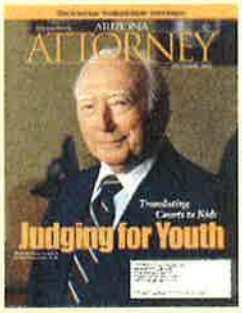
Damron Revisited
Reasonableness the True Judgment Limit

By Robert J. Bruno



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At a seminar I recently attended, the speaker confidently told the audience something that I have heard repeated many times over the last several years. The speaker said that an insurer that declined to defend its insured was exposing itself to the potential of a "*Damron*" stipulated judgment that could not be attacked in the absence of fraud or collusion. The speaker—and others who have said the same thing—all seemed to be on solid footing, because that precise statement recently appeared in dicta in a decision of the Arizona Supreme Court.[1] However, if that dicta is a correct statement of Arizona law, it arguably means our courts have adopt-

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Robert J. Bruno is a Director at Sanders & Parks PC in Phoenix. He focuses his practice on complex tort and business litigation. He is a State Bar-certified specialist in Injury and Wrongful Death Litigation.

ed a rule of law that would allow the enforcement of a multimillion-dollar stipulated judgment against an insurer that declined to defend a minor fender bender involving $500 in actual damages.

This article challenges the conventional wisdom in our legal community that led to what this writer would respectfully submit is erroneous dicta in *Parking Concepts v. Tenney.*[2]

Genesis of *Tenney* Dicta

The genesis for the *Parking Concepts* dicta is the Supreme Court's 1969 decision in *Damron v. Sledge.*[3] In *Damron*, after an insurer declined to provide a defense to its insured, the attorney for the insured withdrew the insured's answer and allowed a default judgment to be taken. The *Damron* court allowed the default judgment to be enforced against the insurer and, in doing so, the court found 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."[4]

In the 35 years since *Damron,* this holding has evolved into the proposition that appeared in *Parking Concepts.* There, the Court addressed the issue of what factors to consider in determining whether a stipulated settlement is reasonable when an insured enters into a *Morris* agreement—one entered into by the insured after the insurer commits to pay for the defense of the claim but reserves the right to contest its duty to indemnify based upon a coverage issue.[5] As part of that discussion, the Court, citing *Damron*, noted that "in contrast" to the situation before the Court, "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."[6]

Though that footnote does reflect a conventional wisdom that has developed in our legal community since *Damron,* this article questions a rule of law that subjects an insurer that declines to defend to a stipulated judgment in any amount—even if that amount has no reasonable relation to the underlying case.

When Judgment Is on the Merits

Notwithstanding the dicta in *Parking Concepts,* Arizona law does in fact recognize a requirement of reasonableness superimposed upon any stipulated judgment entered as a result of a *Damron/Morris* settlement. This article proposes that basic principles of collateral estoppel and indemnity require that when a stipulated judgment is entered as a result of a *Damron/Morris* agreement, the stipulated judgment must be measured by a standard of reasonableness, even when an insurer declines to provide a defense to its insured.

The analysis that leads to this conclusion begins with the original holding in *Damron.* That Court did not hold that an insurer that declines a defense assumes virtually any risk that may follow. The risk specifically identified by the Court was simply that the judgment could be unduly large due to lack of cross-examination and rebuttal. What has become lost over the years is that the judgment in *Damron* was entered after an evidentiary hearing. In addition, the underlying reason why such a judgment (i.e., a judgment "on the merits") is enforceable in the absence of fraud or collusion is found in the Restatement of Judgments and the rules set forth in that Restatement concerning the doctrines of vouching in and collateral estoppel.

The doctrine of "vouching in," a subcategory of the doctrine of collateral estoppel, was first discussed in the context of a *Damron* agreement in *State Farm v. Paynter.*[7] Applying the vouching in doctrine, the court of appeals in *Paynter* observed, "Having refused to provide a defense, the insurer is said to have been 'vouched in' the action against the insured and is bound by the judgment. In the

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absence of fraud or collusion, it is not entitled to relitigate the merits of the claim."[8]

