligation to defend, arises out of contract, and an unwarranted refusal to accept an offered settlement that is reasonable and within the limits of the policy when there is a substantial likelihood of a verdict in excess of those limits makes the insurer liable for the entire judgment.

Id.

128. *See* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 85, at 551 (2d ed. 1996). An insured's breach of the cooperation clause may eliminate the provider's obligations under the insurance contract if the insured's conduct is sufficiently prejudicial to the provider's interests. Douglas R. Richmond, *The Two-Way Street of Insurance Good Faith: Under Construction, but Not Yet Open*, 28 LOY. U. CHI. L.J. 95, 123-24 (1996). "Cooperation clauses are intended to prevent collusion between the insured and third parties and to restrain the insured from materially prejudicing the insurer's rights. Compliance is a condition precedent to recovery." Barbara J. Williams, *Before and After the Loss: Representing a Client Whose Insurer Disclaims Coverage*, N.J. LAW., Oct.-Nov. 1995, at 17.

129. *See* Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d 295, 301 n.12 (Ct. App. 1995) (examining the language of a typical "no action" clause). The "no action" clause of the policy at issue in *Pruyn* stated:

> No action shall lie against the company unless, as a condition precedent thereto, there shall have been full compliance with all of the terms of this policy, nor until the amount of the insured's obligation to pay shall have been finally determined either by judgment against the insured after actual trial or by written agreement of the insured, the claimant and the company.

Id. The *Pruyn* court found no violation of this term by the insured for settling with the plaintiff after the provider refused a defense and denied coverage. *Id.* at 314; *see also* Brady et al., *supra* note 12, at 60-64 (discussing cases in which stipulated judgments were held unenforceable against the providers because of the insureds' breach of either the no-action or cooperation clauses).

When a plaintiff sues the insured for an occurrence which is clearly covered by the insurance contract, the interests of the insured and the provider are somewhat aligned. Both seek to avoid liability, especially where the plaintiff's expected recovery may be beyond the policy limits of the contract.[130] When a plaintiff sues the insured for an occurrence in which coverage is not clear-cut—at least to the provider—the interests of the insured and the provider become adversarial.

In these adversarial situations between the insured and the provider, each party can once again be expected to act out of self-interest. This means the provider will seek to maximize profits by not paying a claim that it believes it did not contract to cover. The insured, likewise, will seek to protect itself against this unexpected loss by limiting personal liability for the plaintiff's claim.

The provider may seek a declaratory judgment from the court, delineating the extent of the provider's liability to defend or indemnify its insured against the plaintiff's claim. The provider may also seek to provide only a defense to its insured, reserving the right to debate the coverage issue should a judgment lie in favor of the plaintiff. The insured, on the other hand, without this procedure, often has only one viable option: to sue the provider for breach of contract either before or after resolution of the underlying plaintiff's claim.

The provider is better able to withstand the many costs of denying a defense and coverage to the insured, even if the provider is found liable at the resolution of all the issues. The plaintiff's pending claim against the insured creates burdens on the insured that just do not apply to the normal provider. The insured often suffers from the fear of potential financial ruin and mounting litigation expenses, which can also cause emotional distress and other similar problems.

An approach that regulates the use of this procedure should bear in mind these facets of the problem. Insurance law is not about applying strict contractual interpretation to every situation. At the same time, the terms of the insurance contract must necessarily be abided by to promote a stable insurance market for providers and insureds, who benefit from the existence of that market. Courts regulating this procedure should attempt to balance these interests and duties for the mutual benefit of those involved in the business of insurance.

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130. Upon receiving notice of a claim against its insured, a provider may be expected to act in one of the following three ways, increasing in the level of adversity between the parties: (1) to accept coverage and provide a defense for the insured; (2) to reserve its right to litigate coverage issues or to seek declaratory action to determine the coverage issue and provide a defense for the insured; or (3) to deny coverage and refuse to provide a defense for the insured.

