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ARIZONA DAMRON AGREEMENTS—AN UNUSUALLY DANGEROUS DANGER ZONE FOR LIABILITY INSURERS

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Insurers that provide a defense to their insureds under a reservation of rights and insurers that decline a defense to an insured altogether are, in many jurisdictions, subject to settlement agreements negotiated directly between an insured and a third party plaintiff. Typically, in return for a covenant not to execute against its own property, the insured stipulates to allow a judgment to be entered in favor of the third party and the insured assigns to the third party plaintiff whatever rights the insured has against its own insurance company. When the third party plaintiff files suit against the insurer seeking to enforce the stipulated judgment, the insurer is then left to defend its position on coverage. If unsuccessful in its coverage defense, the insurer is arguably bound by the stipulated judgment, which often represents a premium value for the underlying claim.

In the great majority of jurisdictions where these agreements are allowed, courts have provided some measure of protection to the insurer and have held that a stipulated judgment must be in a **reasonable** amount. In Arizona in particular, our courts have been vigilant in protecting insurers that have defended under a reservation of rights against excessive stipulated judgments and have enacted a standard that renders the stipulated judgment unenforceable unless it is in an amount that the insured would have itself been willing to pay if it had the resources to do so.[1] Unfortunately, when creating this standard, the court observed in dicta that, in contrast to an insurer that defends under a reservation of rights, an insurer that denies coverage and declines to defend is not entitled to similar protection and, most recently, again in dicta, the Arizona Supreme Court in *Parking Concepts, Inc. v Tenney* observed: "in cases where the insurer has refused to defend and the parties enter into a *Damron* agreement, the insurer has no right to contest the stipulated damages on the basis of reasonableness, but rather may contest the settlement only for fraud or collusion."[2] This statement and dicta from earlier cases has led many in Arizona to conclude that Arizona insurers act at substantial peril whenever they deny an insured coverage for a third-party liability claim.

This article serves two purposes. First, it warns insurers of the significant danger of denying coverage to an Arizona insured exposed to a third-party liability claim. Second, this article proposes that, notwithstanding the Arizona Supreme Court's statement in *Parking Concepts*, Arizona needs to recognize a requirement of reasonableness superimposed upon any **stipulated** judgment, even one entered after an insurer declines to defend.

The argument that all stipulated judgments must be "reasonable" begins with an analysis of the 1969 Arizona Supreme Court decision *Damron v. Sledge*,[3] which the *Parking Concepts*' Court cites as the source of its problematic dicta. In *Damron*, after an insurer declined to provide a defense to its insured, the attorney for the insured withdrew the insured's answer and indicated an intention to allow a default judgment to be taken. The defense attorney's action was challenged by a co-defendant but the *Damron* Court found that the concept of such an agreement was not inherently collusive and allowed the agreement to go forward. In response to the expressed concern that the anticipated default judgment might be somewhat excessive, the Court observed that an insurer that refuses a defense altogether must accept a risk that "an unduly large verdict may result from lack of cross-examination and rebuttal." 105 Ariz. at 155. That is the statement which this article would argue erroneously evolved into the *Parking Concepts'* proposition that, where the insurer has refused to defend and the parties enter into a *Damron* agreement, the insurer has no right to contest the stipulated damages on the basis of reasonableness.[4]

The problem in moving from *Damron* to *Parking Concepts* is that a critical distinction between the two cases has become lost over the years. *Damron* and the cases that followed for many years thereafter were all cases in which the settlements were based upon judgments that were to be entered after an **evidentiary hearing.** Because those judgments were based upon evidentiary hearings and therefore "on the merits," the doctrines of vouching in and collateral estoppel made those judgments enforceable and subject to collateral attack only on the basis of fraud or collusion.[5] Thus, in the cases that followed *Damron* over the years, it became relatively commonplace to see the phrase that the *Damron* settlement judgments could only be collaterally attacked by showing fraud or collusion.