Paynter, like *Damron*, involved a judgment entered after an evidentiary hearing and therefore the court considered the judgment to be on the merits. The significance of the underlying judgment on the merits was further emphasized in the *Damron* context by the Arizona Supreme Court in *Farmers v. Vagnozzi*.[9] As to the applicability of the doctrine of collateral estoppel, the Court, citing RESTATEMENT (SECOND) OF JUDGMENTS § 27 (1982), observed that "under the doctrine of collateral estoppel, the determination of a litigated fact or law which is essential to a valid and final judgment is conclusive between the parties or their privies in a subsequent claim."[10]

Even though *Vagnozzi* involved an insurer defending under a reservation of rights and *Damron* and *Paynter* involved insurers that declined to defend, it was evident in each case that it was not the nature of the insurer's alleged breach that dictated the enforceability of the judgments. Whether the judgments were enforceable was in each case premised upon the basic principles of collateral estoppel. Because each of those cases involved underlying judgments on the merits, all of those judgments were entitled to collateral estoppel effect and therefore could not be attacked in the absence of fraud or collusion.

Enforcing Stipulated Judgments

Collateral estoppel, however, does not apply to a judgment that is not "on the merits" and is entered simply through stipulation.[11] Because of that, when considering the enforceability of stipulated judgments, our courts have had to look to general principles of indemnity instead of the doctrine of collateral estoppel.

Arizona Property and Casualty Ins. Guar. Fund v. Helme[12] and *U.S.A.A. v. Morris*[13] represent the beginning of the evolution of the *Damron* concept into the realm of settlement agreements involving stipulated judgments. *Helme, Morris* and the cases that followed show the movement from those prior cases involving underlying judgments entered on the merits (albeit in brief evidentiary proceedings) to cases involving judgments entered by stipulation of the parties.

In the absence of a judgment on the merits that allows the invocation of collateral estoppel, Arizona courts have had to rely on principles of indemnity that necessarily led the Arizona Supreme Court in *Morris* to invoke the requirement that a stipulated judgment be in a reasonable amount.

That transition began in *Helme*, a case that is especially important because it so clearly established that it is not the nature of the insurer's alleged breach that dictates the enforceability of the *Damron/Morris* judgment. In *Helme*, the alleged breach was the insurer's failure to indemnify. The Court observed, "Although the insurers in *Damron* and *Paynter* breached by refusing to defend, the principle of those cases remains the same: once an insurer breaches any duty to its insured, the insured is no longer fully bound by the cooperation clause."[14] *Helme* also found that an insurer's breach of its obligation to indemnify is a breach of "the most fundamental of an insurer's obligations," a significant point that militates against the idea that a breach of an insurer's duty to defend is an extraordinary breach that justifies special penalties.[15]

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 find that there were limitations upon what the insured could do in terms of settlement agreements. Even though the insurer had breached its duty, the insured was not entitled to "enter into any type of agreement."[16] 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."[17]

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, notwithstanding the dicta that has appeared in decisions since, 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 aware 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."[18] 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.

When the Insurer Is Bound

U.S.A.A. v. Morris involved an insurer that had defended its insured under a reservation of rights. *Morris* considered two new issues. First, it held that, despite the fact that the insurer had committed no breach of the insurance contract, its decision to reserve its right as to indemnity put the insured in potential financial jeopardy and, therefore, the insured was released from the cooperation clause and could enter into a *Damron* agreement. The Court also considered whether the settlement agreement that included a stipulated judgment was enforceable against the insurer.

Over the years, what has gotten "lost is 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—both cases involved a consent judgment versus a judgment on the merits—and had nothing to do with the nature of the insurer's

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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. ... This accords with general principles of indemnification law.[19]

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 rely instead 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 specifically referred to 41 AM. JUR. 2D *Indemnity* § 33 (1968). The cases cited in *Morris* are consistent in principle with § 33, which reads:

> A person legally liable for damages who is entitled to indemnity may settle the claim and recover over 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.[20]

There are two important points to all of this.

First, the requirement of fairness and 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 the *Morris* Court invoked those principles to determine the enforceability of a stipulated judgment that the requirement of "reasonableness" came into play:

> An indemnitor is bound by the settlement made by its indemnitee if, but only if, the indemnitor was given notice and opportunity to defend. ... 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. ... 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. ... 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.[21]

Nature of the Judgment Controls

Reading *Morris* in the context of the principles of collateral estoppel versus general indemnity puts *Morris* into the context in which it was intended. It is the nature of the judgment and not the nature of the insurer's breach that dictates whether a reasonableness hearing is required. That conclusion is further evidenced by an opinion of the court of appeals in *Stufflebeam v. Canadian Indem. Co.*[22] There, the court held that an insurer that defended under a reservation of rights was bound by a judgment entered as a result of an evidentiary hearing pursuant to a *Damron* type agreement. The court noted that the insurer had not sought to intervene in the underlying damage hearing although it could have done so. The court held that the insurer was bound by the judgment on the merits.

