

Collusion Between The Plaintiff and Co-Defendants – The Turncoat Witness

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I. INTRODUCTION

With increasing frequency, collusion is finding its way into courtrooms and arbitrations across the country. Plaintiffs' counsel are looking for a competitive advantage and higher damage awards. Co-Defendants in multiparty litigation are seeking dismissal or nuisance value settlements. Even a lawyer's own client may be willing to confess judgment in exchange for an agreement that the plaintiff will not execute on its assets to collect the judgment. (Not to mention an apparently quick and relatively painless end to protracted litigation.) The lawyer representing such a client has to walk a fine line in order to protect his client's interests while honoring his obligations to be truthful to the Court and opposing counsel.

This paper will examine this complex issue by looking at the competing ethical considerations collusive arrangements raise. Then it will identify rules of evidence that practitioners can employ when a witness does an "about face" on the stand. It will conclude with an analysis of several opinions involving collusive arrangements that have been evaluated by the Appellate Courts.

II. ETHICAL CONSIDERATIONS

One of the reasons collusive agreements are so difficult to deal with is because they can be difficult to identify. What one lawyer considers inappropriate "collusion" may be "creative advocacy" to another lawyer. Before embarking on a particular course of action, a lawyer must remember that his obligation to zealously advocate his client's interests is tempered by broader goals of seeking justice, the duty of candor to the court, and the duty to deal honestly with others.

For this reason, the American Bar Association's Model Rules of Professional Conduct are a good place to start formulating a response to a litigant's collusion. Because the application of these rules to a specific factual scenario is so fact specific, the author has simply highlighted certain guideposts to identify the main factors to consider.

Preamble and Scope

Preamble: A Lawyer's Responsibilities

[1] A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.

[2] As a representative of clients, a lawyer performs various functions. As advisor, a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications. As advocate, a lawyer zealously asserts the client's position under the rules of the adversary system. As negotiator, a lawyer seeks a result advantageous to the client but consistent with requirements of honest dealings with others...

[7] Many of a lawyer's professional responsibilities are prescribed in the Rules of Professional Conduct, as well as substantive and procedural law. However, a lawyer is also guided by personal conscience and the approbation of professional peers...

[8] A lawyer's responsibilities as a representative of clients, an officer of the legal system and a public citizen are usually harmonious. Thus, when an opposing party is well represented, a lawyer can be a zealous advocate on behalf of a client and at the same time assume that justice is being done...

[9] In the nature of the law practice, however, conflicting responsibilities are encountered. Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and the lawyer's own interest in remaining an ethical person while earning a satisfactory living.

Client-Lawyer Relationship

Rule 1.2 Scope of Representation and Allocation of Authority Between Client and Lawyer

(d) A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a

lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Client-Lawyer Relationship

Rule 1.16 Declining or Terminating Representation

(a) Except as stated in paragraph (c), a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if:

(1) the representation will result in violation of the rules of professional conduct or other law;...

(b) Except as stated in paragraph (c), a lawyer may withdraw from representing a client if:

(2) the client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent;

(3) the client has used the lawyer's services to perpetrate a crime or fraud;

(4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement;...

(7) other good cause for withdrawal exists.

Advocate

Rule 3.3 Candor Toward the Tribunal

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer

evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

Advocate

Rule 3.4 Fairness to Opposing Party and Counsel

A lawyer shall not:

(b) falsify evidence, counsel or assist a witness to testify falsely, or offer an inducement to a witness that is prohibited by law;

Maintaining The Integrity of the Profession

Rule 8.3 Reporting Professional Misconduct

(a) A lawyer who knows that another lawyer has committed a violation of the Rules of Professional Conduct that raises a substantial question as to that lawyer's honesty, trustworthiness or fitness as a lawyer in other respects, shall inform the appropriate professional authority.

(b) A lawyer who knows that a judge has committed a violation of applicable rules of judicial conduct that raise a substantial question as to the judge's fitness for office shall inform the appropriate authority.

(c) This Rule does not require disclosure of information otherwise protected by Rule 1.6 or information gained by a lawyer or judge while participating in an approved lawyers assistance program.

Maintaining the Integrity of the Profession

Rule 8.4 Misconduct

It is professional misconduct for a lawyer to:

(a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another.

(b) commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects;

(c) engage in conduct involving dishonesty, fraud, deceit or misrepresentation;

- (d) engage in conduct that is prejudicial to the administration of justice;
- (e) state or imply an ability to influence improperly a government agency or official or to achieve results by means that violate the Rules of Professional Conduct or other law; or
- (f) knowingly assist a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law.

American Bar Association's Model Rules of Professional Conduct (2007), Preamble, 1.2(d), 1.16(a)(1), (b)(2-4) and (7), 3.3(a)(1) and (3), 3.4(b), 8.3, and 8.4.

III. RULES OF EVIDENCE

Although the Rules of Evidence provide mechanisms for dealing with witnesses who engage in collusive tactics, a lawyer confronting these tactics may feel like he has brought a knife to a gun fight. Nonetheless, our view of pertinent rules is helpful.

Rule 607. Who May Impeach

The credibility of a witness may be attacked by any party, including the party calling the witness.

Practice Note: *This rule changes the common law rule which prohibited a party from impeaching his own witness because it was believed that by offering the witness a party held that person out as being worthy of belief. However, attorneys should check their applicable state laws to make sure that state has adopted the federal rule. Certain states still require showing of surprise or affirmative damage before an attorney can impeach his own witness. In addition, counsel must be mindful that their right to impeach their own witness is still subject to Rule 403, and will be constrained or precluded if the probative value of the evidence being offered is severely outweighed by its prejudicial impact.*

Rule 608. Evidence of Character and Conduct of Witness

(b) Specific instances of conduct. Specific instances of the conduct of a witness, for the purpose of attacking or supporting the witness' character for truthfulness, other than conviction of crime as provided in rule 609, may not be proved by extrinsic evidence. They may, however, in the discretion of the court, if probative of truthfulness or untruthfulness, be inquired into on cross-examination of the witness (1) concerning the witness' character for truthfulness or untruthfulness,...

Practice Note: *Some states do not allow any cross-examination on specific acts of conduct where no conviction occurred.*

Rule 613. Prior Statements of Witnesses

(b) Extrinsic evidence of prior inconsistent statement of witnesses. Extrinsic evidence of a prior inconsistent statement by a witness is not admissible unless the witness is afforded an opportunity to explain or deny the same and the opposite party is afforded an opportunity to interrogate the witness thereon, or the interests of justice otherwise require. This provision does not apply to admissions of a party-opponent as defined in rule 801(d)(2).

Practice Note: *Some states may not allow the trier of fact to consider the prior inconsistent statement as substantive evidence, but only for the purpose of evaluating the witness' credibility.*

Rule 801. Definitions.

(d) **Statements which are not hearsay.** A statement is not hearsay if—

(1) **Prior statement by witness.** The declarant testifies at the trial or hearing and is subject to cross-examination concerning the statement, and the statement is (A) inconsistent with the declarant's testimony, and was given under oath subject to the penalty of perjury at a trial, hearing, or other proceeding, or in a deposition.

