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Sometimes the Good Guys Win: Collusive Settlements and Fraudulently Induced "Judgments" Don't Break Policy Limits

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Most insurance lawyers will agree that one of the riskiest things a liability insurer can do is reject a tender of defense if there's any chance at all that a defense is owed. In California and most other states, an insurer that "abandons" its insured by failing to provide a defense can be exposed to liability far in excess of its policy limits if the insured is liable to the third-party-claimant. In some states, policyholders have been allowed to "bust the policy" and recover more than the policy limits even if their "liability" to the claimant was manufactured in a settlement, not adjudicated at trial. Recently, though, a no-nonsense federal judge in San Francisco has held that if the judgment against the insured and in favor of the claimant is collusive (*i.e.*, the product of fraud), the liability of the non-defending insurer is limited to policy limits.

In *Carlson v. Century Surety Co.* 2012 WL 601707 (N.D. Cal. 2012), Judge Susan Illston initially found that the insurer had breached its contractual duty to defend by denying coverage when there was at least some potential factual basis for coverage. However, the court was disturbed by a settlement and $3.3 million default judgment that appeared to "smell bad." Relying on an insurance fraud case, *Andrade v. Jennings*, the federal court ultimately concluded the judgment and settlement were fraudulent, created with the specific purpose of: (1) creating coverage where none existed, and (2) wrongfully increasing the third party's purported damages from $5,000 to $3.3 million. Under those circumstances, the court refused to permit the judgment to be the basis of an excess judgment claim against the insurer.

Carlson involved a $500,000 claims-made Errors and Omissions policy issued to a real estate broker. Two of the broker's clients sued the insured during the policy period, alleging professional negligence (the mishandling of an escrow deposit). They sought $65,000 in damages resulting from a failed house sale. The insured timely tendered the claim to the insurer. After discovery in the Superior Court action strongly suggested that the insured had known about this claim before the policy period commenced, the insurer declined to defend and denied coverage, without doing any further investigation.

Following the declination, the insured "defended itself" by entering into a settlement with the claimants. The insured agreed to allow a default judgment to be entered against it in Superior Court, in return for the claimants' promise not to execute any judgment against the company. The broker then assigned any rights it might have against the insurer to the claimants.

A state court "prove up" hearing, engineered by the plaintiffs, yielded a default judgment of $3.3 million, more than six times greater than the policy limits. It also served as the basis of the federal court bad faith suit against the insurer. The federal judge acknowledged that the $3.3 million judgment was presumptively reasonable because the insurer had failed to provide its insured with the bargained-for defense, and the insured had submitted affidavits attesting to the underlying settlement's reasonability. However, the insurer was entitled to rebut the presumption by proving the settlement did not reflect an "informed and good faith" effort to settle the claim, but was instead grounded on fraud between the insured and the plaintiffs.

The federal court looked to *Andrade v. Jennings*, for guidance as to how to establish the un-reasonability and fraudulent character of the insured's settlement, and noted that there were three key markers of fraud in this situation: (1) a settlement amount greater than justified by the facts; (2) the presence of a covenant not to execute as part of the settlement; and (3) the failure of the insured to consider viable defenses when agreeing to a specific settlement demand.

Applying those markers to the facts of the case, the court held the insurer had proven its collusion case against its insured and the assignees. Furthermore, both the insured and the claimants were fully aware (as evidenced by discovered documents) that, at the time the broker purchased its E&O policy, it had "a basis to believe" that claim already existed, and it was, therefore, not covered by the policy. The parties' collusion in executing sworn declarations to the contrary was proof in and of itself of fraud.

The federal court decision is particularly important because Judge Illston held that the insurer's initial failure to defend was irrelevant, when the subsequent judgment or settlement was the product of fraud and collusion. This reflects California's strong public policy against fraud, and the legal principle that a judgment based upon fraud is void. Both Oregon and Washington have similar public policies regarding fraudulently induced judgments, and might well reach the same conclusion as the *Carlson* court.

For questions regarding this case and/or the *Andrade v. Jennings* case (which Norm defended on behalf of London underwriters) please contact Norm Ronneberg at 415.352.2728.