

What You Need to Know About Stipulated Judgments, Covenants Not to Execute, and Assignments

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From time to time plaintiffs' counsel find themselves in the position of considering whether to enter into a pretrial settlement with an insured, the terms of which might include an amount in excess of policy limits, an assignment of the insured's bad faith or other claims against the insurer to the plaintiff, and a covenant not to execute on the assets of the insured. The questions and perils presented for plaintiffs' counsel are many in structuring this type of resolution and depend primarily on how you got yourself in this position in the first place.

Generally, you are considering such a settlement because there has been some conduct on the part of the insurer alienating or abandoning the insured, such as when the insurer has refused to defend, or is denying it has a duty to indemnify. Alienation or abandonment may also arise when an insurer refuses to settle within policy limits and denies its duty to pay a potential excess verdict. Questions then arise as to the validity and binding nature of any pretrial settlement between a plaintiff and insured on the insurer, and the insurer's liability for amounts in excess of policy limits.

A. When the Insurer has Breached the Duty to Defend

An insurer's duty to defend "is independent from and broader than the duty to indemnify." *Farmers Union Mut. Ins. Co. v. Staples*, 2004 MT 108, ¶21, 321 Mont. 99, ¶21, 90 P.3d 381, ¶21. The duty to defend arises when a "complaint alleges facts, which if proven, would result in coverage." *Staples*, at ¶21. Because of the fundamental protective purpose of an insurance policy, in determining whether the duty to defend exists, an insurer "must look to the allegations of the complaint" and take all factual allegations as true, notwithstanding that the insurer may dispute the facts or that the factual allegations might subsequently be proven untrue. *Staples*, at ¶¶20-26. An insurer may properly refuse to defend by resorting to extrinsic facts, but only if the extrinsic facts unequivocally demonstrate that the claim is outside the scope of coverage, and there is no reasonable dispute the claim is not within the scope of coverage. *Staples*, at ¶¶22, 24-16. Correspondingly, when an insurer, through its duty to conduct an independent investigation, is made aware of facts triggering coverage not otherwise contained in the complaint, the duty to defend may exist. See *Troutt v. Colorado Western Ins. Co.*, 246 F.3d 1150 (9th Cir. (Mont.) 2001).

1. Unjustified Breach of the Duty to Defend

Whether an insurer risks liability for breaching the duty to defend depends on whether the breach was justified. Although the Montana Supreme Court has not specifically addressed the parameters of an unjustified breach, based on language in *Staples* a strong argument can be made that an insurer's refusal to defend is only justified when, in reviewing the complaint and the policy, "there exists an unequivocal demonstration that the claim against the insured does not fall within the insurance policies' coverage." *Staples*, at ¶ 22; *Security National v. Wink*, Cause No.

02-121-M-DWM, Order, p. 8 (D.C. Mont. 3/31/05). Even an honest mistake regarding coverage does not mean the breach was justified. *See American Law Reports, Annotated: Liability Insurer – Refusal to Defend*, 49 ALR 2nd 701. Beware of attempts on the part of insurers to infuse an element of culpability or bad faith into the determination of whether the breach was justified. This is not a question of good faith/bad faith. *Hudson v. Odyssey*, Cause No. CV-00-133-M-DWM, *Order and Findings and Recommendations of U.S. Magistrate Judge*, p. 20 (D.C. Mont. 9/20/02) (showing of bad faith not required). This is a question of whether the duty to defend was triggered by language in the complaint alleging a claim within the possible scope of coverage, and you need to keep this focus.

