CONSENT JUDGMENTS: ARIZONA COURTS REFUSE TO RUBBER STAMP STIPULATED JUDGMENT AMOUNTS

I. INTRODUCTION

Over the past ten years there has been a dramatic increase in the number of stipulated judgments or "consent judgments" arising from insurance claims. Consent judgments typically arise in a situation where a liability insurer allegedly fails to either settle a claim or defend its insured. This allows the insured to proceed to settle a claim with the third party in exchange for the third party agreeing not to execute upon the settlement. Arizona public policy requires that all stipulated judgments bear a reasonable relationship to the damages incurred by the injured claimant in order to prevent unfair awards resulting from passion or prejudice rather than reason and justice. When courts enter judgments, they are required to engage in an adjudicatory process in order to validate the reasonableness of any judgment entered by the parties. However, courts have continuously struggled with this process in the wake of Arizona Supreme Court decisions, *Damron v. Sledge*, 105 Ariz. 151, 152, 460 P.2d 997, 998 (1969) and *USAA v. Morris*, 154 Ariz. 113, 117, 741 P.2d 246, 250 (1987) (commonly referred to as "Damron" and "Morris" Agreements.) These decisions bring with it much confusion regarding the parameters of their application, particularly in the context of construction defect cases.

Today, the Arizona debate continues to surround the issue of whether any stipulated judgment—regardless of its reasonableness—binds an insurer as a consequence of its failure to defend. A third Arizona Supreme Court decision, *Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme*, 153 Ariz. 129, 735 P.2d 451 (1987), seems to signal the progression of insurance law, allowing for an insured to enter into a reasonable consent judgment with the claimant when the insurer breaches any policy duty. Although public policy supports this approach, the Arizona Court of Appeals cautions in *Leflet v. Redwood Fire & Cas. Ins. Co.*, 226 Ariz. 297, 299, 247 P.3d 180, 182 (Ct. App. 2011) that *Morris* agreements are fraught with risk of abuse and any settlement will be unenforceable absent any legal and economic support. It is therefore essential that insurers be weary of what is transpiring in potential lawsuits and remain prepared to take the necessary steps to cut-off any attempts by the insured and opposing parties to create an optimal consent judgment climate.

GENERAL LEGAL PRINCIPLES ARISING IN CONSENT SETTLEMENTS

The following represents some of the basic legal principles applicable to consent judgments in Arizona.

A. Insured's Duty to Cooperate

Arizona has consistently upheld the cooperation clause and found that an insured does have a duty to cooperate with its insurer. The duty to cooperate requires that the insured aid the insurer in its defense. "He may not settle with the claimant without breaching the cooperation clause unless the insurer first breaches one of its contractual duties." *USAA v. Morris*, 154 Ariz. 113, 117, 741 P.2d 246, 250 (1987). As long as the insurer meets its contractual obligations, the duty to cooperate remains in force and any settlement by the insured constitutes a breach of the policy. *Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme*, 153 Ariz. 129, 735 P.2d 451 (1987).

B. *Damron* and *Morris* Agreements

There are two main types of consent agreements in Arizona; *Damron* agreements and *Morris* agreements. A *Damron* agreement arises when the insurer refuses to defend the insured in a claim that may or may not fall under policy coverage. *Damron v. Sledge*, 105 Ariz. 151, 152, 460 P.2d 997, 998 (1969). When plaintiff and the insured enter into this agreement, the insurer may not contest the reasonableness of the agreement and is limited to contesting the judgment on coverage issues or on the basis that the judgment was collusive or fraudulent. *Id.* at 155, 1002. The court stated that "if the [insurer] refuses to defend at all, it must accept the risk that an unduly large verdict may result from lack of cross-examination and rebuttal." *Id*.

Damron agreements can also arise in circumstances where the insurer chooses to defend and does not reserve any rights. *State Farm Mut. Auto Ins. Co. v. Peaton*, 168 Ariz. 184, 812 P.2d 1002 (Ct. App. 1990). The court in *Peaton* ruled that insurers owe their insureds three duties, the duty to indemnify; the duty to defend; and the duty to treat settlement proposals with equal consideration, and that the breach of any of these duties generally frees the insured from his obligations under the cooperation clause. *Id.* at 193, 1011. Therefore, if an insurer defended its insured with no reservations, the insured could still enter into a *Damron* agreement if the insurer failed to treat settlement proposals with equal consideration. Factors to be considered by the trier of fact in determining whether the insurer failed to meet this duty include:

> (1) the strength of the injured claimant's case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to a settlement; (3) failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; (4) the insurer's rejection of advice of its own attorney or agent; (5) failure of the insurer to inform the insured of a compromise offer; (6) the amount of financial risk to which each party is exposed in the event of a refusal to settle; (7) the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts;

> and (8) any other factors tending to establish or negate bad faith on the part of the insurer.