Rule 804. Hearsay Exceptions; Declarant Unavailable

(a) **Definition of unavailability.** "Unavailability as a witness" includes situations in which the declarant--

(1) is exempted by ruling of the court on the ground of privilege from testifying concerning the subject matter of the declarant's statement; or

(2) persists in refusing to testify concerning the subject matter of the declarant's statement despite an order of the court to do so; or

(3) testifies to a lack of memory of the subject matter of the declarant's statement; or

(4) is unable to be present or to testify at the hearing because of death or then existing physical or mental illness or infirmity; or

(5) is absent from the hearing and the proponent of a statement has been unable to procure the declarant's attendance (or in the case of a hearsay

exception under subdivision (b)(2), (3), or (4), the declarant's attendance or testimony) by process or other reasonable means.

A declarant is not unavailable as a witness if exemption, refusal, claim of lack of memory, inability, or absence is due to the procurement or wrongdoing of the proponent of a statement for the purpose of preventing the witness from attending or testifying.

Practice Note: *In cases where a witness invokes her Fifth Amendment privilege, a common law privilege, refuses to speak, or has legitimately forgotten the subject matter of their prior statement, counsel may have to seek relief under the hearsay exceptions and not the impeachment rules. Be sure to check the applicable state rules to see if that jurisdiction has adopted a "necessity" or "catchall" hearsay exception.*

IV. COLLUSION BETWEEN PLAINTIFF AND THE CLIENT

Agreements whereby insureds consent or stipulate to judgments in exchange for a non-levy or non-execution agreement have various names depending on where the parties are located. Such agreements are often called "Damron," "Morris," or "Miller-Shugart" agreements. *Damron v. Sledge*, 105 Ariz. 151, 460 P.2d 997, 1001 (1969); *United Services Auto Ass'n v. Morris*, 741 P.2d 246 (Ariz. 1987); *Miller v. Shugart*, 316 N.W. 2d 729 (Minn. 1982). Such agreements are designed to reconcile the conflicting interests that arise between insureds and insurers when insurers defend under a reservation of rights or a non-waiver agreement. *Safeway Ins. Co., Inc. v. Guerrero*, 210 Ariz. 5, 9, 106 P.3d 1020, 1024 (2005).

Generally, insurers who provide their insureds with an unqualified defense are not bound by stipulated or consent judgments. *Hamilton v. Maryland Casualty Co.*, 27 Cal. 4th 718, 117 Cal. Rptr.2d 318, 41 P.2d 128 (2002) (*See also, State Farm Mut. Auto. Ins. Co. v. Peaton*, 168 Ariz. 184, 812 P.2d 1002 (Ariz. App. 1990) holding that where an insurer tendered its policy limits during the pendency of the action, its insured had the right to negotiate its excess exposure, but could not prejudice the insurer's right to control the defense by agreeing to a default judgment). However, where an insurer fails or refuses to provide an insured with a defense, or if the insurer defends under a reservation of rights, the insured is placed in a precarious position that some courts have held justifies acting reasonably to protect itself from a verdict in excess of policy limits, or a claim that might not be covered at all. *United Services Auto Ass'n. v. Morris*, 741 P.2d 246, 251 (Ariz. 1987) (*See also, Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982)).

Insurers which have refused to defend are generally bound by the determination of the insured's liability and the amount of damages. *1 Auto Liability Insurance*, §14:2 (2005). However, this determination does not bind the insurer on the issue of coverage, or factual determinations that bear on the issue of coverage (*for example, that the insured's conduct was the product of negligence and not*

intentional conduct). *Lodigensky v. American States Preferred Ins. Co.*, 898 S.W.2d 661 (Mo. Ct. App. W.D. 1995); *Morris*, 741 P.2d at 253. In *Sanderson v. Ohio Edison Co.*, the court held that: "[b]y abandoning their insureds to their own devices...the insurer voluntarily foregoes the right to control the litigation and, consequently will not be heard to complain...in the absence of fraud, even if liability is conceded by the insureds as a part of settlement negotiations." *Sanderson v. Ohio Edison Co.*, 69 Ohio St. 3d 582, 635 N.E. 2d 19, 24 (1994).

At least one court has recognized that, if insurers that deny coverage or defend under a reservation of rights aren't bound by a consent/stipulated judgment, they get two opportunities to escape liability. *Morris*, 741 P.2d at 251. One when they litigate the issue of the insured's liability, and another when they litigate the coverage issue. A victory on either suit allows insurers to escape liability. *Id.* For that reason, some courts have held that liability issues are not pertinent to coverage in the context of *Morris* agreements. Instead, they relate solely to whether the *Morris* agreement was reasonable and prudent. *Associated Aviation Underwriters v. Wood*, 209 Ariz. 137, 98 P.3d 572 (Ariz. App. 2004) (*See also, Patterson v. Tice*, 91 Ohio App. 3d 414, 632 N.E.2d 962, 966 (Ohio App. 1993) and *State Farm Mut. Auto. Ins. Co., Inc. v. Day*, 414 So. 2d 105 (Ala. Civ. App. 1982) holding that insurers are bound by findings of fact that create coverage to the extent they are material to findings which create liability on the part of the insured, but there is conflict as to whether they are bound by findings which were not essential or necessary to the judgment against the insured).

One commentator has reasoned that insurers should not be bound by determinations in a tort suit that were not fairly litigated. *1 Insurance Claims and Disputes 4th § 6:24*. Other commentators have argued that the absence of fair litigation as to an issue should be equated with collusion insofar as the insurer is concerned in *Morris* agreement situations. *Id.* The fact that an insured and a plaintiff go through the charade of an uncontested, or virtually uncontested, trial or motion for summary judgment should not alter this rule. *Id.* The Texas Supreme Court has held that "in no event" should an insurer be bound by a settlement an insured enters into with a plaintiff in exchange for a no-levy agreement be binding on the insurer prior to a fully adversarial trial. *State Farm Fire Cas. Co. v. Gandy*, 925 S.W.2d 696, 715 (Tex. 1996).

Courts have recognized that an insured being defended under a reservation of rights does not violate the cooperation clause in its policy when it enters into an unauthorized, reasonable settlement agreement to protect itself from financial ruin. The *USAA v. Morris* court held that, "an insurance carrier should not be allowed to insist upon exclusive control of the defense while reserving coverage issues...." *Id.* at 251-252 (citing, *Miller v. Shugart*, 316 N.W.2d 729, 733 (Minn. 1982)). Specifically, the *Morris* court held that:

an insured being defended under a reservation of rights may enter into [an unauthorized settlement] agreement without breaching the cooperation clause

regardless of policy language. The insurer's insertion of a policy defense by way of a reservation or nonwaiver agreement narrows the reach of the cooperation clause and permits the insured to take reasonable measures to protect himself against the danger of personal liability. Accordingly, we hold 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.

Morris, 741 P.2d at 252.

The *Morris* court tempered its holding by requiring that the settlement agreement the insured enters into be "reasonable and prudent", and be "made fairly, with notice to the insurer, and without fraud or collusion on the insurer." *Id.* at 252-53 (See also, *S.G. v. St. Paul Fire & Marine Ins. Co.*, 460 N.W.2d 639 (Minn. Ct. App. 1990)). The test for determining what is reasonable and prudent is "what a reasonably prudent person in the insured's position would have settled for on the merits of the claimant's case." (*This analysis involves evaluating the facts bearing on liability and damages, as well as the risk of going to trial*) *Id.* at 254. The insured bears the burden of proof on this issue. *Id.* at 253 (See also, *Guerrero*, 106 P.3d at 1024). The court reasoned that these requirements minimized the risk that an insured anxious to relieve itself of personal exposure would enter into almost any type of agreement or stipulation hoping to bind the insurer by judgment and findings of fact. *Id.* at 252-253. The court also recognized that if the insured successfully established that its unauthorized settlement satisfied these criteria, the insurer could still absolve itself of liability by prevailing on the coverage dispute. *Id.* at 254.

