No. 11-1474

In The Supreme Court of the United States

FARMERS INSURANCE COMPANY OF WASHINGTON and FARMERS INSURANCE EXCHANGE,

Petitioners,

v.

EMILY L. MORATTI, a minor, by and through her Guardian Ad Litem GERALD R. TARUTIS,

Respondent.

On Petition For A Writ Of Certiorari To The Washington Court Of Appeals, Division One

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF OF DRI – *THE VOICE OF THE DEFENSE BAR* IN SUPPORT OF PETITIONERS

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MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND AMICUS CURIAE BRIEF OF DRI – *THE VOICE OF THE DEFENSE BAR* IN SUPPORT OF PETITIONERS

Amicus curiae DRI – *The Voice of the Defense Bar* (DRI), an organization comprised of more than 22,000 attorneys, respectfully moves for leave to file the attached amicus curiae brief in this case. The consent of the attorney for petitioners has been obtained. The consent of the attorney for respondent was requested but refused.

The interest of DRI in this case arises from the fact that DRI is an international organization of civil defense attorneys that seeks to address issues of importance to defense attorneys and to improve the efficiency and fairness of the civil justice system. As such, DRI has a strong interest in securing a decision by this Court that the presumptions regarding covenant judgments applied by the Washington Court of Appeals in this matter deprive insurers of a fair hearing and are at odds with the most basic notions of due process.

Good cause exists for permitting this brief to be filed because DRI only recently learned of the pendency of the petition and promptly sought counsel to assist it in preparing the attached amicus curiae brief. However, by the time counsel was retained, the time for providing the requisite 10 days notice of intention to file an amicus curiae brief had passed. *See* Sup. Ct. R. 37.2(a). As soon as counsel was retained,

the parties were promptly notified of DRI's intention to file the attached brief. Specifically, counsel for respondent was notified on July 22, eight days before the brief's due date. Respondent has not been prejudiced by the delayed notice because the time to oppose the petition has been extended to August 24, 2012. Therefore, respondent will have adequate time to respond to the arguments raised in the attached brief.

DRI respectfully requests that this Court accept this amicus curiae brief because it demonstrates how this case involves an "important question of federal law" – specifically, the application of the due process guarantee of the Fourteenth Amendment to covenant judgments in state court – and further demonstrates that "compelling reasons" warrant the grant of certiorari here. *See* Sup. Ct. R. 10.

Respectfully submitted,

July 30, 2012

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INTEREST OF AMICUS CURIAE[1]

DRI is an international organization that includes more than 22,000 attorneys defending businesses and individuals in civil litigation. DRI is committed to enhancing the skills, effectiveness, and professionalism of defense attorneys. To this end, DRI seeks to address issues important to defense attorneys, to promote the role of the defense lawyer, and to improve the civil justice system. DRI has long been a voice in the ongoing effort to make the civil justice system more fair, efficient, and – where national issues are involved – consistent.

To promote these objectives, DRI participates as amicus curiae in cases raising issues of importance to its members, their clients, and the judicial system. This is just such a case because the Washington Court of Appeals' opinion works a deprivation of due process by giving preclusive effect to a covenant judgment negotiated between a policyholder and a tort claimant, and presuming that the agreed amount of such a "judgment" – which the defendant insurer

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[1] No counsel for a party authored this brief in whole or in part, nor did any person or entity, other than amicus or its counsel, make a monetary contribution to the preparation or submission of this brief. Counsel for the parties have been notified of amicus curiae DRI's intention to file this brief but have not received the 10 days notice set forth in Supreme Court Rule 37.2(a). Counsel for petitioners has consented to the filing of this brief. However, as explained in the accompanying Motion for Leave to File Amicus Curiae Brief, counsel for respondent Emily Moratti has refused to consent to the filing of this brief.

can do little to influence – is necessarily the amount of the policyholder's damages arising from the insurer's conduct. Due process requires that the illogical and counter-intuitive presumptions applied by the Washington courts be invalidated, and that the amount of an insurer's liability to its policyholder be determined fairly in an adversarial proceeding.

