Collusion - A Limited Defense

Introduction

Collusion is much misunderstood. The courts know collusion when they see it,[1] but have difficulty defining it[2] and difficulty consistently applying its precepts.[3] Some liability insurers and their appointed dependent counsel are often overly fond of accusing plaintiffs and policyholders of collusion whenever a plaintiff and a policyholder cooperate contrary to the interests of the insurer or dependent counsel. Some plaintiffs, policyholders, and their counsel are easily intimidated by such accusations, ceasing to properly cooperate just to stop groundless accusations. Avoiding collusion is simple. Treat the insurer fairly, even if the insurer has wrongfully denied coverage.

A well developed body of California law describes the contours of the concept of collusion as it applies to liability insurance. The incidence of insurer concern for collusion is directly related to the insurer's denial of coverage. The insurer's coverage position generally fall into three categories: 1) "Yes": conceding full coverage; 2) "No": denying all coverage and a duty to defend; and 3) "Maybe": agreeing to defend under a reservation of rights to later deny indemnity coverage, and perhaps reserving rights to seek reimbursement from the policyholder for costs of defense[4] and settlement.[5]

"Yes": May Concede Full Coverage

An insurer that concedes coverage and agrees to both defend and indemnify its policyholder has the contractual right to control the policyholder's defense[6] and to control settlement.[7] Therefore, if an insurer is providing a defense to its policyholder, the insurer is not obligated to pay for a settlement negotiated by a plaintiff and policyholder to which the insurer does not consent.[8] When the insurer concedes coverage, no disqualifying conflicts of interest usually emerge to cleave the policyholder from the insurer or its lawyers.[9] Thus, the collusion defense almost never comes up when the insurer concedes coverage for the simple reason that even a reasonable, non-collusive settlement between the plaintiff and policyholder cannot be enforced against an insurer which defends its policyholder. "[W]here an insurer provide[s] a defense to its insured in the underlying litigation, and the insured, without the participation or consent of the insurer, stipulate[s] to a judgment without evidentiary support and with no potential for personal loss, such judgment is insufficient to impose liability on the insurer."[10]

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

[2] See, *Elusive Definition of Collusion* at DutytoDefend.com.

[3] See, *Compendium of Collusion Cases* at DutytoDefend.com.

[4] See, *Buss Costs of Defense Reimbursement* at DutytoDefend.com,

[5] See, *Blue Ridge Costs of Settlement Reimbursement* at DutytoDefend.com,

[6] See, *Control of the Defense* at DutytoDefend.com.

[7] See, *Control of Settlement* at DutytoDefend.com.

[8] Typical CGL language is: "No insured will, except at the insured's own cost, voluntarily make any payment, assume any obligation, or incur any expense . . . without out consent."

[9] However, see *How to Make a Policy Limit Settlement Offer Properly* at DutytoDefend.com.

[10] *Wright v. Fireman's Fund Ins. Companies* (1992) 11 Cal. App.4th 998, 1024.

"Maybe": Defends Under a Reservation of Rights

When an insurer agrees to defend under a reservation of rights[11] to later deny coverage and perhaps to sue its policyholder to recover reimbursement of defense costs[12] and settlement costs,[13] the insurer usually retains the contractual right to control settlement.[14] However, a reservation of rights almost always creates some conflicts of interest among the policyholder, the insurer and the insurer's lawyers. These conflicts of interest may create an incentive for plaintiffs, policyholders and their counsel to cooperate to achieve goals which they share, even though the insurer and its lawyers oppose such cooperation.[15] Plaintiffs may properly plead into coverage.[16] Policyholders and plaintiffs may truthfully testify into coverage.[17] While an insurer which defends under a reservation of rights retains control over settlement, it may lose the right to control the defense if its reservation of rights creates a disqualifying conflict of interest.[18]

Still, a plaintiff and a policyholder cannot enforce a reasonable, non-collusive settlement against an insurer which challenges coverage, but is faithfully providing a defense. As a result, the collusion defense almost never arises when the insurer agrees to defend under a reservation of rights.

"No": Denies All Coverage

An insurer that denies all coverage, refusing to provide a defense, may not enforce its contractual right to control settlement. "[I]f the insurer wrongfully refuses to defend, leaving the insured to his own resources to provide a defense, then the insurer forfeits the right to control settlement and defense. In that event, the insured is free to settle the lawsuit on his own, and the insurer is bound by a stipulated judgment."[19] "An insurer that breaches the duty to defend a legal action forfeits the right to assert any control over the defense or settlement of the action."[20]

When the insurer's refusal to defend is wrongful,[21] the plaintiff and the policyholder may agree to adjudicate or settle their dispute without the participation or consent of the insurer. However, the insurer may not be bound if the policyholder failed to assert a good defense.[22] The law respects the reasonable, non-collusive resolution of litigation even when achieved in the absence of an insurer that has wrongfully refused to participate.[23] The collusion defense usually arises in this context. "The denial of liability on the part of the insuring company and its refusal

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[11] See, *Reservation of Rights* at DutytoDefend.com.