Stufflebeam, an opinion that came out in 1987 between *Helme* and *Morris,* hit the nail right on the head. Although the insurer defended under a reservation of rights, it was not entitled to a reasonableness hearing because a judgment had been entered on the merits, and that judgment could only be attacked on the basis of fraud or collusion.

Since the Supreme Court's decision in *Morris* in 1987, the *Damron/Morris* issue has been considered in different contexts by many Arizona courts. In *Anderson v. Martinez,*[23] *H.B.H. v. State Farm*[24] and *Mora v. Phoenix Indem. Ins. Co.*,[25] our court of appeals allowed insurers that had defended their insureds to intervene in damage hearings held after their insureds had entered into *Damron* agreements. Each of those cases considered *Damron* to mean that an insurer that refused a defense forfeited its right to participate in the underlying litigation and therefore could not re-enter that underlying litigation and intervene to participate in a default evidentiary hearing. However, none of those cases intimated that an insurer that did not

provide a defense was subject to an excessively large stipulated judgment that was not reasonable based on the facts of the case.

The hypothesis of this article is further confirmed by the fact that in *Himes v. Safeway Ins. Co.*,[26] the court of appeals accorded an insurer a reasonableness hearing as to the enforceability of a stipulated judgment after the insurer had allegedly breached its duty to give equal consideration to its insured by failing to settle within policy limits. Admittedly, *Himes* did not consider the collateral estoppel/indemnity distinction as a basis for the requirement of a reasonableness hearing, and there is dicta in *Himes* that is altogether inconsistent with this article. However, the fact that *Himes* required a reasonableness hearing even in the face of a breach by the insurer does support the conclusion offered here.

It is correct, as recognized in *Vagnozzi, Paynter, Anderson, H.B.H.* and *Mora,* that an insurer that refuses to defend does pay a price. The price is that if the plaintiff and the insured decide to proceed with an evidentiary hearing in the underlying case, the insurer that has abandoned the underlying suit by refusing to provide a defense cannot intervene to appear in that hearing. Once such a hearing is held, and a judgment on the merits follows, then, if the principles of collateral estoppel apply, the resulting judgment can only be attacked on the basis of fraud or collusion.

Variant Views

There are two other cases that include comments or holdings inconsistent with the hypothesis of this article.

First, there is the footnote in *Parking Concepts.* This writer respectfully submits that the footnote was dicta and included no analysis addressing or explaining the proposition for which *Damron* is cited.

The second very recent case that one might argue is not completely consistent with this article is *Waddell v. Titan Ins. Co.*[27] In *Waddell,* the insurer defended its insured without reservation but allegedly breached its duty of equal consideration when it did not timely accept a settlement

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offer within its policy limits. Based upon the insurer's alleged breach, the insured and the plaintiff entered into a *Damron* agreement that led to a default judgment entered after an evidentiary hearing. The insurer was granted leave to intervene to participate in the evidentiary hearing. However, the trial court prohibited the insurer from presenting evidence regarding liability and comparative fault issues. The court of appeals held that the trial court did not abuse its discretion in limiting the issues the insurer could present because the insurer had not properly raised those issues through amended pleadings. However, the appellate court concluded that, though the resulting evidentiary hearing had given the insurer the opportunity to contest the amount of damages, the hearing had not provided the insurer the opportunity to fully contest the reasonableness of the settlement. Therefore, the court allowed the insurer to engage in a reasonableness hearing after entry of judgment where evidence on liability and comparative fault could be considered to determine the extent to which the amount of the judgment was reasonable.

The result in *Waddell* is, in a sense, not consistent with the hypothesis of this article, because the entry of judgment by the trial court after an evidentiary hearing should have been a judgment on the merits that had collateral estoppel effect that could only be attacked for fraud or collusion.

