The Line Dividing Permissible Cooperation From Impermissible Collusion

Introduction

When a plaintiff sues a defendant for alleged wrongdoing, these two litigants are obviously enemies of one another. When the defendant has liability insurance that may help fund a settlement or adverse judgment in the dispute, a plaintiff and policyholder may also become allies, sharing common interests to resolve the dispute through funding by the insurer. These allies may properly cooperate with each other to advance their shared goals.

Ironically, insurers contractually require cooperation from their policyholders, but bridle at the prospect that the policyholder might also cooperate with a plaintiff. Insurers may raise claims of collusion by a policyholder and a plaintiff regarding both of a liability insurer's primary promises to the policyholder: 1) the promise to defend; and 2) the promise to indemnify.

"The principles of fraud and collusion are self-evident and require no extended discussion. The facts and circumstances which will lead a court to conclude that either are present are limited only by the imagination of those who would cheat and deceive."[1]

Not surprisingly, telling the truth is permissible, while lying, cheating, and stealing are not.

Definitions Of Cooperation And Collusion

The word "cooperation" derives from the Latin for "work together." "Cooperation" means "an act or instance of working or acting together for a common purpose or benefit." Young mothers urge their children to cooperate. Governments pressure warring factions to cooperate. Trial courts push parties and their lawyers to cooperate. Liability insurer contractually require their policyholders to cooperate. Plaintiffs and policyholders may also cooperate, properly.

The dictionary defines collusion as: "[A] secret understanding between two parties who plead, testify or proceed fraudulently against each other in order to defraud a third person."[2] Although collusion is often mentioned with fraud, the two claims are distinct.[3] "Collusion . . . is not necessarily tantamount to the tort of fraud in that there need not be a misrepresentation of a material fact."[4] Neither the insurer nor the policyholder may commit collusion in the name of cooperation, by an insurer and its policyholder against a plaintiff. "Of course, as stated some years ago by Judge Cardozo, a cooperation clause may not be expanded to require the assured 'to combine with the insurer to present a sham defense.'"[5] The same holds true by a plaintiff and policyholder cooperating against an insurer. "What we have here, at bottom, is an effort by [the policyholder] to concoct a bad faith claim out of whole cloth . . . by collusion between the claimants and the insured, with the 'ingenious assistance of counsel.'"[6]

Reported opinions confirm that actionable collusion is rare and the facts which support it

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[1] *Pruyn v. Agricultural Ins. Co.* (1995) 36 Cal.App.4th 500, 530 (*Pruyn*).

[2] Webster's New Universal Unabridged Dictionary.

[3] "The elements of fraud, which give rise to the tort action for deceit, are (a) misrepresentation (false representation, concealment, or nondisclosure); (b) knowledge of falsity (or 'scienter'); (c) intent to defraud, i.e., to induce reliance; (d) justifiable reliance; and (e) resulting damage." (*Lazar v. Superior Court* (1996) 12 Cal.4th 631, 638.)

[4] *Span, Inc. v. Associated Internat. Ins. Co.* (1991) 227 Cal. App. 3d 463, 484 (*Span*).

[5] *Valladao v. Fireman's Fund Indem. Co.* (1939) 13 Cal.2d 322, 329 (*Valladao*).

[6] *J.B. Aguerre, Inc. v. American Guarantee & Liab. Ins. Co.* (1997) 59 Cal.App.4th 6, 18 (*Aguerre*).

are extreme. "One court suggested an example when it stated that a 'cognizable claim of fraud or collusion would [require a showing that the third party claimant] had no substantial claim or chance of recovery and that the [insured] had permitted a judgment in [the claimant's] favor which was disproportionate to his injuries; [and that the insurer] had no notice of this in time to intervene.'"[7]

