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SETTLING WITHOUT CONSENT: THE WHEN AND THE HOW

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A manufacturer has been sued in several toxic tort cases, its carrier is contesting coverage, but the underlying personal injury plaintiffs are willing to settle with the manufacturer for a reasonable amount. Can the manufacturer settle without its carrier's consent but maintain its right to seek reimbursement under its policy?

An insurer is defending an insured under a reservation of rights and receives notice that the insured intends to settle with the underlying plaintiff unless the insurer does so first. If the insurer declines, will the insurer be bound by this settlement if coverage is later found?

The answer to these two questions is maybe. Over the years, courts have become increasingly receptive to the enforcement of settlement agreements against insurers that never authorized the settlement. In some cases, the insured settled, paid the settlement amount, and sought reimbursement from the insurer. In other instances, the insured was never personally liable for the settlement amount. Instead, the terms of the settlement limited the source of the claimant's recovery to the applicable insurance policy and assigned the insured's rights against the carrier. Depending on the requirements of the particular jurisdiction, this type of settlement agreement may be accompanied by a stipulated judgment against the insured in the underlying lawsuit and a covenant not to execute. In either of these settlement scenarios, the enforceability of the settlement agreement against the insurer will ultimately hinge on the coverage positions of the parties, the terms and conditions of the settlement, and the law of the applicable jurisdiction. However, two issues arise in all of these cases: (1) whether the circumstances even allow for the possibility of an unauthorized settlement, and (2) even if they do, the extent to which the insurer is bound by the settlement agreement.

I. The When: In What Circumstances Can Insureds Settle Claims Without Consent of the Insurer, But Maintain The Possibility Of Coverage For The Settlement?

A standard right of the insurer under a liability policy is the power to control the defense of the insured, including control over settlements under the policy. Generally, where an insured enters into a settlement without the insurer's consent, the settlement violates a term of the policy, such as a "no action" clause or "cooperation" clause, and the insurer is not required to pay the settlement amount.

Over time, however, two exceptions to this general rule have emerged. The first and most commonly recognized exception entails the presence of a breach by the insurer of the duty to defend. As the Fifth Circuit Court of Appeals observed, "[i]t is well settled that once an insurer has breached its duty to defend, the insured is free to proceed as he sees fit; he may engage his own counsel and either settle or litigate, at his option." *Rhodes v. Chicago Ins. Co., a Div. of Interstate Nat'l Corp.*, 719 F.2d 116, 120 (5th Cir. 1983); *see also Taylor v. Safeco Ins. Co.*, 361 So. 2d 743, 746 (Fla. Ct. App. 1978)(noting that the court was "aware that many authorities speak of the insured's privilege to effect a reasonable settlement, payable by the insurer upon a finding that insurance existed, as arising upon the insurer's unjustified refusal to defend" (emphasis added). As a consequence, a reasonable settlement by the insured after

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a breach of the duty to defend will usually bind the insurer. *Rhodes*, 719 F.2d at 120 ("An additional consequence of a breach of the duty to defend is the inability to enforce against the insured any conditions in the policy; the insured is no longer constrained by 'no action' or 'no voluntary assumption of liability' clauses. A consequence of breach, therefore, is that an insurer who wrongfully fails to defend its insured is liable for any damages assessed against the insured, up to policy limits, subject only to the condition that any settlement be reasonable."(internal citations omitted)); *Losser v. Atlanta Int'l Ins. Co.,* 615 F. Supp. 58, 61 (D. Utah 1985) ("We join with other courts that have reviewed this issue in holding that where, as here, the insurer refuses to defend on a claim against the policy, and the insured enters into a good faith agreement not deemed to be in the best interests of the insurer, the insurer has assumed the risk that it may be bound to the terms of the agreement.").

While the defendant insureds have a duty to cooperate with the insurer, they also have a right to protect themselves against plaintiff's claim.