C. *A Balancing Act*

An adequate balance may be drawn under an approach that permits insureds to settle with a plaintiff and assign his claims against his provider to the plaintiff, in exchange for a covenant not to execute, only when the insured is truly abandoned by the provider.[131] In these situations, the provider is the one in breach of the insurance contract. The insured is justified in taking affirmative steps to limit his personal liability by using this procedure, even though the risk of fraud and collusion between the plaintiff and the insured is higher than would normally be preferred.

If the insured were to settle with the plaintiff, and assign any potential claims he might have against his provider to the plaintiff while the provider is defending the insured and seeking resolution of the coverage issue, the insured could be considered the party breaching the insurance contract. The justifications for allowing the use of this procedure in this situation simply are not strong enough to overcome the risk of fraudulent and collusive agreements.

In short, when the provider has abandoned its insured, the provider is in no position to argue against the insured's use of this procedure on the grounds that the risks of fraud and collusion are great. Allowing the use of this procedure in situations where the provider is fulfilling the terms of the contract, however, not only may be a breach of the insurance contract by the insured, but also tips the scale of "equities" in favor of the provider in light of the risk of abuse.

The main issue that arises after a court allows the use of this procedure concerns the effect of the device by which the insured becomes liable to the plaintiff—be it a settlement agreement, a stipulated judgment, a default judgment, or any other device. Does it bind the provider to the amount agreed upon by the plaintiff and the insured; does it provide a presumption of what the amount of damages should be which the provider must rebut; or does it have no effect on the determination of the amount the provider owes whatsoever?

On this issue, the Iowa approach is the most balanced. If the provider is determined to have breached its duty to indemnify its insured, the assignee must show that the figure for damages it reached was reasonable and prudent. This prevents a windfall to the assignee for unsupported damages, thereby minimizing some of the risk of fraudulent and collusive behavior between the assignee and the insured. The provider may still be liable for bad-faith damages in situations

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131. *See* Pruyn v. Agricultural Ins. Co., 42 Cal. Rptr. 2d at 303. The court explained:

> First, such a settlement would probably breach the policy's "cooperation" clause and give the insurer a defense to an action on the policy if prejudice could be shown. Second, the standard "no action" clause . . . will preclude any recovery by the insured of amounts which may have been paid to the claimants.

Id. (citations omitted).

where its breach of the duties to defend or indemnify are held to constitute a breach of the implied covenant of good faith and fair dealing. A jury may then determine on a special verdict whether the settlement amount, or any part thereof, was reasonable and prudent. This is tantamount to a trial on the issue of damages, with a little extra leeway given to the assignee in that it must only prove the amount was reasonable, and not that it was exactly the figure which would have been awarded had there been a fully adversarial trial of all the issues.

California's burden-shifting approach to this issue is more favorable to the assignee and less protective of the interests of the provider, but is similar in that it also attempts to fairly determine the damages that would arise from a fully adversarial trial of the issues. The Texas approach would require a trial on the issue of damages and is the most protective of the interests of the provider of the three approaches evaluated in this Note. All three approaches, however, are tolerable. Their differences may be explained by varying judicial confidence in the reliability of a figure generated by a particular type of agreement, and will probably not amount to a substantial difference in the size of damage awards.

V. CONCLUSION

The approaches detailed in Part III illustrate the spectrum of issues the courts address when faced with the use of this procedure under widely varying facts. Ultimately, the courts are in search of an approach which balances the interests of the abandoned insured who has wrongfully been refused coverage, with the interests of the provider being set up for an outrageous judgment by a cunning plaintiff's attorney. The problem lies in drawing a line that discriminates adequately between those two classes without removing the court's protection from either party.

By allowing the use of this procedure only in those situations where the provider has breached its duty to defend, the courts can balance the interests of insureds and providers and restrain the risk of fraudulent and collusive agreements to those situations where such a risk is tolerable due to the relative positions of the parties.

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