SUMMARY OF ARGUMENT

Under a "covenant judgment" like the one at issue, an insurance policyholder settles with a third-party tort claimant without its insurer's consent even though the insurer is providing the policyholder with a defense to the claimant's action. The policyholder agrees to the entry of an adverse judgment in excess of policy limits in exchange for the claimant's agreement not to execute the judgment against the policyholder. The policyholder then assigns its claims against its insurer for bad faith to the claimant.

As the petition demonstrates, the Washington Court of Appeals' opinion applies an improper state law presumption that violates an insurer's due process rights by conclusively presuming in the claimant's assigned action against the insurer that the amount of the negotiated covenant judgment is the amount of damages actually sustained by the policyholder as a result of the insurer's conduct. Under this Court's prior holdings, this presumption offends due process because it is not "necessarily or universally

true" that the amount of the covenant judgment is the amount of the policyholder's damages arising from the insurer's breach. Indeed, that is *never* the case because a covenant judgment, by definition, includes an agreement not to execute the judgment against the policyholder.

The related presumption applied by the Washington court, that the insurer's conduct necessarily caused damage to the policyholder, also violates due process because there is no reason that should be the case and, therefore, the presumption is arbitrary. The Washington Supreme Court has recognized that, given the nature of assigned bad faith actions following covenant judgments, the presumption is "almost impossible" to rebut. The presumption thus affords insurers no "fair opportunity to repel it."

Decisions by the Supreme Courts of California and Texas are squarely at odds with the presumptions endorsed by the Washington Supreme Court and applied in this case. Those decisions recognize that the fundamental due process problem with covenant judgments like the one at issue is that they do not result from any adversarial proceeding and instead arise from private negotiations between the policyholder and the tort claimant. Such negotiations are inherently unreliable because the tort claimant desires as large a judgment as possible, while the policyholder has no incentive to limit the award because the judgment will not be enforced against the policyholder. Thus, the California Supreme Court has held such "judgments" are not reliable evidence of the

policyholder's damages, and a defending insurer must be permitted to litigate its insured's defense of the underlying claims through an adversarial trial to judgment. The Texas Supreme Court has reached the same conclusion, holding that a judgment "rendered without a fully adversarial trial" is not binding against an insurer or even admissible as evidence "in an action against defendant's insurer by plaintiff as defendant's assignee."

Despite the cautionary words of the California and Texas high courts, covenant judgments have spread to other jurisdictions, several of which, like Washington, give the judgments preclusive effect. Absent review by this court, the most basic notions of due process will be eroded, and insurers will be denied their due process right to challenge the liability and damages findings embodied in potentially collusive judgments.

ARGUMENT

I. THE STATE LAW PRESUMPTIONS APPLIED BY THE WASHINGTON COURTS VIOLATE THE FOURTEENTH AMENDMENT'S DUE PROCESS GUARANTEE.

Washington's conclusive presumption that an insured is harmed in the amount of a covenant judgment agreed to between the insured policyholder and third-party tort claimant, and that the amount of such judgment is the measure of damages in a bad

faith action against the insurer, violates the Fourteenth Amendment's due process guarantee because it is not "necessarily or universally true" that a policyholder is damaged in the full amount of a covenant judgment he or she will never have to pay. *Vlandis v. Kline*, 412 U.S. 441, 452 (1973). Indeed, that presumption is *never* true because, as petitioners note, a covenant judgment includes a covenant that the claimant will not execute the judgment against the policyholder, and instead will seek to recover the full amount of the judgment only by suing the insurer for bad faith, as the policyholder's assignee. Pet. Cert. 11, June 4, 2012.

Washington's related presumption that the insurer's conduct has harmed the policyholder likewise violates due process because the presumption is "arbitrary" and denies the insurer "a fair opportunity to repel it." *W. & Atl. R.R. v. Henderson*, 279 U.S. 639, 642 (1929). While the presumption is technically rebuttable, the Washington Supreme Court itself has observed that, in fact, it is "almost impossible" for the insurer to rebut this presumption. *Mut. of Enumclaw Ins. Co. v. Dan Paulson Constr., Inc.*, 169 P.3d 1, 11 (Wash. 2007). The Washington Supreme Court has imposed this insurmountable burden on insurers only because, as a policy matter, it seeks to create a disincentive to insurers breaching their policies. *Id.* ("'[t]o hold otherwise would provide an incentive to an insurer to breach its policy'"). In effect, the courts are imposing a form of punitive damages without the due

process constraints that normally accompany such awards.