[12] See, *Buss v. Superior Court* (1997) 16 Cal.4th 35.

[13] See, *Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489.

[14] Typical CGL language is: "We will have the right and duty to defend the insured against any 'suit'."

[15] See, *Policyholder's Duty to Cooperate* at DutytoDefend.com.

[16] See, *Plead Into Coverage Properly* at DutytoDefend.com.

[17] See, *Testify Into Coverage Truthfully* at DutytoDefend.com.

[18] See, *Disqualifying Conflicts of Interest* at DutytoDefend.com.

[19] *Safeco Ins. Co. v. Superior Court* (1999) 71 Cal.App.4th 782, 787.

[20] Restatement of Liability Insurance, § 19.

[21] See, *Duty to Defend: Step by Step Analysis* at DutytoDefend.com.

[22] "A stipulation that a judgment against the person indemnified shall be conclusive upon the person indemnifying, is inapplicable if he had a good defense upon the merits, which by want of ordinary care he failed to establish in the action." (Civ. Code § 2778(7).)

[23] "[W]hen . . . a liability insurer wrongfully denies coverage or refuses to provide a defense, then the insured is free to negotiate the best possible settlement consistent with his or her interests, including a stipulated judgment accompanied by a covenant not to execute." (*Pruyn, supra*, 36 Cal.App.4th at 509.)

to defend the suits constituted such a breach of the contract that the insured was released from his obligation to leave the management thereof to it, and was justified in proceeding to defend on his own account. . . . The law is well settled that, where one is bound either by law or agreement to protect another from liability, he is bound by the result of a litigation to which such other is a party, provided he had notice of the suit and an opportunity to control and manage it. The judgment is conclusive evidence that the insured was liable, and to the extent of the amount of the judgment. On the other hand, where there is no trial and no judgment establishing the liability of the insured, but a settlement of the litigation has been made, the settlement, or a judgment rendered upon a stipulation of such a settlement, becomes presumptive evidence only of the liability of the insured and the amount thereof, which presumption is subject to being overcome by proof on the part of the insurer."[24]

Collusion Undermines the System of Justice

Collusive settlements "convey no rights against the" insurer.[25] It is axiomatic that courts will not tolerate either collusion and fraud.[26] 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[27] not only because it improperly takes advantage of a defaulting insurer, but also because it operates as a fraud upon the judicial system.[28] 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."[29]

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."[30] 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 damages.[31] These two conclusions are essential to establish the insurer's obligation to pay for the

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[24] *Lamb v. Belt Casualty Co.* (1935) 3 Cal. App. 2d 624, 630-632 (citations and ellipses omitted.)

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

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

[27] "What we have here, at bottom, is an effort by Aguerre to concoct a bad faith claim out of whole cloth. . . . 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." (*J.B. Aguerre, Inc. v. American Guarantee & Liability Ins. Co.* (1997) 59 Cal.App.4th 6, 18.)

[28] "Collusion has been variously defined as . . . 'a secret arrangement between two or more persons, whose interests are apparently conflicting, to make use of the forms and proceedings of law in order to defraud a third person, or to obtain that which justice would not give them, *by deceiving a court or its officers*' (*Hone v. Climatrol Industries, Inc.* (1976) 59 Cal.App.3d 513, 522, fn. 4.)" (*Span, Inc. v. Associated Internat. Ins. Co.* (1991) 227 Cal. App. 3d 463, 484 (emphasis added).)

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

[30] *Id*. at 516.

[31] See, *Favorable Evidentiary Presumptions from Settlement* at DutytoDefend.com.

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.

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?"[32] 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."[33]

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.[34]

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 usually unenforceable when the insurer wrongfully fails to defend. As a rule, the defaulting insurer is then bound by the outcome. In a subsequent coverage fight, the policyholder has either a conclusive or rebuttable presumption of liability and damage.[35]

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

[33] *Id*. at 530.

[34] See, *Compendium of Cases - Collusion* at DutytoDefend.com.

[35] See, *Favorable Evidentiary Presumptions from Settlement* at DutytoDefend.com.