The second, less prevalent exception is the "reservation-of-rights" exception. Under this exception, in certain circumstances, the insured can enter into a reasonable settlement without consent where the insurer has not breached its duty to defend, but has reserved its right to deny coverage. In these situations, if coverage is later found, the settlement may nonetheless bind the insurer notwithstanding the presence of a cooperation clause or other policy condition precluding unauthorized settlements. *United Servs. Auto Ass'n v. Morris,* 154 Ariz. 113, 119, 741 P.2d 246, 252 (1987) (observing that "[a]n insurer that performs the duty to defend but reserves the right to deny the duty to pay should not be allowed to control the conditions of payment" and the insurer's "insertion of a policy defense by way of reservation or non-waiver agreement narrows the reach of the cooperation clause"); *Insurance Co. of N. Am. v. Spangler*, 881 F. Supp. 539, 544 (D. Wy. 1995) (citing, with approval, cases allowing the "reservation-of-rights" exception to the prohibition against unauthorized settlements). As a rationale for this exception, one court has stated:

> . . . While the defendant insureds have a duty to cooperate with the insurer, they also have a right to protect themselves against plaintiff's claim. If, as here, the insureds are offered a settlement that effectively relieves them of any personal liability, at a time when their insurance coverage is in doubt, surely it cannot be said that it is not in their best interest to accept the offer. Nor, do we think, can the insurer who is disputing coverage compel the insureds to forego a settlement which is in their best interest.

Miller v. Shugart, 316 N.W.2d 729, 733 (Minn. 1982). However, even where courts recognize the "reservation-of-rights" exception, they often limit the insured's ability to settle without consent. First, prior to accepting a settlement offer, the insured must give notice to its insurer so the insurer may participate in the settlement. *Morris*, 154 Ariz. at 119, 741 P.2d at 252 (notice to the insurer of the settlement is required); *Spangler*, 881 F. Supp. at 545 (discussing the notice requirement to insurers). Second, according to some courts, an unauthorized settlement under the "reservation-of-rights" exception will only bind the insurer if the insurer acted unreasonably in rejecting the claimant's offer. As the Iowa Supreme Court explained,

> At the point in time that the insurer is faced with a fair and reasonable settlement demand that a reasonable and prudent insurer would pay, the insurer must either abandon its coverage defense and pay the demand or lose its right to control the conditions of settlement. If the insurer prefers to debate coverage and, accordingly, refuses to pay the settlement demand, the insured is free to either pay the settlement demand or stipulate to the entry of judgment in the amount of the demand. The insurer, if found to have coverage, will be liable for the insured's settlement if the settlement is found to be fair and reasonable.

Kelly v. Iowa Mut. Ins. Co., 620 N.W.2d 637, 644-45 (Iowa 2000); *see also Babcock & Wilcox Co. v. American Nuclear Insurers*, 131 A.3d 445, 462 (Pa. 2014) (finding that a fair and reasonable settlement reached by an insured while the insurer reserved rights can bind the insurer "where an insured accepts a settlement offer after an insurer breaches its duty by refusing the fair and reasonable settlement while maintaining its reservation of rights and, thus, subjects an insured to potential responsibility for the judgment in a case where the policy is ultimately deemed to cover the relevant claims."). Finally, some courts seemingly restrict the "reservation-of-rights" exception to situations where the insurer's reservation of rights created a conflict of interest between the insured and insurer, and this conflict required the insurer to relinquish control over the defense of the underlying case to the insured. *See*, e.g., *Commonwealth Edison Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 323 Ill. App. 3d 970, 983-85, 752 N.E.2d 555, 566-67 (1st Dist. 2001); *Cay Divers, Inc. v. Raven*, 812 F.2d 866, 870 (3rd Cir. 1987) (finding that "when a complaint, or a part of it, in an action against an insured is arguably within the scope of the insurance coverage, an insurer's discharge of its duty to defend by providing independent counsel, even though reserving the right to contest coverage, relieves it of control over the litigation, and a reasonable settlement effectuated by the insured does not bar an action for indemnification against the insurer."