From the perspective of the defense bar, the fundamental due process problem with Washington's presumptions pertaining to covenant judgments is that they prevent a defending insurer's liability to its policyholder, and the amount of any resulting damages, from being determined fairly in an adversarial proceeding. *See Osorio v. Dole Food Co.*, 665 F. Supp. 2d 1307, 1347 (S.D.Fla. 2009), *aff'd sub nom. Osorio v. Dow Chem. Co.*, 635 F.3d 1277 (11th Cir. 2011) (state law presumptions should "provide guarantees that are essential to due process in any adversarial proceeding" because "without these basic guarantees a presumption deprives defendants of a fair process"). Instead, Washington's presumptions permit a policyholder and a third-party tort claimant to set an arbitrary, but conclusive, damages figure without any regard to the actual harm the insurer's conduct might, or might not, have caused. Under this skewed and unfair scheme, the claimant and the policyholder have no incentive except to agree on an exorbitantly high damages amount, which the claimant hopes to collect and which the policyholder – by virtue of a covenant not to execute – is certain never to pay. Indeed, the policyholder's incentive is to agree to as high a judgment as necessary to induce the claimant to agree to a covenant not to execute. The Washington scheme's inevitable effect is thus to encourage collusion and gamesmanship at the expense of insurers. *See* Justin A. Harris, Note, *Judicial Approaches to*

Stipulated Judgments, Assignments of Rights, and Covenants Not to Execute in Insurance Litigation, 47 Drake L. Rev. 853, 855 (1999) ("[W]here the provider has agreed to defend the insured, assignments of claims, following a stipulated judgment and a covenant not to execute, are fraught with an unjustified risk of fraud and collusion, and should be disallowed to protect the interests of providers").

The due process problems presented by Washington's presumptions are illustrated by the opinions of two state supreme courts, each of which has roundly rejected the approach adopted by the Washington Supreme Court in *Besel v. Viking Insurance Co. of Wisconsin*, 49 P.3d 887, 892 (Wash. 2002), and applied by the Washington Court of Appeals in this case. On facts analogous to those presented here, the Supreme Courts of California and Texas each have held that a covenant judgment like the one at issue should be ignored in determining the existence and amount of a defending insurer's actual bad faith liability to its policyholder.

In *Hamilton v. Maryland Casualty Co.*, 27 Cal. 4th 718 (2002), an insurer agreed to defend its insured in a personal injury lawsuit. After the insurer refused to settle within the policy limits, the policyholder and the claimant agreed to settle without the insurer's participation. *Id.* at 721-22. Under their settlement agreement, the policyholder agreed to entry of a stipulated judgment in excess of the policy limits and the claimant agreed not to execute on the judgment against the policyholder. *Id.* at 722. The policyholder

assigned to the claimant its cause of action against the insurer for breach of the duty to accept a reasonable settlement demand. *Id.*

On the insurer's appeal from the judgment in favor of the claimant on the assigned cause of action, the California Supreme Court held the claimant could not "maintain an action for breach of the duty to settle because, *in light of the settlement before trial and the covenant not to execute against the insured, the stipulated judgment is insufficient to prove that the insured suffered any damages from the insurer's breach of its settlement duty*." *Id.*, emphasis added; *id.* at 726 (the entry of a stipulated judgment "is insufficient to show, even rebuttably, that the insured has been injured to *any* extent by the failure to settle, much less in the amount of the stipulated judgment").