Clearwater v. State Farm Mut. Auto. Ins. Co., 164 Ariz. 256, 259, 792 P.2d 719, 722 (1990).

Morris agreements arise when the insurer defends its insured under reservation of rights. *Morris, supra*. The court in *Morris* dealt with two main issues: 1) whether this type of agreement violated the insured's duty to cooperate, and 2) whether the insurer was bound by the settlement. *Id.* at 117, 250. The court ruled that "the cooperation clause prohibition against settling without the insurer's consent forbids an insured from settling only claims for which the insurer unconditionally assumes liability under the policy." *Id.* at 119, 252. The insured is not prohibited from entering into these settlements when the insurer defends under a reservation of rights but the insurer must be given notice of the agreement so it has the opportunity to withdraw its reservation of rights. *Id.* Finally, the court found that the settlement will only bind an insurer if the plaintiff can show that the amount of the settlement was reasonable and that it was neither fraudulent nor collusive. *Id*. at 121, 254.

C. Reasonableness Hearing

When parties enter into a *Morris* agreement, an insurance carrier must be allowed to contest the reasonableness of the settlement between the plaintiff and its insured. *Anderson v. Martinez*, 158 Ariz. 358, 363, 762, P.2d 645, 650 (Ct. App. 1988); *Monterey Homes Arizona, Inc. v. Federated Mut. Ins. Co.*, 221 Ariz. 351, 358, 212 P.3d 43, 50 (Ct. App. 2009). In this type of reasonableness hearing, the finder of fact is charged with determining the following issues: 1) the reasonableness of the settlement between the plaintiff and the insured; 2) whether or not the settlement was fraudulent or collusive; and 3) whether the insurance carrier received proper notice of the settlement. *Id*. "The primary purpose of a reasonableness hearing is to attempt to re-create the same result that would have occurred if there were an arm's length negotiation on the merits of the case between interested parties." *Waddell v. Titan Ins. Co.*, 207 Ariz. 529, 534, 88 P.3d 1141, 1146 (Ct. App. 2004) (quoting *Himes v. Safeway Ins. Co.*, 205 Ariz. 31, 38, 66 P.3d 74, 81 (Ct. App. 2003)). Notably, "reasonableness" does not mean the full value of a claim if it were to be presented to a jury. Rather, it means what a reasonable arm's length transaction/settlement between the parties would have been had it taken place. In other words, the court must view the claim as if the parties were negotiating a settlement, taking into account all of the pros and cons of the case and all of the factors typically considered by parties and their attorneys when entering into a settlement.

The test to determine the reasonableness of a settlement is "what a reasonably prudent person in the insured's position would have settled for on the merits of the claimant's

case." *Himes*, 205 Ariz. at 36-8, 66 P.3d at 79-81. A "reasonably prudent person" is a person who is making the decision as though the money is coming out of his or her pocket, not with someone else's money, based on the merits of the case. *Id*. at 39, 82. There are several factors that a court must consider in evaluating the reasonableness of a settlement: (1) the extent of claimant's damages; (2) the merits of claimant's liability theory; (3) the merits of the insured's defense theory; (4) the insured's relative fault; (5) the risks and expenses of continued litigation on the merits; (6) evidence of bad faith, fraud, or collusion; (7) the extent of claimant's investigation and preparation of the case; and (8) the interests of the parties not being released. *Id.* at 42, 85 (citing *Chaussee v. Md. Cas. Co.*, 60 Wash. App. 504, 803 P.2d 1339, 1343 (1991)).

Parties are required to present witnesses and testimony at reasonableness hearings to better evaluate each of the above-listed factors. Attorneys for the insured have been compelled to testify and to produce documents related to the settlement in Arizona courts.