This author would propose looking at *Waddell* as bringing into focus some reasons why *Damron/Morris* default judgments might not be accorded collateral estoppel effect in the future. Notwithstanding everything that has been said in this article, the fact is that *Damron, Paynter* and *Vagnozzi* were all in a "gray" area when the courts were attributing collateral estoppel effect to default judgments. According to § 27 of the RESTATEMENT (SECOND) OF JUDGMENTS, "in the case of a judgment entered by confession, consent, or default, none of the issues is actually litigated" and therefore there is no issue preclusion or collateral estoppel effect.[28] Furthermore, the reasoning of *Waddell* highlights the fact that default judgments that accompany *Damron/Morris* agreements are traditionally limited to consideration of damage rather than liability issues; to the extent liability or comparative fault questions affect the reasonableness of any settlement, those considerations become lost if a party is bound by an underlying judgment entered through a default hearing limited to the issue of damages.

Waddell may be a sign of the future in this evolving area of law. Although Arizona courts have in the past chosen to give these *Damron* default judgments collateral estoppel effect, the *Waddell* decision may be recognition of the fact that reasonableness should "trump" all other considerations when we are dealing with judgments that are essentially the product of agreement, whether through stipulation or default judgment.

In addition to these possibilities, this writer proposes that the result in *Waddell* also can be explained if one accepts the proposition that a judgment that does not bear a reasonable relationship to the merits of the underlying case is by definition a judgment entered into through fraud or collusion. After all, what could be more of a fraud than to ask a court to enter a judgment that does not have a reasonable justification in the facts of the case. Though that proposition is offered as food for thought, the resolution of that issue goes beyond the scope of this article.

What is certain is that *Waddell* and the other cases that have followed since *Morris* have approached these issues as if the *Morris* reasonableness requirement were a new principle peculiar to the insurance context. This writer proposes that *Morris* did not go into new territory as far as the enforceability of a judgment is concerned. Recognizing that collateral estoppel did not apply to a consent judgment, *Morris* applied existing legal concepts of indemnification to a new set of circumstances (i.e., stipulated judgments in the context of an insurance situation) and came up with the right answer under already established principles of indemnity law. The premise of this article is that after *Morris* our courts have not focused on the fact that general principles of collateral estoppel and indemnity should be applied to determine whether any judgment or settlement may be enforced against a third party—and a *Damron/Morris* judgment should be no exception.

Notwithstanding the many years of "conventional wisdom" exchanged within our legal community to the effect that an insurer that declines a defense can be exposed to a stipulated judgment subject to attack only for fraud or collusion, there has never been—in the 35 years since *Damron*—such a holding. To the contrary, at every opportunity, the courts have consistently extended the requirement of reasonableness. If the hypothesis of this article is correct, the application of reasonableness to a stipulated judgment is always required by the principles of indemnity addressed in *Morris*.

endnotes

1. *Parking Concepts, Inc. v. Tenney*, 83 P.3d 19, 22, note 3 (Ariz. 2004).
2. 83 P.3d 19 (Ariz. 2004).
3. 460 P.2d 997 (Ariz. 1969).
4. *Id.* at 1001.
5. 741 P.2d 246 (Ariz. 1987).
6. 83 P.2d at 22, note 3.
7. 593 P.2d. 948 (Ariz. Ct. App. 1979).
8. *Id.* at 950-51.
9. 675 P.2d 703 (Ariz. 1983).
10. *Id.* at 706.
11. *Chaney Bldg. Co. v. City of Tucson*, 716 P.2d 28 (Ariz. 1986).
12. 735 P.2d 451 (Ariz. 1987).
13. 741 P.2d 246 (Ariz. 1987).
14. 735 P.2d at 459.
15. *Id.*
16. *Id.* at 460.
17. *Id.*
18. 735 P.2d at 460.
19. 741 P.2d at 253 (internal citations omitted).
20. 41 AM. JUR. 2D *Indemnity* § 33, at 723-24 (1968).
21. 741 P.2d at 253 (internal citations omitted).
22. 754 P.2d 246 (Ariz. Ct. App. 1987).
23. 762 P.2d 645 (Ariz. Ct. App. 1988).
24. 823 P.2d 1332 (Ariz. Ct. App. 1991).
25. 996 P.2d 116 (Ariz. Ct. App. 1999).
26. 66 P.3d 74 (Ariz. Ct. App. 2003)
27. 88 P.3d 1141 (Ariz. Ct. App. 2004).
28. *See* RESTATEMENT (SECOND) OF JUDGMENTS § 27 cmt. e.