Thus, an insurer faced with a factual conflict between allegations contained in the complaint and otherwise known extrinsic facts may safely contest coverage only by defending under a reservation of rights and filing a declaratory judgment to resolve the dispute, and an insurer refusing to defend “does so at its own risk.” *Staples*, at ¶¶24, 26. The risks associated with an unjustified breach of the duty to defend stem from the notion that breach of the duty to defend is a breach of the insurance contract, and the insured is entitled to recover all damages naturally and ordinarily occurring as a consequence of the breach. The three primary risks include:

a. Estopped to Deny Coverage

The first penalty courts have imposed on insurers for failing to defend is that the insurer is thereby estopped from denying policy coverage. *Lee v. USA Casualty Ins. Co.*, 2004 MT 54, ¶19, 320 Mont. 174, ¶19, 86 P.3d 562, ¶19; *Grindheim v. Safeco*, 908 Fed. Supp. 794, 798 (Mont. 1995). “An unjustified failure to defend precludes the insurer from denying coverage.” *Hudson*, at p. 18. Due to the unequal bargaining power of an insurer and its insured, and the rule of law favoring providing a defense on behalf of an insured, the courts have imposed this penalty for the breach of the duty to defend beyond the mere costs of the defense. Otherwise, an insurer would be economically motivated to refuse tender of a defense in all cases if the only consequence was the cost of the defense it would have to pay in any event.

b. Insured Entitled to Compromise Claim

The second penalty courts have imposed on insurers for failing to defend is that the insured is allowed to settle the claim directly with the plaintiff without the insurer’s consent. *Staples*, at ¶27, *Independent Milk & Cream Co. v. Aetna Life Ins. Co.*, 68 Mont. 152, 157, 216 P. 1109, 1110 (1923). Ordinarily, “the insured must . . . cooperate with the insurer . . . He may not settle with the claimant without breaching the cooperation clause in the policy.” *Lozier v. Auto Owners Ins. Co.*, 951 F.2d 251, 256 (9th Cir. (Ariz.) 1991). However,

Any breach of the insurer’s duties deprives the insured of the security that he has purchased because the breach leaves him exposed to personal judgment and damage which . . . may exceed the policy limits. Accordingly, when such a breach occurs, the insured is generally held to be freed from his obligations under the cooperation clause.

Id. (quoting *USAA v. Morris*, 741 P.2d 246, 250 (Ariz. 1987)).

The same rule exists in Montana:

When an insurer declines coverage, as here, an insured may settle rather than proceed to trial to determine its liability. In order to recover the amount of a settlement from the insurer, the insured need not establish actual liability to the party with whom it has settled so long as . . . a potential liability on the facts known to the insured is shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant's success against the insured.

McCarvel v. Insurance Company of North America, Cause No. CV-89-176-GF, *Memorandum and Order*, p. 10 (D.C. Mont. 3/18/91).

Thus, so long as the amount is within “the range of reasonableness,” insureds are entitled, in good faith and without collusion, to settle the underlying claim.

c. Insurer Liable for Amounts in Excess of Policy Limits

The third penalty courts have imposed on insurers for failing to defend is to hold the insurer liable for amounts in excess of policy limits. The rule in Montana is that an insured may recover in excess of policy limits on a breach of contract claim against an insurance company. “It is clear that the parties can contract and limit the liability of the insurer; so long as the damages are being paid under the terms of the policy . . .” *Lewis v. Mid-Century Ins. Co.*, 152 Mont. 328, 335, 449 P.2d 679, 682 (1968). When the insurer breaches its contract with the insured, however, by definition, the damages are not being paid under the terms of the contract and contract language limiting damages is inapplicable:

There is an important difference between the liability of an insurer who performs its obligations and that of an insurer who breaches its contract. The policy limits restrict only the amount the insurer may have to pay in performance of the contract as compensation to a third person for personal injuries caused by the insured; they do not restrict the damages recoverable by the insured for a breach of contract by the insurer.