D. Burden of Proof

In a reasonableness hearing, the plaintiff bears the burden of proving the reasonableness of the settlement amount by a preponderance of the evidence. *Himes*, 205 Ariz. at 36-38, 66 P.3d at 79-81. A court cannot simply rubber stamp a stipulated judgment amount for it to stand as a reasonable settlement. There is no presumption reasonableness and the burden of proof does not shift to the carrier. *Id.* at 37, 80. Rather, there is an affirmative duty on the part of the plaintiff to establish reasonableness for each element of the stipulated judgment. *Id.*

Finally, the trial court, in the reasonableness hearing, cannot consider non-financial consequences that the insured may face as a result of an adverse judgment when determining whether the settlement or stipulated judgment amount is reasonable. *Parking Concepts, Inc. v. Tenney*, 207 Ariz. 19, 83 P.3d 19, 26 (Ariz. 2004). The carrier does not have a contractual obligation to consider its insured's non-financial consequences under the insurance policy. *Id.* at 25-6.

E. Unreasonable Settlements

Courts have a duty to determine a reasonable settlement amount if the plaintiff cannot meet his burden. *See Morris, supra; Himes, supra*. "If [claimant] cannot show that the entire amount of the stipulated judgment was reasonable, he may recover only the portion that he proves was reasonable. If he is unable to prove the reasonableness of any portion of the judgment, [the insurer] will not be bound by the settlement." *Morris*, 154 Ariz. at 120, 741 P.2d at 253.

After hearing all of the witness testimony and reviewing all of the evidence, the court must then determine what a reasonable settlement would have been, or should have been,

based on the merits and circumstances of the case. This requires the court to determine a specific dollar amount as reasonable. *Himes*, 205 Ariz. at 38, 66 P.3d at 81.

For example, in *Cosgrove v. WTM Construction Inc. et al.*, 2010 WL 5195933 (Ariz. Super. 2010) following a *Morris* hearing, an Arizona trial court significantly reduced the stipulated judgment of $443,690 to a net reasonable settlement of $254,373. In *Cosgrove*, a home owner filed a lawsuit against WTM Construction after discovering several defects and asserted numerous legal theories including fraud and negligent misrepresentation. Before trial both parties entered into a *Damron/Morris* agreement, which provided that a stipulated judgment would be entered against WTM in the amount of $443,690. The court determined a reasonable settlement by examining the plaintiff's claims and assigning settlement values to various claims based on chances of prevailing on these claims. The court also looked at settlement as a whole and found that a reasonable defendant would pay, and a reasonable plaintiff would accept, $304,373 in full settlement of this case based on the merits in an arm's length transaction considering all the factors required by *Morris* and its progeny. The court held that the defendant's insurer was only bound to pay the reasonable settlement of $254,373.

F. Recent Developments

The Arizona Court of Appeals recently clarified the permitted parameters of *Morris* agreements in construction defect cases. In *Leflet v. Redwood Fire & Cas. Ins. Co.*, the developer of a project and its direct insurers attempted to enter into a *Morris* agreement with the plaintiff homeowners, stipulating to an $8.475 million judgment against them and paying plaintiffs $375,000 in addition to assigning plaintiffs their rights against all subcontractors and subcontractors' insurers in exchange for a covenant not to execute on the judgment. 226 Ariz. 297, 299, 247 P.3d 180, 182 (Ct. App. 2011). The court ruled that such an agreement is invalid when it exposes the excess insurer to liability in excess of their policy limits and its clear intent is to favor the primary insurers and burden the excess insurer. *Id.* at 301-02, 184-85. This defeats the whole purpose of *Morris* because the direct insurer does not face the risks that an insured does that gave rise to *Morris*; the risk of being subjected to an excess judgment or a judgment within policy limits for which it may not receive coverage. *Id.*

In *Colo. Cas. Ins. Co. v. Safety Control Co.*, the Arizona Court of Appeals ruled that an insured and its excess insurer can enter into a *Damron/Morris* agreement when the primary insurers have refused coverage. 230 Ariz. 560, 566 288 P.3d 764, 770 (Ct. App. 2012). The court stated that an agreement in this setting puts the liability where it should have been in the first place—on the primary insurer. *Id.* For the judgment to be enforceable, it must prove to be a liability that is within the scope of the subcontractor's insurer's coverage. *Id.* at 567, 771.