In *McLaughlin v. National Union Fire Insurance Co.*, 23 Cal. App. 4th 1132, 1154-1155, 29 Cal. Rptr.2d 496 (3d Dist. 1994), the California appellate court set forth some factors that justified allowing the plaintiff to proceed against the tortfeasor's insurer. These included:

1. the stipulation applied only to liability and the amount of damages, if any, was based on jury awards in test cases;
2. the parties only entered into the stipulated agreement after the trial court denied the insured's motion for summary judgment (i.e., triable issues of fact remained);
3. although the no-levy agreement eliminated the insured's personal exposure, the personal judgments still stood and could adversely affect the insured's future credit; and

4. the insurer knew of the underlying litigation and encouraged the insured to enter stipulations of liability with protective covenants.

Id. The events preceding the consent judgment are also important factors in determining whether the Morris agreement was reasonable. *John K. DiMugno, "Consent Judgments And Covenants Not to Execute: Good Deals Or Too Good To Be True? Part II: Practical Concerns About Collusion and Fraud", 25 No. 1, Insurance Litigation Reporter 5 (2003).*

Some courts have held that consent judgment arrangements that absolve insureds from further liability to the plaintiff eliminate the insurer's obligation to pay and are, in effect, releases. *Smith v. State Farm Mutual Auto. Ins. Co.*, 5 Cal. App. 4th 1104, 7 Cal. Rptr. 2d 131 (1st Dist. 1992); *Lancaster v. Royal Ins. Co. of America*, 302 Or. 62, 726 P.2d 371 (1986); *Huffman v. Peerless Ins. Co.*, 17 N.C. App. 292, 193 S.E.2d 773 (1973); *American Cas. Co. of Reading, Pa. v. Griffith*, 107 Ga. App. 224, 129 S.E.2d 549 (1963). However, most jurisdictions have held that Morris agreements do not alter an insurer's indemnity obligations and are enforceable. *1 Auto Liability Insurance 4th, §14:2.*

A slight majority of courts hold that consent judgments are presumptive evidence of the insured's liability, and that the insurer bears the burden of proving that the judgment is unreasonable or the product of fraud, collusion, or bad faith. *Coblentz v. American Sur. Co. of New York*, 416 F.2d 1059 (5th Cir. 1969); *Detroit Edison Co. v. Michigan Mut. Ins. Co.*, 102 Mich. App. 136, 301 N.W. 2d 832 (1980); *Shawnee Auto Service Center, Ltd. v. Continental Cas. Co.*, 782 F. Supp. 1503 (D. Kan. 1992). Florida, Kansas, and New Jersey require plaintiffs to make an initial showing of reasonableness that, if established, the insurer can rebut. *Steil v. Florida Physicians' Ins. Reciprocal*, 448 So. 2d 589 (Fla. 2d Dist. Ct. App. 1984); *Glenn v. Fleming*, 247 Kan. 296, 799 P.2d 79, 92-93 (1990); *Griggs v. Bertram*, 8 N.J. 347, 443 A.2d 163 (1982). Arizona, Connecticut, Iowa, Minnesota, North Dakota, Texas, and Washington place the burden of demonstrating the settlement's reasonableness on the plaintiff. *Morris*, 741 P. 2d at 253; *Black v. Goodwin, Loomis, & Britton*, 239 Conn. 144, 681 A.2d 293 (Conn. 1996); *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 535 (Iowa 1995); *Miller*, 316 N.W. 2d at 735; *Medd v. Fonder*, 543 N.W.2d 483, 495 (N.D. 1996); *Wilcox v. American Home Assurance Co.*, 900 F. Supp. 850, 853-56 (S.D. Tex. 1995); *Chaussee v. Maryland Cas. Co.*, 60 Wash. App. 504, 803 P.2d 1339 (Div. 1 1991). The test is objective and is generally limited to the facts known at the time of settlement. *Luria Bros. & Co., Inc. v. Alliance Assur. Co., Ltd.*, 780 F.2d 1082, 1091 (2d Cir. 1986); *Metropolitan Life Ins. Co. v. Aetna Cas. and Sur. Co.*, 249 Conn. 36, 730 A.2d 51, 61 (1999).

Courts should be reluctant to enforce Morris agreements in cases where the judgment is not subject to a sufficient degree of judicial scrutiny. *John K. DiMugno, "Consent Judgments And Covenants Not to Execute: Good Deals Or Too Good To Be True? Part II: Practical Concerns About Collusion and*

Fraud", 25 No. 1, *Insurance Litigation Reporter* 5 (2003). Some commentators perceive a pattern emerging between the degree of judicial scrutiny required and the breach that freed the insured to enter into the settlement in the first place. *Id.* (i.e., the burden on the party seeking to enforce the settlement is greater when the insurer breaches an implied duty [duty to settle] as opposed to an express duty [duty to defend]) (See also, *Besel v. Viking Ins. Co. of Wisconsin*, 49 P.2d 887 (Wash. 2002); *Truck Ins.Co. v. Vanport Homes, Inc.*, 58 P.3d 276 (Wash. 2002); *Hamilton v. Maryland Casualty Co.*, 27 Cal. 4th 718, 728, 117 Cal. Rptr.2d 318 (Cal. App. 2002)). Regardless of the breach involved, the more judicial scrutiny a Morris agreement receives, the less vulnerable it will be to a subsequent attack on the grounds of collusion, fraud, and unreasonableness. *John K. DiMugno*, 25 No. 1, *Consent Judgments And Covenants Not to Execute: Good Deals Or Too Good To Be True? Part II: Practical Concerns About Collusion and Fraud*, *Insurance Litigation Reporter* 5 (2003).

In *Lipson v. Jordache Enterprises, Inc.*, 9 Cal. App. 4th 151, 11 Cal. Rptr. 2d 271 (1st Dist. 1992), the appellate court refused to enforce a stipulated judgment based on a proceeding in which the trial court merely "rubber stamped" an agreement between the insured and the claimant designed to create coverage. *Lipson* started out as a breach of contract action between a salesman and his employer. Because there were no covered claims initially, the employer's insurer denied coverage and refused to defend. *Id.* at 154. Two days before trial, the plaintiff filed an amended complaint pursuant to an agreement with the insured. *Id.* This complaint added potentially covered claims (negligence and defamation). *Id.* The trial court held a 25 minute trial in which the salesman was the only witness. *Id.* The insured did not cross-examine the salesman. *Id.* Based upon this limited, uncontested evidence, the trial court rendered a \$100,000 verdict against the salesman on the negligence and defamation claims. *Id.* at 155. In its order refusing to enforce the judgment, the appellate court held that:

Clearly something seems amiss in the circumstances surrounding the 'trial': the last-minute stipulation to amend the complaint with new causes of action arguably covered by the policy and the extremely perfunctory trial itself with virtually no opposition from defendant. It appears that the trial was substituted for a stipulated judgment, in order to provide unchallengeable findings of negligence and defamation, with the aim of creating some form of policy coverage.