Id. (quoting *Comunale*, 328 P.2d at 201).

i. Protecting Reasonableness of the Settlement in Future Litigation Against Insurer

You can be almost certain that in future litigation by the plaintiff against the insurer, the insurer will argue it should not be liable in excess of policy limits and the settlement amount was unreasonable. However, on review, any such settlement or stipulated judgment is presumed reasonable and conclusive as to damages. “[W]hen an insurer refuses to defend a claim within

the policy coverage, and the insured settles, the insurer faces the burden of showing that the . . . amount of settlement was unreasonable.” *McCarvel*, at p. 10 (citing 1A Long, *The Law of Liability Insurance*, §5.22 (1990)). The insurer must “persuade 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.” *Pruyn v. Agricultural Ins. Co.*, 42 Cal. Rptr. 2d 295, 314 (Ct. App. 1995).

In *Hudson*, the insurer raised the issue of the reasonableness of the underlying default judgment entered by the state court. The federal court, sitting in diversity jurisdiction, declined to review the state court judgment under the *Rooker-Feldman* doctrine prohibiting a federal court from conducting an appellate review of state judicial proceedings. *Hudson*, at p. 22. This is an important doctrine to keep in mind as much of the litigation between the plaintiff and insurer is brought in federal court under diversity jurisdiction. However, the *Rooker-Feldman* doctrine does not generally apply when the federal court litigants were not involved in the state court action, questioning the importance of this argument for these purposes. See *Johnson v. DeGrandy*, 512 U.S. 997, 1006, 114 S.Ct. 2647, 129 L.Ed.2d 775 (1994).

In ensuring the amount of the settlement is within the range of reasonableness, the settlement amount should be made subject to review by the court. The best way to establish the reasonableness of the settlement is to request a hearing to present evidence that the settlement is within the range of reasonableness. This evidence may include lay and expert witness testimony, medical bills and records, jury verdict research, etc. Be sure to give timely notice to the insurer of the reasonableness hearing. Other jurisdictions have recognized that an insurer’s refusal to defend does not release it from its implied duty to consider the insured’s interest in any settlement, and on review in future litigation against the insurer, courts have found the insurers participation or contesting of the settlement amount relevant. See *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198, 201 (Cal. 1958); *Manekis v. St. Paul Ins. Co. of Illinois*, 655 F.2d 818, 827 (7th Cir. (Ill.) 1981). It is useful to state explicitly in the record that the purpose of the hearing is to establish the reasonableness of the settlement. This is not a guarantee the settlement will be upheld in later litigation against the insurer, but these efforts are usually persuasive.

ii. Countering Allegations the Settlement is Collusive

One suggestion for countering any argument the settlement was collusive is to make sure the insurer is well informed, by yourself and the insured’s personal counsel, if possible, that by breaching the duty to defend, or failing to defend under a reservation of rights, the insurer is unjustifiably exposing its insured to significant risk. You can outline why coverage exists and why the duty to defend has been triggered. An offer to settle within policy limits, when appropriate, sets the stage for a clear conflict of interest between the insurer and insured. Let the insurer know that, as a result of its refusal to defend, you are going to enter into settlement negotiations with the insured to protect the insured’s personal assets, etc. Put your cards on the table so the insurer is made aware of the consequences of its actions. Of course, these measures do not suggest that a plaintiff has the burden to provide the factual, legal, and policy analysis demonstrating coverage. An insurer always has the duty to conduct its own investigation,

understand the terms of its policy, understand the law, understand the facts, and make appropriate defense and coverage decisions.

There is no dispute that the fairness of the process of establishing the insured's liability and the plaintiff's damages affects the credibility of the settlement. A judgment following a trial is obviously the best way to establish liability and damages. However, when an insured is denied a defense, the time, money, and risk of trial often make a pretrial settlement the most practical option. In the latter case, care should be taken to demonstrate the reasonableness of the settlement at a reasonableness hearing. You will have wasted a lot of time, money, and credibility if a court later finds you entered into an unreasonable and/or collusive settlement.