It was not until 1987 that the Arizona Courts had to consider *Damron* agreements

where the amount of the judgment was created by stipulation rather than through an evidentiary hearing. *Arizona Property and Casualty Ins. Guaranty Fund v. Helme*[6] and *U.S.A.A. v. Morris*[7] represent the beginning of the evolution of the *Damron* concept into the realm of settlement agreements involving **stipulated** judgments.

Helme is especially significant because, unlike *Damron*, the insurer had provided a defense to its insured. The problem arose when the insurer disputed the claim that there were two occurrences and advised its insured it would pay for only one covered claim. The Court found that the insurer's position was an anticipatory breach of the insurer's duty to indemnify, which the Court observed was a breach of "**the most fundamental of an insurer's obligations."**[8]

After making it clear that the anticipatory breach by the insurer relieved the insured from its obligation under the cooperation clause, *Helme* went on to make it clear that there were limitations upon what the insured could do in terms of settlement agreements. The Court held that "the insurer's breach narrows the insured's obligations under the cooperation clause and permits him to take **reasonable steps** to save himself," and that "**among those steps is making a reasonable settlement with the claimant."**[9]

Thus, in its first opportunity to speak on the issue as to what kind of settlements could be entered into when an insurer **breached** its "most fundamental" obligation, the Arizona Supreme Court held that the insured could not enter into "any type" of agreement but was entitled to enter into a "**reasonable**" settlement agreement. The Supreme Court has never retreated from this statement in *Helme*, and this principle should be equally as valid today as it was when the *Helme* decision was issued.

For purposes of this analysis, however, the most significant aspect of *Helme* is that the court was well-tuned into the fact that the *Damron* settlement in that case had led to a **stipulated** judgment. The Court stated: "this opinion does not reach any issue regarding the extent to which **stipulations** which form part of the settlement agreement are binding upon the insurer." 153 Ariz. at 138. It was in *Morris*, which came out three months after *Helme*, that Justice Feldman, who authored both decisions, spelled out the rules for determining when settlement agreements involving **stipulated** judgments are binding upon the insurer.

Morris involved an insurer that had defended its insured under a reservation of rights. *Morris* considered two new issues. First, *Morris* held that, despite the fact that the insurer had committed no breach of the insurance contract, its decision to reserve its rights as to indemnity put the insured in potential financial jeopardy. The Court felt this predicament was unacceptable and determined that the cooperation clause bars an insured against settling without the insurer's consent only when an insurer "unconditionally assumes liability under the policy." The second significant aspect of *Morris* is that the court went on to consider whether the settlement agreement that included a **stipulated** judgment was enforceable against the insurer.

Over the years what has gotten "lost in the shuffle" is the fact that, as to this second aspect of *Morris*, what the court was actually doing was answering the question that had been posed at the end of *Helme*. Reading *Helme* and *Morris* together, it is apparent that the **requirement of reasonableness in both cases** grew out of **the nature of the judgment** (i.e., both cases involved stipulated consent judgments as opposed to judgments on the merits) and had nothing to do with the nature of the insurer's breach (as in *Helme*) or the fact that there was no breach (as in *Morris*).

This conclusion is further evidenced in the analysis conducted by the *Morris* Court as to whether the insurer was bound by a *Damron* settlement that culminated in a stipulated judgment. *Morris* zeroed in on the fact that stipulated judgments were not adjudications on the merits.

> **Plainly, the [stipulated] "judgment" does not purport to be an adjudication on the merits**, it only reflects the settlement agreement. … *Miller* resolves this concern by holding that **neither the fact nor amount of liability to the claimant is binding on the insurer unless the insured or claimant can show that the settlement was reasonable and prudent. *Id.* This accords with general principles of indemnification law.** 154 Ariz. at 120. [Emphasis added]

The Court's observance of the fact that a stipulated judgment is not an adjudication on the merits necessarily took the analysis out of the realm of the doctrine of collateral estoppel and the Court **had to** instead rely upon "**general principles of indemnification law**" to determine the enforceability of the stipulated judgment. In defining those general indemnification principles, the Court looked to several out-of-state cases and the Court specifically referred to 41 Am.Jur.2d *Indemnity* §33. The cases cited in *Morris* are consistent in principle with §33 of 41 Am.Jur.2d *Indemnity* which reads:

> A person legally liable for damages who is entitled to indemnity **may settle** the claim and recover against the indemnitor, even though he has not been compelled by judgment to pay the loss. **In order to recover**, the indemnitee settling the claim **must show** that the indemnitor was legally liable, and that **the settlement was reasonable**.
>
> However, when the indemnitor has notice of the claim and refuses to defend, **the indemnitor is bound by any good faith reasonable settlement**, and the indemnitee need only show potential liability. 41 Am.Jur.2d *Indemnity* §33. [Emphasis added]

There are two important points to all of this. First, the requirement of reasonableness in a stipulated settlement is something that emanates from basic principles of indemnification. The requirement of reasonableness **is not** something that is premised upon the nature of the insurer's alleged breach or whether an insurer refused to defend, defended under a reservation of rights or failed to consider a demand for settlement within its policy limits.

The second important point is that all of the discussion in *Damron*, and the cases that immediately followed thereafter, that addressed an insurer's limited ability to attack a judgment only on the basis of fraud or collusion, involved underlying judgments **on the merits**. Those judgments, on the merits, invoked the principles of collateral estoppel and that is why the insurer's only remedy was to attack the judgment for fraud or collusion. On the other hand, Damron-type settlements leading to a consent judgment, such as in *Helme* and *Morris*, do not result in a judgment on the merits and therefore one cannot invoke the doctrine of collateral estoppel.

Absent a judgment on the merits, the court must invoke general indemnity principles and that is exactly what happened in *Morris*. It was when *Morris* invoked general indemnification principles to determine the enforceability of a stipulated judgment that the requirement of "reasonableness" of the judgment came into play. As to that issue, the Court stated:

> An indemnitor is bound by the settlement made by its indemnitee if, but only if, the indemnitor was given notice and opportunity to defend. *Id.*

> By settling against the insurer's instructions, the insured, in effect, ousts the insurer from the defense of the action and assumes the defense himself. In such case, the indemnitor may contest its liability. *Beeson, supra*; *Vagnozzi, supra*. **Failing in that, the indemnitor will be liable to the indemnitee to the extent that the indemnitee establishes that the settlement was reasonable and prudent under all the circumstances.** *Beeson, supra*; *Miller, supra*. The indemnitee need not establish, however, that he would have lost the case; he need only establish that given the circumstances affecting liability, defense and coverage, the settlement was reasonable. *Id.* 154 Ariz. at 120.

Reading *Morris* in the context of the principles of collateral estoppel versus general indemnity principles puts *Morris* into the context in which it was intended. It was the nature of the judgment and not the nature of the insurer's breach that led to the conclusion that a reasonableness hearing was required. As to the nature of the insurer's conduct, Morris merely held that "an insured being defended under a reservation of rights may enter into a *Damron* agreement without breaching the cooperation clause," thus opening the door to *Damron* agreements where there was no actual breach or anticipatory breach by the insurer.

Given the language in *Morris*, it appeared that Arizona law was well-settled and in accord with the premise of this article. A problem, however, has arisen in the intervening years. It is a problem that may have been created because, in the appellate cases that have followed in Arizona since *Morris*, our courts have never been squarely presented with a case involving an insurer that denied coverage that was facing an unreasonable excessive **stipulated** judgment. In the wide variety of cases that have been considered in the last 18 years, Arizona courts have gone to great lengths in each particular case to protect insurers against unreasonable *Damron* agreements.[10] The irony is, while doing so, dicta has unnecessarily appeared that this writer would respectfully submit has misstated the intent of *Morris*.