II. The How: Even If The Insured Can Settle Permissibly Without Consent, Under What Circumstances Does It Bind The Insurer?

Even where an insured can settle without consent, the insured's power to bind the insurer is not unfettered. Rather, requirements exist to protect insurers from abuse, fraud, and collusion. Indeed, in these situations, the risk of collusion between the insured and the underlying claimant can be acute, particularly where the insured will not be personally liable under the settlement agreement. As the Arizona Supreme Court noted, "[p]ermitting the insured to settle with the

claimant presents a great danger to the insurer." *Morris*, 154 Ariz. at 119, 741 P.2d at 252. This is because, "[t]o relieve himself of personal exposure, the insured may be persuaded to enter into almost any type of agreement or stipulation by which the claimant hopes to bind the insurer by judgment and findings of fact." *Id*. at 119-120, 741 P.2d at 252-253. Consequently, even where they are permissible, courts often will enforce unauthorized settlements against insurers only if (1) they settle claims covered under the applicable policy, and (2) the settlement is reasonable and prudent. *See*, e.g., *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 535 (Iowa 1995); *United States Gypsum Co. v. Admiral Ins. Co.*, 268 Ill. App. 3d 598, 625-26, 643 N.E.2d 1226, 1244 (1st Dist. 1994).

While the burden to prove coverage and reasonableness usually falls on the insured, the burden to prove fraud or collusion falls on the insurer.

The party bearing the burden to prove coverage and reasonableness can vary among jurisdictions. However, most jurisdictions addressing this issue have imposed this burden on the insureds or the underlying claimants (who may be seeking recovery from the insurer through an assignment). *See Red Giant Oil Co.*, 528 N.W.2d at 535; *Gainsco Ins. Co. v. Amoco Prod. Co.*, 53 P.3d 1051, 1071-1072 (Wy.S.Ct. 2002). However, where the insurer has breached the duty to defend, some jurisdictions impose the obligation to prove that the settlement was unreasonable onto the insurer. *See,* e.g., *Pruyn v. Agricultural Ins. Co.*, 36 Cal.App.4th 500, 530, 42 Cal.Rptr.2d 295 (2nd Dist. 1995) (where the insurer breached its duty to defend, the settlement agreement is presumptive evidence of the insurer's liability and, in order to overcome this presumption, the insurer has the burden to prove that the agreement was unreasonable or the product of fraud or collusion). The placement of the burden on the insureds or claimants has been justified on two grounds. First, from a practicality and fairness perspective, the insured and/or the claimant are the ones who agreed to the settlement in the first place and likely have superior access to facts and information regarding reasonableness. *Guillen v. Potomac Ins. Co.*, 203 Ill.2d 141, 163-64, 785 N.E.2d 1, 14 (2003). Second, particularly where the settlement involves an assignment of rights and a covenant not to execute, the imposition of the burden of proof on the insureds or the claimants reduces the risk of fraud and collusion. *Id*. at 163, 785 N.E.2d at 14. Nonetheless, even where the insureds have the burden of proof, in a contested proceeding, the insurer still has the right to present its own evidence contesting reasonableness or showing the presence of fraud or collusion. *Guillen*, 203 Ill.2d at 164, 785 N.E.2d at 14. While the burden to prove coverage and reasonableness usually falls on the insured, the burden to prove fraud or collusion falls on the insurer. *See Red Giant Oil Co.*, 528 N.W.2d at 535.

A. Settlement Must Be For Covered Claims.

An unauthorized settlement normally cannot bind the insurer unless the insured first shows that the settlement resolved a claim that was covered under the applicable policy. *See*, e.g., *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 535 (Iowa 1995); *United States Gypsum Co. v. Admiral Ins. Co.*, 268 Ill. App. 3d 598, 625-26, 643 N.E.2d 1226, 1244 (1st Dist. 1994). Such a rule makes sense. Even if allowed, the right to settle without consent is not a right to transfer liability for uncovered claims onto the insurer.