Id. at 158 (See also, *Rose v. Royal Ins. Co.*, 2 Cal. App. 4th 709, 715-716, 3 Cal. Rptr.2d 483 (2d Dist. 1991) holding that the "no action clause" in an insurance policy requires a judgment against the insured, not an "agreed result that happens to have been preceded by a trial." The *Rose* court quoted from a Texas appellate decision saying that, "[t]he term 'judgment after actual trial' presupposes 'a contest of issues leading up to final determination by court or jury, in contrast to a

resolving of the same issues by agreement of the parties; i.e., without a contest.") (*But see, Glenbrook Homeowners Ass'n. v. Scottsdale Ins. Co.*, 858 F. Supp. 986 (N.D. Cal. 1994) in which court enforced agreement after a 1 hour trial in which the insured did not present any evidence or cross-examine any witnesses).

The Alaska Supreme Court's decision in *Grace v. Insurance Company of North America* is an interesting example of how some courts determine whether to enforce a Morris agreement. *Grace v. Insurance Company of North America*, 944 P.2d 460 (Alaska 1997). That case arose out of a motorcycle accident that injured James Grace. *Id.* at 462. At the time of his accident, Grace was wearing a helmet manufactured by Bell Helmets (Bell). *Id.* The Graces claimed the helmet cracked on impact which allegedly compounded Grace's injuries. *Id.* The Graces sued Bell along with the seller of the helmet. *Id.* Bell had several layers of insurance coverage for this suit. It had a \$100,000 SIR with its primary insurer, Mission National Insurance Co. (Mission). It also had a first layer of excess coverage with Integrity Insurance Co. (Integrity). *Id.* Between its Mission and Integrity policies, Bell had \$5,000,000 in liability coverage. *Id.* Insurance Company of North America (INA) ostensibly provided coverage in excess of \$5,100,000 up to a maximum of \$15,100,000. *Id.* at 463. Mission and Integrity both became insolvent in 1987. *Id.* at 462.

The Graces offered to settle their suit against Bell for \$3,000,000. *Id.* at 463. Bell refused to spend any of its assets in excess of its \$100,000 SIR, tendered its defense to INA, and demanded that INA drop down and cover Mission's and Integrity's obligations. *Id.* INA refused to drop down and stated that its policy would "not respond until the underlying \$5 million coverages are spent, whether they are spent via insurance carrier's assets or are spent directly from the assets of Bell Helmet themselves." *Id.*

The seller settled confessed judgment in the Graces' favor based on an anticipated verdict of \$8,120,920. *Id.* With interest and attorney's fees, the final judgment exceeded \$15,000,000. *Id.* The seller assigned its rights to indemnification from Bell or its insurers to the Graces. *Id.* Bell did not enter into the settlement, and denounced it as unreasonable because it claimed that the Graces were "unlikely to prevail at trial, and even if [they] did, the amount of any judgment would be substantially less than \$15.6 million." *Id.* However, Bell reconsidered its opposition to such a settlement after its defense to the Graces' action was drawn into question. *Id.* Its policy with INA forbade it from settling the claim without INA's consent. *Id.*

INA filed a declaratory judgment action seeking a declaration that it had no obligation to provide any coverage in the Grace litigation. *Id.* The Graces counterclaimed seeking a declaration that INA had an obligation to pay all liabilities in excess of \$5,100,000 regardless of whether the underlying policy amounts were ever paid. *Id.* They also claimed that INA had a duty to drop down and provide Bell a defense. *Id.*

After INA filed its declaratory judgment action, Bell settled with the Graces for a confessed judgment of \$8,120,920. *Id.* With interest and attorney's fees, the final judgment amount exceeded \$17,000,000. *Id.* In return for the confessed judgment, the Graces agreed not to execute the judgment against Bell. *Id.* Despite INA's objection, the trial court found the settlement to be reasonable and made in good faith. *Id.* INA amended its complaint to allege that the settlement was the product of collusion. *Id.* On INA's motion, the trial court set aside Bell's attorney-client privilege to allow INA discovery pertinent to its collusion claim. *Id.*

The trial court ultimately ruled that INA was prejudiced by Bell's settlement as a matter of law, and that the settlement voided INA's coverage. *Id.* at 464. It granted summary judgment in INA's favor on its claims. *Id.* The Graces appealed claiming that, although Bell's settlement breached INA's cooperation clause, INA's breach excused Bell from that provision. *Id.* INA cross-appealed. *Id.*

The Supreme Court recognized that, if INA wrongfully refused to defend or indemnify Bell, Bell would not have to comply with the cooperation clause. *Id.* at 465. However, the court determined that INA had no obligation to drop down upon Mission's and Integrity's insolvency. *Id.* Therefore, it had no duty to defend Bell. *Id.* at 466. The court also held that INA had not breached its duty to settle the case within policy limits. *Id.* Specifically, the court held that:

. . .INA's failure to tender its policy limits did not present an obstacle to the settlement of this case within Bell's policy limits. Prior to the settlement, the Grace's highest demand was \$3,000,000. This amount fell short of INA's lower limit. Nevertheless, Bell refused that demand. Any risk that Bell would become subject to a verdict that invaded INA's coverage was due to Bell's refusal to settle for \$3,000,000, rather than INA's failure to make it possible for Bell to settle for an amount in excess of \$5,100,000....INA had no duty to evaluate the Grace's claim or to make its policy limits available for use in a settlement.

Id. at 466-467. Thus, it upheld the trial court's ruling on the issue of whether INA wrongfully refused to drop down, defend, and settle the Graces' claim.

The Supreme Court did, however, reverse and remand that portion of the trial court's order finding that INA had not breached its obligation to indemnify. *Id.* at 467. The court determined that a question of fact existed as to whether INA refused to honor its indemnity commitments until the underlying \$5,100,000 was actually paid as opposed to when Bell became legally obligated to pay it. *Id.* The court's instructions to the trial court were as follows:

If, on remand, the jury determines that INA did breach its obligation to provide excess coverage, the jury must consider the additional factual issues whether the settlement was reasonable and non-fraudulent. Only if the jury resolves these issues favorably to the Graces can the settlement be enforced against INA.

Id. at 467-468. Essentially, the court held that if INA first repudiated its obligations by wrongfully refusing to respond until \$5,100,000 was actually paid, and Bell's settlement was reasonable and non-collusive, INA would be bound by the settlement.

Several aspects of the *Grace* opinion are noteworthy. The court's opinion clearly indicates that an insurer that has not breached an implied or express duty to its insured is not bound by a consent judgment. INA also took a position adverse to its insured when it filed a declaratory judgment action during the pendency of the underlying litigation, and the court's opinion did not criticize or penalize INA for doing so. The court did not comment on the trial court's order setting aside Bell's attorney client privilege, which arguably supports an assertion that such orders are proper in cases involving Morris agreements. The opinion appears to require the insurer to breach or repudiate its obligations before an insured is relieved of its duty to cooperate. Unfortunately, the opinion does not address the effect of a defense under a reservation of rights.

The Alabama Supreme Court issued an opinion enforcing a Morris agreement in *Liberty Mutual Insurance Co. v. Wheelwright Trucking Co., Inc.*, 851 So.2d 466 (Ala. 2002). *Wheelwright* involved a claim by a trucking company against Dorsey Trailers (Dorsey) that trailers Wheelwright had purchased from Dorsey were defective and that Dorsey had misrepresented the trailers' capacities during negotiations with Wheelwright. *Id.* at 469. Dorsey put its insurance carriers on notice of the claim, and they denied Dorsey's demand for a defense and indemnity. *Id.* The insurers filed declaratory judgment actions seeking a declaration that their policies did not provide coverage to Dorsey for the claims at issue. *Id.* Dorsey then filed a bankruptcy petition, and the insurers filed motions for relief from the stay so that they could proceed with their declaratory judgment actions. *Id.* at 470.