Echoing the due process concerns articulated in the petition, the court observed: "In these circumstances, *the judgment provides no reliable basis to establish damages resulting from a refusal to settle. . . .*" *Id.* at 726, emphasis added; *id.* at 731 ("The stipulated judgment in this case . . . carries no weight in the bad faith action"). The court explained the stipulated judgment was unreliable because it was the product of negotiation between the claimant and the policyholder, and not the result of any adversarial trial proceeding:

> No evidentiary hearing was held to determine [the policyholder's] liability; the settlement, of which the stipulated judgment,

> assignment and covenant not to execute were parts, was the product of negotiation, not fact-finding. . . . [The insurer] neither accepted nor opposed the settlement and, given an opportunity, could not have realistically opposed the settlement without risking further liability for acting against the interest of its insured. [¶] Under these circumstances, we need not find the stipulated judgment collusive in order to refuse it any weight or effect in the present action. A defending insurer cannot be bound by a settlement made without its participation and without any actual commitment on its insured's part to pay the judgment.

Id. at 730.[2]

The California Supreme Court emphasized – in stark contrast to Washington's approach – that there is no reason to deem the amount of a stipulated judgment to be the measure of damages for breach of an insurance policy or bad faith, because a policyholder who believes its insurer has acted unreasonably "has . . . other means of minimizing further injury to itself." *Hamilton*, 27 Cal. 4th at 732. For

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[2] The situation presented here and in *Hamilton*, in which the insurer has furnished a defense to its policyholder, is to be distinguished from the situation in which the insurer refuses to provide any defense. In the latter situation, the policyholder is usually free to obtain the best settlement it can and, in later litigation against the insurer, the amount of that settlement is deemed presumptive evidence of the extent of the insurer's liability. *See Hamilton*, 27 Cal. 4th at 728-29.

example, "if the claimant is willing, an exchange of an assignment and a covenant not to execute can be made before trial, eliminating the insured's personal exposure to an excess judgment." *Id.* But the court emphasized that a policyholder's efforts to limit its own liability in this fashion cannot come at the expense of an insurer's fundamental right to have the extent of its own liability reliably adjudicated in an adversarial proceeding: "'This assignment, however, is not immediately assertable, and it does not settle the third party's claim. *As long as the insurer is providing a defense, the insurer is allowed to proceed through trial to judgment.*'" *Id.*, emphasis added.

Hamilton thus holds a covenant judgment like the one at issue is inherently unreliable because it is the product of negotiation between the policyholder and the third-party claimant, neither of whom has an incentive to limit the insurer's liability. Under California law, an insurer who provides a defense is entitled to have the extent of its potential liability to its policyholder adjudicated in an adversarial proceeding consistent with due process. *Id.*; *id.* at 722 (a covenant judgment is "insufficient to prove that the insured suffered any damages" from the insurer's alleged breach of duty).

Similar concerns to those articulated in *Hamilton* caused the Texas Supreme Court to reach the same result in *State Farm Fire and Casualty Co. v. Gandy*, 925 S.W.2d 696 (Tex. 1996). There, the plaintiff sued her stepfather and mother, alleging the stepfather had sexually abused her over a period of years. *Id.*

at 697. The stepfather's insurer provided a defense under a reservation of rights. *Id.* The stepfather eventually settled with the plaintiff for an amount far in excess of the policy limits, without notifying his insurer. *Id.* at 698. The terms of the settlement were that the stepfather would stipulate to entry of a judgment in the plaintiff's favor and would assign his rights to sue the insurer for bad faith to the plaintiff, in return for the plaintiff's covenant not to execute on the judgment. *Id.*

In the plaintiff's action against the insurer on the assigned claim, the trial court held sexual abuse was intentional conduct not covered by the policy, but nonetheless entered judgment on a jury verdict finding the insurer had failed to conduct the stepfather's defense properly. *Id.* The Texas Supreme Court reversed, holding the stepfather's assignment of his claims was void as against public policy. *Id.* at 713 ("Without the assignment and covenant not to execute, the agreed judgment would never have been rendered. In these circumstances, we have no hesitation in holding that the assignment was invalid").

In reaching its holding, the court in *Gandy* noted that the intermediate appellate court "did not exaggerate," *id.*, when it pointedly observed that a covenant judgment, like the one at issue here, is "a sham" that "perpetrates a fraud" and "an untruth":

> 'The amount of the judgment in a case like this, where a covenant not to execute is given contemporaneously with and as a part of a

> settlement and agreed judgment, cannot constitute damage to the judgment debtor. Allowing an assignee of the named judgment debtor in such a case to collect all or part of the judgment amount perpetrates a fraud on the court, because it bases the recovery on an untruth, i.e., that the judgment debtor may have to pay the judgment. (Citations omitted.) Such a result should be against public policy, because it allows, as here, parties to take a sham (footnote omitted) judgment by agreement, without any trial or evidence concerning the merits, and then collect all or a part of that judgment from a third party. Allowing recovery in such a case encourages fraud and collusion and corrupts the judicial process by basing the recovery on a fiction.'