This process culminated in the footnote addressed at the beginning of this article in the Arizona Supreme Court's 2004 decision, *Parking Concepts*. In holding that the reasonableness of a stipulated judgment could not be justified by circumstances extraneous to the risk that was insured, *Parking Concepts* continued the trend of applying a high and critical standard against the enforcement of stipulated judgments. Unfortunately, in protecting the rights of the insurer that had defended its insured under a reservation of rights, the Court unnecessarily observed (since that issue was not before the Court) that an insurer that had refused to defend its insured would not be entitled to the same protection of reasonableness and would have "no right to contest the stipulated judgment on the basis of reasonableness."

Parking Concepts cited *Damron* for support for the above statement and, in doing so, this writer would respectfully submit that the Court did not address the fact that the *Damron* judgment was "on the merits" nor did the Court address the distinctions that had been identified in *Morris* between the enforcement of judgments entered on the merits versus those where the amount of the judgment had been created only by stipulation.

In closing, this writer would observe that, notwithstanding the statement found in *Parking Concepts*, no Arizona court in the 37 years since *Damron* has actually held that an insurer that declines a defense can be exposed to a stipulated judgment in any excessive amount without regard to reasonableness. To the contrary, at every opportunity, Arizona courts have consistently extended the requirement of reasonableness. The hypothesis of this article is that *Damron/Morris* judgments should not be exempted from the application of the basic principles applicable to the enforcement of all judgments. If an Arizona appellate court is someday finally presented with a case in which an insurer that has declined coverage is defending against an excessive *Damron* stipulated judgment and, if the court is presented with the correct arguments, this article proposes that the court should apply a reasonableness standard required by the principles of indemnity identified in *Morris*. Whether that case will ever be presented is problematic since, as things currently stand, it is a very risky proposition in Arizona for any insurer to deny coverage to an insured on a third-party liability claim.

FOOTNOTES

1 *Himes v. Safeway Ins. Co.*, 396 Ariz. Adv. Rep. 56, 66 P.3d 74 (App. 2003).

2 *Parking Concepts, Inc. v Tenney*, 207 Ariz. 19; 83 P.3d 19, 22 at note 3. (2004 Ariz.) *Parking Concepts* does not discuss what evidence is relevant to establish fraud or collusion. Jurisdictions that have considered this issue have found that the excessive amount of a judgment is relevant to prove a stipulated judgment is fraudulent and collusive.

3 *Damron v Sledge*, 105 Ariz. 151, 460 P2d 997 (1969).

4 Although both *Himes* and *Parking Concepts* cite *Damron* as support for this proposition, *Damron* never actually dealt with the issue of the enforceability of a judgment. *Damron* went up on appeal when the concept of the agreement was challenged as collusive before the *Damron* agreement culminated in a judgment.

5 *State Farm v Paynter*, 593 P.2d. 948, 122 Ariz. 198 (App. 1979); *Farmers v Vagnozzi*, 138 Ariz. 443, 675 P.2d 703 (1983)

6 *Arizona Property and Casualty Ins. Guaranty Fund v. Helme* 153 Ariz. 129, 735 P.2d 451 (1987)

7 *U.S.A.A. v. Morris* 154 Ariz. 113, 741 P.2d 246 (1987).

8 153 Ariz. at 137, 735 P. 2d at 459.

9 153 Ariz. at 138, 735 P.2d at 460.

10 In addition to *Himes and Parking Concepts, also see: State Farm v Peaton*, 168, Ariz. 184, 812 P. 2d 1002 (1990), court disallowed *Damron* agreement, holding insured was not relieved from cooperation clause simply because of amount of claim put insured in financial jeopardy; *Rogan v. Auto-Owners Insurance Company*, 171 Ariz. 559, 832 P. 2d 212 (1991), even when an insurer denies coverage in bad faith it cannot be held responsible for a *Damron* judgment in excess of policy limits when there was no evidence insurer had refused to settle for a demand within policy limits; and *Mora v. Phoenix Indemnity*, 196 Ariz. 315, 996 P.2d 116 (2000), insurer that defended under a reservation of rights entitled to intervene on damage hearing before amount of *Damron* judgment is assessed by court.

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