Dorsey then reached a settlement agreement with Wheelwright and another party (hereinafter collectively referred to as "Wheelwright"). *Id.* Wheelwright filed a motion with the bankruptcy court seeking relief from the automatic stay and approval of a proposed order from the state court that incorporated the terms of the parties' settlement agreement. *Id.* The insurers objected to the form and contents of this motion on the ground that the proposed order contained language relating to the insurers' conduct that was not supported by any evidence. *Id.* All of the insurers' objections indicated that they did not object "to the entry of a proper order at the proper time relieving or modifying the stay of 11 U.S.C. § 362

for the purpose of the entry of a consent judgment as announced by the litigating parties...." *Id.*

Dorsey filed the proposed settlement with the bankruptcy court in a "Motion to Compromise and Settle Claim" (*hereinafter "Motion to Compromise"*), and served each of the insurers with a copy. *Id.* The relevant portion of the settlement provided that:

[t]o reduce potential claims against the bankruptcy estate and because it is unable to defend the Action, the Debtor has negotiated a resolution whereby the Debtor will agree to a Consent Judgment of \$2,500,000 in favor of the Plaintiffs in the Action. The amount of this Consent Judgment is substantially less than the potential liability for the Debtor at trial. In addition, the Plaintiffs have agreed to collect the Consent Judgment only to the extent that the Debtor's insurance provides coverage.

Id. The bankruptcy court held a hearing on Dorsey's motion, and none of the insurer's opposed it. *Id.* Thereafter, the court granted an order approving the Motion to Compromise and lifted all stays in the pending actions. *Id.*

The state court then entered a consent judgment against Dorsey for \$2,500,000. *Id.* This order expressly stated that Dorsey was not admitting to any intentional conduct. *Id.* at 471. Wheelwright immediately initiated garnishment proceedings against the insurers. *Id.* Despite the fact that the circuit court expressly acknowledged that "[t]he sole issue to be decided in these garnishments is whether any or all of the insurance contracts between Dorsey and the Insurers [and National Union] provide coverage for the judgment entered in this action..," the trial court denied the insurers' motions to dismiss or abstain from ruling in the garnishment proceedings. *Id.* (*Unfortunately, the opinion doesn't expound on this point. The insurers probably argued that the federal court was already deciding the issue of coverage in the declaratory judgment action.*) The circuit court granted summary judgment in Wheelwright's favor, specifically finding that the insurers were precluded from challenging the consent judgment because they failed to defend Dorsey, that there was no evidence of bad faith or collusion, that the insurers did owe Dorsey a defense, and setting forth each insurer's pro rata liability for the judgment. *Id.* at 471-472. The insurers appealed. *Id.*

On issues unrelated to the effectiveness of the Morris agreement, the Alabama Supreme Court reversed and remanded the trial court's order. *Id.* at 496-497. The court began its analysis by noting that under both Alabama and Georgia law, an insurer who has been given notice of an action against its insured, and an opportunity to defend or settle the action, is precluding from contesting the insured's liability in a subsequent action. *Id.* at 476. In these cases, the insured

need only show that the insurer was legally obligated to cover the claim and that the settlement was reasonable. *Id.* at 476. However in cases where the insurer is not afforded the opportunity to defend or settle the claim, the insured must prove actual liability to the plaintiff. *Id.* The court suggested the following practical guide for insureds to follow:

[a] practical device by which an indemnitee can protect against the awkward possibility of having to prove the original defendant, is to offer the indemnitor before any settlement is concluded the choice of (1) approving the settlement or (2) taking over the defense of the case and agreeing to hold the indemnitee harmless against him in excess of the amount of the proposed settlement. If the indemnitor approves the settlement or defends unsuccessfully against the original claim, the indemnitor cannot later question the indemnitee's liability to the original claimant. If the indemnitor declines to take either course, then the indemnitee will only be required to show potential liability to the original plaintiff in order to support his claim over against the indemnitor.

Id. (quoting, 41 Am.Jur.2d Indemnity § 46 (1995)).

Based upon this rationale, the Court found that the insurers had the right and opportunity to defend Dorsey in this case and refused to do so. *Id.* at 478. Unlike some courts in other jurisdictions, the Court also held that the distinction between rejecting the duty to defend and rejecting the right to defend was not material in this case. *Id.* at 491. In either circumstance, the insurers would be bound by Dorsey's consent judgment to the extent it was reasonable and entered into in good faith. *Id.* at 478.

The court rejected the insurers' argument that the agreement was per se collusive and that Wheelwright should bear the burden of proving it wasn't collusive. *Id.* at 479. Specifically, the court declined to adopt such a rule "...under the facts of this case...." *Id.* In support of its decision, the Court noted that the insurers had been informed of the consent judgment and its terms before it was entered and had ample opportunity to contest those terms before it was approved by the bankruptcy court. *Id.* The Court also found Wheelwright's evidence supporting damages of between \$3,000,000 and \$10,000,000 compelling. *Id.* Finally, the Court found that the insurers had expressly consented to the consent judgment in their objection to Wheelwright's motion for relief from stay which stated that they did not object to the entry of a proper order at the proper time for the purpose of entering a consent judgment. *Id.*

Another portion of the Court's opinion is noteworthy. *Id.* at 483. The Court rejected one insurer's assertion that the trial court erred when it refused to dismiss Wheelwright's garnishment proceeding because it claimed the writ of garnishment was a compulsory counterclaim to its declaratory judgment action pursuant to Fed.R.Civ.P. and Ala.R.Civ.P. 13(a). *Id.* (See also, *fn. 11* in which the Court states that the determination of whether a claim is a compulsory counterclaim is procedural and is not subject to the law of a sister state.) The Court found that, because the declaratory judgment action was filed five (5) months before Wheelwright's garnishment claim matured or was acquired, the garnishment proceeding was a permissive counterclaim. *Id.* at 484. Therefore, the trial court did not err when it allowed that claim to proceed in the state court action. *Id.*

The Texas Supreme Court has held that Morris agreements are unenforceable in cases where certain factors were present. *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 714 (Tex. 1996). The factors the *Gandy* court found compelling were that:

1. the insured assigned its claims against the insurer prior to an adjudication of the plaintiff's claim against the insured in a fully adversarial trial;
2. the defendant's insurer had tendered a defense; and
3. either the insurer had (a) accepted coverage or (b) made a good faith effort to adjudicate coverage issues prior to the adjudication of the plaintiff's claim.