The application of this principle in practice, however, may not be so straightforward. Circumstances giving rise to the right to settle without consent often involve cases with both potentially covered and uncovered claims. But, the ensuing settlement agreement between the injured party and the insured may be for an unallocated lump sum. Courts have addressed this problem in different ways. Some place the burden on the insurer to prove that particular amounts of the settlement can be allocated solely to claims that are not even potentially covered by the policy. Others place the burden on the insured to prove that the amounts sought were for settlement of potentially covered claims under the applicable policy. *See Santa's Best Craft, LLC v. St. Paul Fire & Marine Ins. Co.*, 611 F.3d 339, 351-52 (7th Cir. 2010) (discussing the different ways that courts approach unallocated settlements where both covered and uncovered claims are implicated); *Shawnee Auto Serv. Ctr., Ltd. v. Continental Cas. Co.*, 782 F. Supp. 1503 (D. Kans. 1992) (Where the settlement agreement allocated the entire settlement amount to a covered negligence claim, the insured met its prima facie burden of establishing coverage, and insurer bore the burden of proving collusion or bad faith. The insurer did not meet is burden of proof and was, therefore, bound by the allocation set forth in the settlement agreement).

Other courts still, such as the court in *Federal Ins. Co. v. Binney & Smith, Inc.*, 393 Ill. App. 3d 277, 913 N.E.2d 43 (1st Dist. 2009) have taken hybrid approaches. In *Binney*, the defendant manufacturer was sued in a class action alleging that it had sold toxic crayons containing trace levels of asbestos fibers and was responsible for breach of implied warranties and consumer fraud. After the manufacturer's insurer filed a declaratory judgment action contesting coverage, the manufacturer settled the class action. In the ensuing coverage litigation, the insurer argued that the settlement amount must be allocated between covered claims (the consumer fraud claims) and uncovered claims (warranty claims). *Id.* at 288-289, 913 N.E.2d at 53-54. The Illinois Appellate Court declined the insurer's request to require allocation. Instead, the court held that "an allocation between covered and non-covered claims was unnecessary where the [insured or its assignees] demonstrated the primary focus of the underlying litigation was a covered loss and settled in reasonable anticipation of that litigation." *Id*. at 289, 913 N.E.2d at 53-54 (citing, with approval, *Commonwealth Edison Co. v. National Union Fire Ins. Co.*, 323 Ill. App.3d 1970, 752 N.E.2d 555 (2001)).

B. The Settlement Agreement Must Be Reasonable And Prudent

Before it binds the insurer, courts typically require that the settlement between the claimant and the insured is reasonable and prudent. *See*, e.g., *Red Giant Oil Co*., 528 N.W.2d at 535; *Miller*, 316 N.W.2d at 735; *Guillen*, 203 Ill 2d at 163, 785 N.E.2d at 14; *Amoco Prod. Co.*, 53 P.3d at 1071; *Morris*, 154 Airz. at 120-21, 741 P.2d at 253-54. According to some courts, this test involves an analysis of "what a reasonably prudent person in the insureds' position would have settled for on the merits of the claimant's case," which involves an evaluation of "the facts bearing on the liability and damage aspects of claimant's case, as well as the risks of going to trial." *Morris*, 154 Ariz. at 121, 741 P.2d at 254 (emphasis in original). The criteria used by courts when applying these principles can vary by jurisdiction. *Amoco Prod. Co.*, 53 P.3d at 1070 (noting that there are "many views" on what is required to prove reasonableness of a settlement); *Guillen*, 203 Ill. 2d at 163, 785 N.E.2d at 14. However, conceptually, the "reasonably prudent insured" test can be broken into two components: (1) the reasonableness of the decision to settle and (2) the reasonableness of the settlement amount. *Guillen*, 203 Ill. 2d at 163, 785 N.E.2d at 14

While the reasonableness analysis may vary across the different courts, this analysis acts as a safety measure to limit the perils of fraud and collusion.