A Policyholder's Duty To Cooperate With An Insurer

"The insurer is entitled to know from its assured the true facts (of which he may have knowledge) underlying an accident and upon which the injured person bases his claim in order that it may determine for itself, in the light of such information, whether it should contest or attempt to settle the claim. . . . [T]he general rule [is] that under a cooperation clause the assured is required to give a fair and frank disclosure of information reasonably demanded by the insurer to enable it to determine whether there is a genuine defense. . . . 'The company is entitled, however, to an honest statement by the insured of the pertinent circumstances surrounding the accident, as he remembers them. Lacking that, the company is deprived of the opportunity to negotiate a settlement, or to defend upon the solid ground of fact. Nothing is more dangerous than a client who deliberately falsifies the facts.'"[8]

Coverage Defenses

There are two primary fields in which insurers may claim collusion by a plaintiff and policyholder: 1) Settlements to which plaintiff and policyholder agree, but to which the insurer does not consent; and 2) Efforts by a plaintiff and policyholder to trigger the duty to defend to change a "No" to "Maybe" or a "Maybe" to "Yes". There is a rich body of California case law specifically addressing #1, but none addressing #2.

1. Notification and Secrecy

Standard liability policies include a requirement that a policyholder notify the insure of a suit. However, there is no contractual obligation that the policyholder keep the insurer that denies coverage informed. "The 'general rule' is that an insurer is not bound by a judgment unless it had notice of the pendency of the action. However, if an insurer denies coverage to the insured, the insured's contractual obligation to notify the insurer ceases. The insured is relieved of his obligation to inform the insurance company of the service of summons or the date of trial of the action."[9]

2. Collusion Defense

Collusion is a limited defense by which even a defaulting insurer may avoid being bound by a settlement entered into by its policyholder. The collusion defense usually arises where the insurer has wrongfully failed to defend. Despite the insurer's breach, the abandoned policyholder may not settle on arbitrary terms by which procedural due process is not satisfied. The purpose of the defense is to "strike a proper balance between the competing interests of the insurer and the abandoned insured when there is a dispute as to the bona fides of a settlement made by the insured."[10] Through the collusion defense, the courts "provide to the [defaulting] insurer some measure of procedural due process in order to protect against the consequences of a fraudulent or

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[7] *Pruyn, supra* at 530, fn.27, quoting from *Zander v. Texaco, Inc.* (1968) 259 Cal.App.2d 793, 806).

[8] *Valladao, supra*, 13 Cal.2d at 329.

[9] *Samson v. Transamerica Ins. Co.* (1981) 30 Cal.3d 220, 238 (citations omitted.)

[10] *Pruyn, supra*, 36 Cal.App.4th at 527.

collusive settlement."[11]

3. Violation of Cooperation Clause

Similarly, an insurer may avoid coverage if its policyholder has violated the cooperation clause of a policy in a fashion that causes substantial prejudice by preventing the insurer from conducting a defense. "[T]he insurer is ordinarily released from its contract by the total and unjustifiable refusal of cooperation by the insured including unjustifiable refusal of the insured to permit the insurer to make any defense."[12] "[A]n insurer . . . must establish at the very least that if the cooperation clause had not been breached there was a substantial likelihood the trier of fact would have found in the insured's favor."[13]

4. Tangent Of The Two Defenses

"[T]he purpose of the cooperation clause is 'to protect the insurer's interests and to prevent collusion between the insured and the injured party.'"[14] "Collusive assistance in the procurement of a judgment . . . constitutes a breach of the cooperation clause."[15]

Collusive Settlements Undermine the System of Justice

Collusive settlements "convey no rights against the" insurer.[16] It is axiomatic that courts will not tolerate either collusion and fraud.[17] Collusion occurs when 1) an agreement 2) is steeped in secrecy 3) for an evil purpose 4) that operates to defraud an insurer and the system of justice. The courts properly abhor collusion[18] not only because it improperly takes advantage of a defaulting insurer, but also because it operates as a fraud upon the judicial system.[19] The upshot is that in one forum or another, the issues of the policyholder's liability and amount of damage will always have their day in court, whether or not the defaulting insurer is present. "[I]t will always be the insurer's option to raise an issue as to the insured's liability."[20]