Id. The court specifically stated that it was leaving open the question of whether an assignment would be invalid if one or more of these elements was lacking. *Id.* at 715. Despite the *Gandy* court's limitation on its holding, it unequivocally held that, "[i]n no event, however, is a judgment for plaintiff against defendant, rendered without a fully adversarial trial, binding on defendant's insurer or admissible as evidence of damages in an action against defendant's insurer by plaintiff as defendant's assignee. We disapprove the contrary suggestion *in dicta* in *Employer's Casualty Co. v. Block*, 744 S.W.2d 940, 943 (Tex. 1988) and *United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 954 (5th Cir. 1990)." *Id.*

Prior to analyzing *Gandy* and its progeny, a brief overview of Texas's law of insurance coverage is helpful. The duty to defend and the existence of coverage are separate and distinct issues under Texas law. *Costley v. State Farm Fire & Cas. Co.*, 894 S.W.2d 380, 385 (Tex. App. 1994). In Texas, insurers who "wrongfully" refuse to defend their insureds are precluded from insisting on compliance with certain policy conditions, as well as from collaterally attacking the reasonableness of an agreed judgment their insured entered into with a third

party. *St. Paul Ins. Co. v. Rahn*, 641 S.W.2d 276, 278 (Tex. App. 1982); *Transportation Insurance Co. v. Heiman*, 1999 WL 239917 at 3 (Tex. App.). When faced with the question of whether to defend a particular claim, Texas law affords insurers four (4) options:

1. completely decline to assume the insured's defense;
2. seek a declaratory judgment as to its rights and obligations;
3. defend under a reservation of rights or non-waiver agreement; or
4. assume the insured's defense without qualification.

Id. If an insurer assumes its insured's defense, without qualification and with knowledge of facts indicating that there may not be coverage, it waives all policy defenses and may be estopped from raising them. *Id.* (citing, *State Farm Lloyds, Inc. v. Williams*, 791 S.W.2d 542, 550 (Tex. App. 1990)).

Texas law recognizes that insurers who are called upon to provide their insured with a defense must be able to offer that defense without waiving defenses to liability it may have under the policy. *Costley*, 894 S.W. 2d at 385. An insurer who offers a defense subject to a reservation of rights does not breach its duty to defend. *Id.* at 4 (*See also, Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) (reservation of rights is proper if insurer has good faith belief that claims may not be covered); *American Eagle Ins. Co. v. Nettleton*, 932 S.W.2d 169, 174 (Tex. App. 1996) (insurer did not breach duty to defend by refusing to tender an unconditional defense); *First Gen. Realty Corp. v. Maryland Cas. Co.*, 981 S.W.2d 495, 501 (Tex. App. 1998) (offer to defend under reservation of rights did not constitute refusal to defend)). Consequently, an insurer who offers its insured a defense subject to a reservation of rights has not "wrongfully" refused to defend. *Id.* (*stating that a defense under a reservation of rights is not limited or incomplete*).

The plaintiff in *Gandy* alleged that her stepfather had sexually abused her over a three and a half year period. *Gandy*, 925 S.W.2d at 698. She sued her stepfather and her mother. *Id.* The stepfather initially hired an attorney, E. Ray Andrews, to represent him in his divorce proceedings, as well as the criminal and civil cases. *Id.* *Gandy's* mother hired another attorney, Melvin Bateman, to represent her in the divorce proceedings and the criminal and civil cases as well. *Id.* Bateman notified State Farm, which had issued a homeowner's policy to the stepfather. *Id.*

State Farm investigated the claim, determined that the claims might not be covered, and assumed the defense of both insured's (*i.e., stepfather and mother*) under a reservation of rights. *Id.* It wrote the stepfather, the mother, and the step

father's attorney informing them of the reservation of rights, that State Farm would be filing a declaratory judgment action to resolve the coverage questions, and that they would pay the attorney's fees for defending the stepfather in the interim. *Id.* at 699-700. Despite State Farm's agreement to pay his fees, Mr. Andrews never submitted an invoice to State Farm and never charged the stepfather for his work on the criminal matter. *Id.*

Gandy's mother fired her attorney and State Farm provided her with another. *Id.* Gandy's stepfather fired his attorney and hired another, Howard Pattison, but did not inform State Farm. *Id.* At first, the new attorney and the stepfather were not aware of State Farm's agreement to pay for his criminal defense. However, even after they discovered State Farm's letter in Andrews' file, they did not contact State Farm. *Id.*

After a hearing, Gandy's counsel offered the stepfather's counsel a Morris agreement. If the stepfather would consent to a judgment and assign his claims against State Farm, Gandy would agree not to collect the judgment from him. *Id.* Although the stepfather vehemently denied Gandy's allegations, he accepted the offer. *Id.* (*He would later testify that Gandy was "a liar" Id. at 704.*). State Farm was not informed of the offer or the stepfather's decision to accept it. *Id.*

The stepfather plead no contest to the criminal charges against him. *Id.* He also assigned his claims against State Farm to Gandy. *Id.* at 700-701. In his assignment, the stepfather claimed that State Farm had ignored his request for a defense and denied him a defense and/or coverage. *Id.* He and Gandy also executed an agreement whereby Gandy agreed not to execute on the judgment against the stepfather. *Id.* at 701-702.

The assignment and covenant not to execute (*both executed on December 29, 1991*) both refer to a signed judgment dated January 16, 1992 although it was not signed until that date. *Id.* at 702. State Farm got notice that Andrews was no longer representing the stepfather after December 29 and before the judgment was signed. *Id.* It contacted Pattison for a status update and was told that he had not had time to review the file and would call back. *Id.* He did not call State Farm back. *Id.* On January 16, 1992, the trial court entered a consent judgment containing the following pertinent provisions:

1. the court claimed to have taken formal, oral stipulations;
2. the stepfather "admitted" to sexually abusing his stepdaughter 325 times in a two year period ;
3. the stepfather conceded that Gandy's actual damages were \$12,500 per occurrence;
4. that Gandy was to be awarded \$4,062,500 in actual damages plus pre and post judgment interest;

5. that Gandy was to be awarded \$2,000,000 in exemplary damages with post judgment interest until paid in full;
6. that there was no fraud or collusion in the entry of the judgment; and
7. that the assignment and covenant not to execute were proper and did not affect the stepfather's legal liability to pay the judgment.

Id. at 702-703. Thereafter, Gandy non-suited her mother and another defendant to make the judgment final. *Id.* at 703.

Gandy then sued State Farm and her stepfather's initial attorney, Andrews. *Id.* She claimed State Farm was obligated to pay the judgment she and her step father agreed to, and she claimed damages as her stepfather's assignee because State Farm failed to defend him and failed to settle her claims against him. *Id.* Finally, she claimed that Andrews was State Farm's agent and that he negligently defended her stepfather. *Id.* The trial court granted State Farm's motion for summary judgment and found that it had no duty to defend or indemnify the stepfather. *Id.* at 704. However, it held that by volunteering to defend the stepfather, it had assumed a duty to do it properly and it allowed Gandy to try her claim for negligently handling her stepfather's defense. *Id.*

At trial, her stepfather insisted that, despite the consent judgment, he had never abused Gandy and that she was "a liar". *Id.* He also testified that he thought Andrews was State Farm's choice, and that he never understood that State Farm would pay for an attorney of his choosing. *Id.* He claimed to have called State Farm on numerous occasions to complain about Andrews, but State Farm had no record of those calls. *Id.* Andrews also testified on Gandy's behalf. Despite his deposition testimony that he had represented the stepfather in the divorce proceedings and that he was qualified to represent him in the civil case, he testified at trial that he did not represent the stepfather in the divorce proceedings and that he was not qualified to defend against Gandy's lawsuit. *Id.* Coincidentally, Gandy had non-suited her claims against Andrews a few minutes before trial. *Id.* An expert witness for Gandy testified that, had her stepfather's counsel been competent, the judgment against him would have been in the range of \$1.7-\$2.0 million. *Id.* The Texas Court of Appeals reluctantly affirmed the verdict.