With respect to the decision to settle, one should focus on "whether, considering the totality of the circumstances, the insured's decision 'conformed to the standard of a prudent uninsured.'" *Id., see also Amoco Prod. Co.*, 2002 WY 122; 53 P.3d 1051. When evaluating whether a "reasonably prudent uninsured" would have settled, the question "becomes whether the hypothetical defendant would reasonably choose to devote a portion of its assets to litigate (or at least threaten to litigate) certain issues designed to eliminate or, at a minimum, circumscribe its liability for the claims asserted." *Central Mut. Ins. Co. v. Tracy's Treasures, Inc.*, 19 N.E.3d 1100, 1115-1116(Ill.Ct.App,, 1st Dvi. 2014). And, when conducting this analysis, one should "assume that the defendant is not on the brink of bankruptcy." *Id.* at 1116. Rather, one should "posit that the uninsured defendant has assets sufficient to satisfy a substantial judgment and that it must weigh whether those assets are best put to use litigating certain issues that could lower the value of the case or whether an early settlement, presumably at a discount, is more advantageous." *Id.*

When evaluating the reasonableness of the settlement amount, one should consider "'what a reasonably prudent person in the position of the [insured] would have settled for on the merits of plaintiff's claim.'" *Guillen*, 203 Ill. 2d at 163, 785 N.E.2d at 14 (quoting *Miller*, 316 N.W.2d at 735). When assessing the reasonableness of the amount and determining whether a settlement is collusive, the analysis "is guided by a 'commonsense consideration of the totality of facts bearing on the liability and damage aspects of plaintiff's claim.'" *Tracy's Treasures, Inc., supra.* at 1119. A number of factors can be considered, including:

- The amount of the overall settlement in light of the value of the case;
- A comparison with awards or verdicts in similar cases involving similar injuries;
- The facts known to the settling insured at the time of the settlement;
- The presence of a covenant not to execute as part of the settlement; and
- The failure of the settling insured to consider viable available defenses.

Tracy's Treasures, 18 N.E.3d at 1119-1121; *Guillen*, 203 Ill. 2d at 163, 785 N.E.2d at 14 (noting that the insurer's concern about collusion was "well taken"); *Babcock & Wilcox Co.*, 131 A.3d at 462 ("a determination of whether the settlement is fair and reasonable necessarily entails consideration of the terms of the settlement, the strength of the insured's defense against the asserted claims, and whether there is any evidence of fraud or collusion on the part of the insured").

Concluding Remarks and Observations

Courts addressing this topic find themselves in a thorny balancing act. On one hand, binding insurers to an unauthorized settlement is a derogation of the insurer's contractual rights under their policies because such settlements erode the meaning and value of certain policy provisions, such as "no action" clauses and "cooperation" clauses. Unauthorized settlements also expose insurers to the potential risk of fraud, collusion, and abuse. On the other hand, courts recognize that insureds have a right to sensibly protect themselves where their insurers have acted unreasonably, particularly where the insurer has breached its policy obligation to defend.

The case law discussed above reflects the different ways that courts have attempted to strike the right equilibrium for this balancing act. Not surprisingly, courts feel most comfortable binding insurers to unauthorized settlements where the insurer has breached its duties under the terms and provisions of the policy. Where the insurer has not breached its obligations, but has only reserved rights to deny indemnity, courts appear more reluctant to recognize an ability to bind the insurer through an unauthorized settlement, at least not without narrowing the scope of the insured's power to do so.

Similarly, even where an unauthorized settlement may bind the insurer, courts have adopted safeguards to reduce the dangers to insurers endemic in this scenario. For instance, in many jurisdictions, even where the insurer has breached its policy, an unauthorized settlement will not bind the insurer unless the settlement agreement reasonably settled claims covered under the policy. While the reasonableness analysis may vary across the different courts, this analysis acts as a safety measure to limit the perils of fraud and collusion.