Most recently, in *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 748 F.3d 911 (9th Cir. 2014), the United States Court of Appeals for the 9th Circuit certified a question to the Arizona Supreme Court to decide whether an insurer who declines to defend its insured can be estopped from raising a coverage defense in a subsequent action based on a default judgment entered pursuant to a *Damron* agreement that included a stipulation between the third-party plaintiffs and the insured. *Id.* at 912. On June 3, 2014 the Arizona Supreme Court heard oral arguments for the *Quihuis* case, which may have significant consequences for insurers in cases where the insured has entered into a *Damron* agreement with the injured plaintiff.

In *Quihuis*, a couple insured their vehicle under a State Farm automobile insurance policy. *Id.* at 913. The couple sold their vehicle to the plaintiff through a signed written agreement, but did not transfer the vehicle's title because the couple thought it was necessary to retain the title as collateral until the vehicle was paid off. *Id.* The plaintiff lent the vehicle to her daughter to drive, who was later in a vehicle accident with the plaintiff. *Id.* The couple did not cancel their State Farm policy until after this accident occurred. *Id.* The plaintiff sued the daughter for negligence and the couple for negligent entrustment. *Id.* Both named parties tendered their defense to State Farm, which declined to defend or indemnify based on its determination that coverage for the vehicle ended on the date of the sale. *Id.* Plaintiff entered into a *Damron* agreement with both parties in which they stipulated that the couple legally owned the vehicle at the time of the accident, establishing the couples' liability for negligent entrustment. *Id.* The couple assigned their rights under the State Farm policy to the plaintiff, and a default judgment was entered for the plaintiff against both parties for $350,000. *Id.* Based on the undisputed facts and policy language, the federal court granted State Farm's summary judgment, since the vehicle no longer qualified as an insured vehicle on the date of the accident because it was previously sold. *Id.* In agreement with the district court, the Circuit Court held that the default judgment did not preclude the insurer from litigating who owned the vehicle for purposes of coverage, but the outcome depends on whether the stipulation between the parties that the couple owned the vehicle prevents State Farm from contesting coverage under the policy. *Id.* at 914.

This issue will require the Court to resolve the inconsistencies between *Morris* and the narrower holding in *Assoc. Aviation Underwriters v. Wood*, 209 Ariz. 137, 98 P.3d 572 (Ct. App. 2004), applying collateral estoppel to preclude insurers from relitigating facts necessary to both liability and coverage. *Wood*, 209 Ariz. at 149, 98 P.3d at 584. The case is now in the hands of the Arizona Supreme Court, and insurers anxiously await its decision.

II. PRACTICE TIPS REGARDING CONSENT JUDGMENTS

When an insurance carrier receives notification that its insured is contemplating a Morris agreement, the insurance carrier can limit its exposure and solidify its coverage defenses by sending the insured a *Munzer* letter. In *Munzer v. Feola*, the Arizona Court of Appeals held that a *Morris* agreement is only limited to those claims and damages for which the insurer reserved its rights. *Munzer v. Feola*, 195 Ariz. 131, 985 P.2d 616 (Ct. App. 1999). A *Munzer* letter is a letter sent to the insured by the insurer which specifically states which of plaintiff's claims will be defended without a reservation of rights, and those as to which it will reserve its rights. *Id.* More specifically, the letter outlines which alleged damages are covered under the policy and which alleged damages are not. This letter prevents plaintiff and the insured from entering into a *Morris* agreement that settles any claim the insurer agreed to defend without reservation. *Id*. at 135-6, 620-1. Any such *Morris* agreement will be deemed a breach of the cooperation clause, voiding the policy. *Id*. at 136, 621.

III. CONCLUSION

Early defense and careful evaluation of construction defect cases on behalf of insureds can go a long way toward militating against *Damron/Morris* assignments, which most often result in more headaches and expense for carriers. It is important to keep in mind that settlement agreements should be reached through a meaningful process; a collusive settlement will not be upheld. For this reason, it is vital that the settlement is appropriately negotiated in an arm's length manner, documented, and supported by evidence that portrays its reasonableness in light of real exposures and appropriate damages. If the parties fail to build their cases, the absence of evidence can be used to support the claim that the settlement is unreasonable, and likely will be received by the court better than an unsupported objection.

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