2. Other Factors

a. Covenant Not to Execute

The granting of a covenant not to execute provides the insured with a guarantee that their personal assets will not be executed upon to satisfy the stipulated judgment. Use of covenants not to execute in conjunction with pre-verdict settlements have been approved in Montana. *Staples*, at ¶32. While insurance companies have raised various arguments against covenants not to execute, essentially all of them have been categorically rejected. For example, insurance companies have argued a covenant not to execute against an insured means the insured is not “legally obligated to pay,” a necessary condition under the terms of the insurance contract to trigger the insurer's duty to indemnify. However, 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.” Harris, Justin A., *Note: Judicial Approaches to Stipulated Judgments, Assignments of Rights, and Covenants Not to Execute in Insurance Litigation*, 47 Drake L. Rev. 853, 857-858 (1999). An alternative ground for upholding the covenant not to execute is that the policy language “legally obligated to pay” is ambiguous and is construed against the insurer. *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 533 (Iowa 1995).

b. Assignment of First-Party Claims

It is well established that a claim by an insured against his insurer for failure of the insurer to defend may be assigned to the plaintiff. *Staples*, at ¶12; *Security National v. Wink*, Cause No. 02-121-M-DWM, *Order*, p. 2 (D.C. Mont. 6/1/04).

When the insurer breaches its obligation of good faith settlement, it exposes its policyholder to the sharp thrust of personal liability. At that point, there is an acute change in the relationship between policyholder and insurer. The change does not or should not affect the policyholder's obligation to appear as defendant and to testify to the truth. He need not indulge in financial masochism, however. Whatever may be his obligation to the carrier, it does not demand that he bare his breast to the continued danger of personal liability. By executing the assignment, he attempts only to shield himself from the danger to which the company has exposed him.

Critz v. Farmers Ins. Group, 41 Cal.Rptr. 401, ___ (Dist. Ct. App. 1964).

c. Interest

Plaintiffs are entitled to both pre- and post-judgment interest on the amount of the settlement and stipulated judgment. Judge Molloy has ruled plaintiffs are entitled to recover pre-judgment interest from the date the court in the underlying action approved the reasonableness of the settlement and stipulated judgment, and that post-judgment interest would then run from the date the court entered judgment against the insurer in the declaratory judgment action until paid. *Security National, Order*, pp. 11-12 (D.C. Mont. 3/31/05).

d. Attorneys' Fee

Under the supplemental relief provision of the UDJA and rulings of the Montana Supreme Court, plaintiffs may be entitled to a reasonable attorneys' fee stemming from the declaratory judgment action against the insurer to recover on the settlement and stipulated judgment. Mont. Code Ann. §27-8-313; *Trustees of Indiana University v. Buxbaum*, 2003 MT 97, 315 Mont. 210, 69 P.3d 663.

B. When the Insurer is Present and Defending

It is an open question in Montana law whether the same procedure of obtaining a stipulated judgment, assignment of first-party claims in exchange for a covenant not to execute, and establishment of liability in excess of policy limits is permissible before a verdict has been rendered when the insurer has not breached its duty to defend, but has refused to settle within policy limits. Other jurisdictions are split depending on the whether there has been a material breach on the part of the insurer which justifies the insured entering into such a settlement.

1. Insurer is Defending and Acknowledging Coverage

a. Procedure Not Allowed

At present, a majority of jurisdictions do not sanction a pre-verdict settlement when an insurer is defending and acknowledging coverage, the essential reasoning being that the insurer should only be on the hook for the settlement in excess of policy limits when the insured is truly abandoned by the insurer. The foremost case representing this position is *Hamilton v. Maryland Cas. Co.*, 41 P.3d 128 (Cal. 2002). *Hamilton* involved a situation where the insurer agreed to defend its insured in a personal injury lawsuit, but refused a settlement demand within policy limits. The California Supreme Court held when an insurer is defending and acknowledging coverage, the insured cannot enter into any agreement prejudicing the rights of the insurer. The *Hamilton* court based its decision on the principle that a stipulated judgment entered into prior to trial is not a reliable basis to establish damages arising out of the *potential* breach, and that such a procedure takes the rug out from beneath the insurer who has agreed to go forward through trial and may, in fact, prevail. The essential rationale is that allowing this procedure when the insurer is present and defending elevates the interests of the insured above a level supported by

public policy, and allows an insured to breach their duties to the insurer when the insured has not been truly abandoned, constituting what may be labeled as an unjustified breach on the part of the insured.