Id. at 705.

As in *Hamilton*, the Texas Supreme Court cited due process concerns in support of its holding. It noted that determining the value of an assigned chose in action is virtually impossible where, before trial, the defendant ceases to oppose the plaintiff and, instead, the parties collaborate to name a price. *Id.* at 698. And, like the California Supreme Court, *Hamilton*, 27 Cal. 4th at 732, the Texas Supreme Court noted that these concerns are obviated *only* where the value of the assigned claim is first determined by adjudication in an adversarial trial. *Gandy*, 925 S.W.2d at 714 ("[I]f the settlement follows an adversarial trial, the difficulties in evaluating *P*'s claim are no longer present. That value has been fairly

determined"); see also *id.* ("In no event . . . 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") (emphasis added); accord, *Glenn v. Fleming*, 799 P.2d 79, 92 (Kan. 1990) ("It would be highly unusual for fraud or collusion to taint the amount of the judgment when . . . the assignment/covenant is executed after a jury verdict").

II. REVIEW BY THIS COURT IS WARRANTED BECAUSE COURTS IN OTHER JURISDICTIONS HAVE BEGUN TO GIVE PRECLUSIVE EFFECT TO COVENANT JUDGMENTS IN DEROGATION OF DUE PROCESS.

The deprivation of due process that occurs when a court accords preclusive effect to a covenant judgment negotiated between a policyholder and a tort claimant is not a problem limited to the State of Washington. "Courts in many states . . . have held that when an insured and tort claimant enter into an agreed judgment and a covenant not to execute the judgment against the insured, the judgment can be enforced against the insurer if coverage is shown." *Midwestern Indem. Co. v. Laikin*, 119 F. Supp. 2d 831, 841 (S.D. Ind. 2000); Harris, *supra*, at 860 ("a judgment creating liability on the part of the insured, coupled with a covenant not to execute against the insured and the insured's assignment of its claims creates the procedure necessary for the plaintiff to

step into the shoes of the insured and bring suit directly against the provider in most jurisdictions").

In fact, despite the criticisms leveled against covenant judgments by the high courts of California and Texas, with some variations in approach, many jurisdictions give such "judgments" preclusive effect. *See Campione v. Wilson*, 661 N.E.2d 658, 662 (Mass. 1996) ("Neither the existence of claims against [the insured], nor their value . . . has been established and tested in full adversary proceedings. Nonetheless, we are reluctant to foreclose the possibility of settlement like the one entered into" by the insured and the tort claimants); *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 533 (Iowa 1995) ("Prejudgment assignments – like the one here – in return for covenants not to execute are not inherently collusive or fraudulent"); *United Services Auto. Ass'n v. Morris*, 741 P.2d 246, 253 (Ariz. 1987) (insurer's attempt "to relitigate all aspects of the liability case, including liability and amount of damages . . . would destroy the purpose served by allowing insureds to enter into [covenant judgments] because claimants would never settle with insureds if they never could receive any benefit"); *Griggs v. Bertram*, 443 A.2d 163, 174 (N.J. 1982) (a covenant judgment is enforceable "if it is reasonable in amount and entered into in good faith"); *Miller v. Shugart*, 316 N.W.2d 729, 735 (Minn. 1982) (insurer may be bound by stipulated judgment where claimant proves the amount of the settlement was reasonable and prudent); *Gray v. Nationwide Mut. Ins. Co.*, 223 A.2d 8, 12-13 (Pa. 1966). Review by this

court is therefore critical to prevent the sham covenant judgment process from working an ongoing deprivation of due process on a nationwide basis.

CONCLUSION

For the foregoing reasons, the petition for certiorari should be granted.

Respectfully submitted,

July 30, 2012

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