The Texas Supreme Court began by criticizing the trial court and the process by which the judgment was determined. *Id.* at 703. It noted that despite the language in the judgment, the trial court had not taken "formal, oral stipulations". *Id.* Neither the parties nor their counsel appeared before the trial court in connection with the entry of the judgment. *Id.* In addition, the trial court did not have the assignment, the covenant not to execute, or any other evidence regarding

these documents at the time it entered the judgment. *Id.* Therefore, there was no basis for the trial court's finding that there was no fraud or collusion in the entry of the judgment or that these agreements were proper. *Id.* The court agreed with the Court of Appeals saying that, "[t]he court of appeals did not exaggerate when it called Gandy's agreed judgment against Pearce [the stepfather] 'a sham', or when it stated that the judgment 'perpetrates a fraud' and 'an untruth'." *Id.* at 713. The court held that Gandy's assignment from her stepfather of his rights against State Farm conveyed her nothing because it violated public policy. *Id.* at 698. It reversed the judgment against State Farm and rendered a judgment that Gandy take nothing. *Id.*

The court undertook an exhaustive analysis of why the law disfavors the assignment of chooses in action. *Id.* at 705-711. The court then focused on two particular evils inherent in Morris agreements. *Id.* at 711-712. First, these agreements tend to prolong litigation rather than end it. For that reason, the general rule of favoring settlements doesn't apply to these cases. *Id.* at 712. Gandy's counsel had acknowledged in testimony that the whole purpose of the settlement "was to find a way to recover against State Farm." *Id.* Second, these agreements greatly distort the litigation that follows by encouraging parties to take positions that are contrary to their natural interests. *Id.* Specifically, the court noted the following changes of position:

1. Gandy's lawyer had at one time testified that "a fair evaluation" of Gandy's damages was \$12,500 per instance of abuse. However, in his suit against State Farm for mis-handling the stepfather's defense, he claimed as damages the difference between the actual amount of the judgment and what the judgment would have been if State Farm had properly handled the claim. If he had continued to evaluate the damages at \$12,500 per instance, that amount would have been zero, so he had to revise his valuation of Gandy's claim downward.
2. Gandy had to assert in her suit against State Farm that her stepfather was not as liable as she had asserted in her initial case against him.
3. Prior to entering into the Morris agreement, the stepfather had steadfastly denied abusing Gandy. After entering into the agreement, he plead no contest to criminal abuse charges, agreed to a judgment saying he had abused her 325 times, and agreed to a judgment against himself of over \$6 million. In the case against State Farm, he once again denied abusing Gandy, and claimed he would have been exonerated if State Farm had provided

him with competent counsel. In Gandy's suit against him, he opposed her vigorously. In her suit against State Farm, he cooperated with her.

Id. Under these circumstances, the court had "...no hesitation in holding that the assignment was invalid." *Id.* at 713. The court specifically held, however, that it would not invalidate such an arrangement if the settlement followed a fully adversarial trial. *Id.* at 714.

The court then undertook a lengthy analysis of how to determine the true value of the plaintiff's claims absent a fully adversarial trial. *Id.* at 713-714. It compared and contrasted the methods other jurisdictions used to ascertain whether Morris agreements represent reasonable estimates of the value of the plaintiff's claims, and concluded that this analysis "...should ordinarily be avoided ... absent compelling reasons to the contrary." *Id.* at 719. In conclusion, the court stated:

[a]s we have said, we do not address whether an assignment is invalid when any element of the rule is lacking, such as when an insurer has not tendered a defense of its insured. Adjudication of an insurer's obligations before determination of the defendant insured's liability to the plaintiff removes the justification for a settlement like the one in this case in most instances. In no event should a judgment agreed to between plaintiff and defendant be binding on defendant's insurer. If an insurer's liability is to be litigated in an action by a plaintiff as a defendant's assignee after such a judgment is rendered, it should be done on the strength of plaintiff's claims rather than the generosity of defendant's concessions.

Id. (See also, *State Farm Lloyds, Inc. v. Williams*, 960 S.W.2d 781 (Tex. App. 1997) affirming a Morris agreement entered into after a fully adversarial trial between the plaintiff and the defendant.)

V. COLLUSION BETWEEN PLAINTIFF, A CO-DEFENDANT AND THE CLIENT

The 8th Circuit has actually held that "legal" collusion, as opposed to "ethical" collusion, exists as a matter of law where an insurer that is obligated to provide coverage and which provides a defense participates in an arrangement with the claimant and the insured for a stipulated judgment against the insured which is collectible only from another insurer which has denied coverage and the obligation to defend. *Koehnen v. Herald Fire Ins. Co.*, 89 F.3d 525 (8th Cir. 1996) (returning parties to their pre-agreement status upon a finding that the stipulated judgment was invalid); *Sargent v. Johnson*, 551 F.2d 221 (8th Cir.

1977). Joseph Koehnen filed suit against Rachel Paul, the daughter of divorced parents. *Koehnen*, 89 F.3d at 527. Although the divorce decree stated that Rachel's primary residence was in the state of Florida with her mother, she had lived in Minnesota with her father for a number of years at the time of the incident at issue. *Id.* While at her father's home, she hosted a party and served alcohol to under-age drinkers that assaulted and injured Mr. Koehnen. *Id.* Her father's insurer agreed to defend her under his homeowner's policy, but her mother's insurer refused to defend Rachel (*it did defend her mother*) because she was not an insured under the policy. *Id.* (*Presumably, the policy provided coverage to minor children living in the home*).

Without the mother's insurer's participation, Rachel and the plaintiff stipulated to the entry of a judgment in the amount of \$325,000.00 to be satisfied solely from insurance coverage available under her mother's policy. *Id.* The trial court entered a judgment in accordance with the parties' settlement, and Koehnen served a garnishment summons on the mother's insurer. The mother's insurer removed the garnishment complaint to federal court. *Id.* at 527-528. The Eighth Circuit Court of Appeals held that the settlement was collusive as a matter of law, and set aside the settlement. *Id.* at 530. It concluded that the litigating parties should be returned to the positions they held prior to the settlement. *Id.*

The court analyzed the Miller-Shugart Doctrine and noted that it was fashioned to protect insureds that were left to their own devices because their insurers refused to defend against a plaintiff's liability claim. *Id.* at 529. The court noted, however, that the mother's insurer had not left Rachel to her own defenses because she was defended by her father's insurer. *Id.* For that reason, the court held that this Miller-Shugart settlement was atypical. *Id.*

The court noted that in substance, the insurer that had agreed to defend Rachel shifted the entire risk that she might be liable to Koehnen to the mother's insurer, which had denied it was even obligated to defend her. *Id.* By the same token, the plaintiff had relinquished his right to collect anything from the father's insurer, which had admitted it had a duty to defend, in exchange for a stipulated judgment collectable only from a non-participating insurer, ". . . with a far more remote connection to the events in question." *Id.* at 529-530. The court specifically held that the agreement was not collusive in the ethical sense, because none of the attorneys failed to fairly represent their clients' interests. *Id.* The court found, however, that it was collusive in a legal sense because it deprived the mother's insurer of the right to participate in the settlement process even though Rachel was adequately defended by her father's insurer and did not require the protections of the Miller-Shugart Doctrine. *Id.*

VI. COLLUSION IN ARBITRATION

At one time, defendants thought arbitration was the solution to many of the problems associated with litigation. This new weapon was particularly potent for defendants who regularly faced claims from consumers. It didn't take long,

however, for the shortcomings of arbitration to become apparent. The procedures employed by arbitrators are often inconsistent. For instance, the amount and type of discovery permitted often varies widely because these issues are often left to the discretion of the arbitrator. They also have very wide latitude to determine the facts and the law, and are virtually without appellate oversight.