b. Procedure Allowed

Jurisdictions allowing pre-verdict settlements when the insurer is defending generally only allow it when the insurer has breached a substantial duty, e.g., rejected a reasonable offer to settle within policy limits. In this situation, the insured's breach of their duties is justified because the insurer has also breached the contract by refusing a reasonable settlement. See *Weber v. Indemnity Insurance Company of North America*, 345 F.Supp.2d 1139 (D.C. Hawai'i 2004) (insured and plaintiff entered into settlement mid-trial with a "defense within limits" policy). The rationale behind these cases is that a failure to settle within policy limits is a material breach of the insurance contract, and the insurer is liable for breaching its duty to act in good faith regarding the interests of its insured. See *Great Divide Ins. Co. v. Carpenter*, 79 P.3d 599 (Alaska 2003).

In other contexts the Montana Supreme Court has articulated elements to consider in determining whether a refusal to settle within policy limits constitutes bad faith, which may be instructive in determining if the decision was justified. See *Watters v. Guaranty Nat. Ins. Co.*, 2000 MT 150, 300 Mont. 91, 3 P.3d 626; *Jessen v. O'Daniel*, 210 F.Supp. 317 (D.C. Mont. 1962). However, it is not being suggested an element of bad faith should be injected into the question of whether a pre-verdict settlement is binding on an insurer in an amount in excess of policy limits in breach of reasonable settlement duty cases, when it is not required in breach of the duty to defend cases. In this context, what will be a substantial breach by an insurer will likely be intensely fact-driven.

In a nutshell, if an insurer wishes to gamble, either on the issue of defense, coverage, or damages, it should do so with its own money. An insurer's fiduciary duty to give its insured's financial interests at least equal consideration as its own prohibits a course of action which places the insurer's financial interest above that of the insured. Thus, when the insurer is defending and acknowledging coverage, absent unusual circumstances, the best practice is perhaps to take the case through trial to establish damages. If the verdict is in excess of policy limits, one may then take the assignment of the bad faith claim in conjunction with a covenant not to execute. Otherwise, it must be closely evaluated whether the insurer was unjustified in refusing to settle within policy limits, or engaged in other conduct constituting a substantial breach of the insurance contract.

2. Insurer Defending Under a Reservation of Rights

This procedure has been allowed when an insurer is defending under a reservation of rights, but is denying that coverage exists. The essential rationale in these cases follows that of the breach of the duty to defend cases. In *McNicholes v. Subotnik*, 12 F.3d 105 (8th Cir. (Minn.) 1993), the court held that when an insurer is defending under a reservation of rights the insured is entitled to settle with the plaintiff so long as three provisions are met: (1) the settlement is reasonable and prudent; (2) the insured did not violate his duty to cooperate with the insurer, and

(3) the settlement is not a product of fraud or collusion. *McNicholes*, 12 F.3d at 107. In this type of situation, where the insurer is effectively denying coverage and has not filed a declaratory judgment action to establish coverage, it is not a breach of the duty to cooperate for the insured to enter into a settlement to protect their own assets. “While the defendant insureds have a duty to cooperate with the insurer, they also have the right to protect themselves against plaintiff’s claim.” *McNicholes*, 12 F.3d at 108 (quoting *Miller v. Shugart*, 316 N.W.2d 729, 732 (Minn. 1982)).

If you find yourself in the situation where the insurer has breached a substantial duty under the policy, you should carefully consider your options under the case law before proceeding to judgment or settlement as the case may be, in order to give your client the best possible chance in any subsequent litigation against the breaching insurer.