In applying the collusion defense, "[c]ourts have reached differing results . . . depending upon the following two factors: (1) whether or not the insurer provided a defense to the insured and (2) the nature and extent of judicial oversight of, or participation in, the settlement process so as to give some assurance that there was no fraud and collusion in the making of the settlement."[21] An independent adjudication of the plaintiff's claim against the policyholder conducted without the participation or consent of the insurer usually yields two conclusive presumption: 1) that the policyholder is liable to the plaintiff; and 2) the amount of the plaintiff's

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[11] *Id*. at 530.

[12] *O'Morrow v. Borad* (1946) 27 Cal.2d 794, 800.

[13] *Billington v. Interinsurance Exchange* (1969) 71 Cal. 2d 728, 737-38.

[14] The Cooperation Clause and Communications between Insurers and Their Insureds (https://apps.americanbar.org/litigation/committees/insurance/docs/2011-cle-materials/14-FailureCommunicate/14bCooperationClauseCommunications.pdf)

[15] *Span, supra*, 227 Cal. App. 3d at 483.

[16] *Xebec Development Partners, Ltd. v. National Union Fire Ins. Co.* (1993) 12 Cal. App.4th 501, 551.

[17] See, *Pruyn, supra*, 36 Cal.App.4th at 530.

[18] "Bad faith litigation is not a game, where insureds are free to manufacture claims for recovery. Every judgment against an insurer potentially increases the amounts that other citizens must pay for their insurance premiums." (*Aguerre, supra* 59 Cal.App.4th at 18.)

[19] See, *Hone v. Climatrol Industries Inc.* (1976) 59 Cal.App.3d 513, 522, fn.4; *Span, supra,* 227 Cal. App. 3d at 484.

[20] *Pruyn, supra*, 36 Cal.App.4th at 521.

[21] *Id*. at 516.

damages. These two conclusions are essential to establish the insurer's obligation to pay for the outcome of litigation that the insurer should have defended, but did not. As an alternative to an independent adjudication, the parties may enter into a reasonable, non-collusive two party settlement, that usually yields a rebuttable presumption of liability and damages in a subsequent coverage fight, often subject the collusion defense.

The Role Of Procedural Due Process

The collusion defense usually arises where the insurer has wrongfully failed to defend. Despite the insurer's breach, the abandoned policyholder may not settle on arbitrary terms. "This leaves us with the question of just how we strike a proper balance between the competing interests of the insurer and the abandoned insured when there is a dispute as to the bona fides of a settlement made by the insured. How do we bring final resolution to the critical issues of whether the settlement was reasonable and free from fraud and collusion?"[22] The collusion defense supplies the procedural due process opportunity to root out collusive settlements that the justice system requires. "It is sound and rational to conclude that the burden of showing that the settlement does not reflect the fact and amount of the insured's liability should fall upon the insurer whose breach has occasioned the settlement. . . . In no other way can the courts give any meaningful protection to an insured who is abandoned by a liability insurer wrongfully denying coverage or refusing a defense and at the same time provide to the insurer some measure of procedural due process in order to protect against the consequences of a fraudulent or collusive settlement."[23]

Set-Up: Just Not Possible

The collusion defense assures that it is simply not possible to "set-up" the insurer. Plaintiffs and policyholder who have tried to set-up an insurer have consistently failed because of the collusion defense. Those who attempt to impose unrealistic deadlines or withholding vital information from the insurer usually fail to recover.

Conclusion

The circumstances in which the issue of collusion arises are actually quite limited. The defense of collusion comes up when the insurer wrongfully fails to defend, and the abandoned policyholder resolves the plaintiff's lawsuit without the insurer's participation. While standard policies include numerous provisions that confer upon a performing insurer the exclusive right to settle, such provisions are often unenforceable when the insurer wrongfully fails to defend.

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[22] *Id.* at 527.

[23] *Id.* at 530.