Arbitration also lends itself to collusive agreements among parties. For example, a party may bargain away their right to participate in the selection of the arbitrator to the claimant in exchange for a dismissal, a nuisance value settlement, or an agreement not to execute on the party's assets if a judgment is rendered against them.

Practice Note: *One of the ways to avoid this type of collusion is to use a recognized dispute administrator such as the American Arbitration Association or the American Health Lawyer's Association. Often, parties will mutually agree to ask an attorney to serve as arbitrator in an effort to avoid the higher filing fees associated with pursuing claims through these services. However, counsel must be wary of such agreements. Without the administrative support and somewhat formalized procedures these services provide, parties are very much at the mercy of the arbitrator they've selected. It is in these situations that the potential for collusion is at its highest. Another important step counsel can take is to make sure there is a transcript of the proceedings.*

The case of *Waverlee Homes, Inc. v. McMichael* provides an excellent example of collusion in arbitration. *Waverlee Homes, Inc. v. McMichael*, 855 So. 2d 493 (Ala. 2003). This appeal was from a judgment entered against the defendant confirming an arbitration award. *Id.* at 495-96. The defendant claimed the arbitrator was biased, and introduced evidence of collusion between the plaintiffs and the arbitrator. Although the court did reverse and remand the trial court's order entering judgment against the defendant, one striking feature of the opinion is the fact that the court doesn't even criticize the collusive conduct between the plaintiff and one of the defendants. *Id.* at 508.

The plaintiffs purchased a mobile home manufactured by Waverlee Homes, Inc. from a dealer, Holly Brook Homes, LLC. *Id.* at 494. They filed suit against Waverlee and Holly Brook seeking compensatory and punitive damages, alleging fraud, breach of express and implied warranties, and negligent/wanton construction, inspection, transport, and setup of the home. *Id.* The defendants filed motions to compel arbitration pursuant to a provision in the sales contract, and the trial court granted these motions. *Id.* at 495. The plaintiffs settled with the dealer for \$5,000 and proceeded with their claims against Waverlee. *Id.* The arbitrator refused to allow Waverlee to depose the plaintiffs or their experts prior to the hearing, and awarded the plaintiffs \$490,000 and assessed \$3,000 in costs against Waverlee. *Id.* Ironically, the largest estimate of the cost to repair the mobile home was the plaintiffs' expert who opined that it would cost between \$4,500 and \$5,500 to repair the home. *Id.* at 499. The trial court entered a

judgment based on the award, and Waverlee filed a post judgment motion to vacate the judgment which was denied. *Id.* Waverlee appealed, and the Alabama Supreme Court reversed and remanded the trial court's order with instructions. *Id.* at 508.

Waverlee alleged that the judgment was obtained by fraud and should be set aside. It introduced evidence that the plaintiffs counsel had written the following letter to the Alabama State Bar seeking an ethics opinion:

I represent a purchaser against a manufacturer and a seller of a mobile home. This case has been ordered to arbitration. The terms of the arbitration are that I pick one arbitrator, the seller picks one arbitrator and the two arbitrators together pick on arbitrator. Can I make an agreement with the seller that I will argue him out of the case or in the event a verdict is returned against them, either through a jury trial or an arbitration, I will never try to collect the judgment from his client? In return for this, I would be given the right to select his arbitrator.

Before I do anything, I want to know if this is unethical behavior. If this agreement is deemed ethical, do I have to inform the other parties to this case of the agreement? I thank you in advance and with warmest personal regards. I await your reply.

Id. at 496. The pertinent portion of the Bar's reply was:

[s]ince the scheme for selecting arbitrators is specified in an arbitration agreement and not fashioned by a particular order, there is nothing unethical in proceeding in the manner you have described in your letter. I trust the above is sufficient to answer your inquiry. If you have any further questions, please feel free to contact this office.

Id. at 497.

Waverlee also introduced evidence that the plaintiffs had objected to all of the potential arbitrators it had proposed, and that the dealer's counsel had suggested that the arbitrator that ultimately heard the claim was acceptable to him and the plaintiffs' counsel. *Id.* at 496. The dealer's counsel also stated that he wasn't aware of any relationship between the arbitrator it and the plaintiffs' counsel selected and plaintiffs' counsel. *Id.* According to Waverlee's evidence, the dealer's counsel said he thought the arbitrator had no prior adversarial relationship with the mobile home industry and would be fair to all parties. *Id.*

Waverlee's counsel gave an affidavit in support of its motion to vacate the judgment that the appellate court found significant. *Id.* at 497. In his affidavit,

Waverlee's counsel attested that the arbitrator failed to disclose any prior dealings with the plaintiffs' counsel despite having served as an arbitrator in at least three (3) other mobile home cases filed by the plaintiffs' counsel. *Id.* at 497-98. The arbitrator had ruled in favor of the plaintiffs in each of these prior cases, and awarded significant damages ranging from \$360,000 to \$590,000. In each case, as in the case at hand, the arbitrator also assessed \$3,000 in costs against the manufacturer. *Id.* at 498. Finally, Waverlee introduced evidence that the plaintiffs' counsel had attempted to make deals with counsel for dealers in other cases to select this particular arbitrator to decide the dispute. *Id.* at 498-99. Based upon this evidence, the court held that the trial court erred by not granting Waverlee an evidentiary hearing on its motion to vacate the judgment for bias. *Id.* at 508.

Although the opinion is pregnant with subtext, the court never directly addressed the collusive agreement between the plaintiffs, Waverlee's co-defendant, and the arbitrator. Instead the court focused its inquiry on whether Waverlee had presented sufficient evidence to warrant a hearing to determine if the award was due to be vacated pursuant to 9 U.S.C. §10(a). *Id.* at 503.

For other cases analyzing arbitrator bias, fraud, and/or collusion, the following opinions are instructive:

Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145, 89 S.Ct. 337, L.Ed.2d 301 (1968).

Sanko S.S. Co. v. Cook Industries, Inc., 495 F.2d 1260 (2nd Cir. 1973).

Middlesex Mutual Insurance Co. v. Levine, 675 F.2d 1197 (11th Cir. 1982).

Morelite Construction Corp. v. New York City District Council Carpenters Benefit Funds, 748 F.2d 79 (2nd Cir. 1984).

Health Services Management Corp. v. Hughes, 975 F.2d 1253 (7th Cir. 1992).

Schmitz v. Zilveti, 20 F.3d 1043 (9th Cir. 1994).

Lifecare International, Inc. v. CD Medical, Inc., 68 F.3d 429 (11th Cir. 1995).

Consolidation Coal Co. v. Local 1643, United Mine Workers of America, 48 F.3d 125 (4th Cir. 1995).

Gianelli Money Purchase Plan & Trust v. ADM Investor Servs., Inc., 146 F.3d 1309 (11th Cir. 1998).

University Commons-Urbana, Ltd. V. Universal Constructors, Inc., 304 F.3d 1331 (11th Cir. 2002).