INSURED AND CLAIMANT COLLABORATION: INSURER RECOURSE AND STRATEGIES

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I. Introduction

Every insurer has at some point faced a situation in which it knows or suspects that its insured has collaborated with a third-party claimant in order to influence the availability of insurance coverage for the claims against it. While such conduct may seem wholly improper to the insurer, the reality is that the law tolerates a certain degree of collaboration, particularly in cases where the insurer has refused to defend. This paper will identify some of the standards and defenses that insurers and their counsel must bear in mind when faced with one of these situations.

II. Effect of Refusal to Defend

Liability insurance policies generally reserve to the insurer both the right and duty to defend the insured in suits by third parties. The purpose of such provisions, in part, is to preserve in the insurer the right to exclusive control over the litigation. *Hooper v. Zurich American Ins. Co.*, 552 N.W.2d 31, 36-37 (Minn. App. 1996) (insured's failure to give sufficient notice of lawsuit prejudiced the insurer by depriving it of opportunity to control litigation); 14 *Couch on Insurance 2d* § 51:35 (rev. ed. 1982). One reason for retaining the right to exclusive control of the defense is the prevention of collusion between a claimant and an insured. Couch at § 51:131. An insurer that refuses to defend provides its insured with both the motive and opportunity to engage in collusive conduct through the insured's control of the defense and settlement of the claim.

In addition to practical issues of control, an insurer's refusal to defend its insured may impact the insurer's legal right to challenge the subsequent conduct of the insured. Courts have held that an insurer that denies coverage and refuses to defend its insured may have limited recourse against the insured who thereafter acts to minimize its uninsured exposure through agreements with a third-party claimant. Most notably, in *Brownsdale Cooperative Assoc. v. Home Ins. Co.*, 473 N.W.2d 339 (Minn. App. 1991), the court held that:

> "[The insurer's] breach of its duty to defend released [the insured] from its reciprocal duty to cooperate with [the insurer] and left 'the entire control and conduct of the litigation with [the insured]. Accordingly, [the insured] was entitled to protect itself from personal liability by entering a reasonable, good faith settlement without notifying [its insurer]."

This rule derives, in part, from the seminal Minnesota case *Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982), in which the Minnesota Supreme Court states: "[i]f a risk is to be borne, it is better to have the insurer who makes the decision to contest coverage bear the risk." *Id.* at 734.

III. Fraud and Collusion

The closer the insured's conduct comes to actionable fraud or collusion, the better the insurer's chances are of defeating coverage based on such conduct. Some courts have held that an insurer has no recourse against an insured for collaborative conduct absent proof of fraudulent intent. *St. Paul Fire & Marine Ins. Co. v. Perl*, 415 N.W.2d 663, 667 (Minn. 1987) (duty to indemnify for settlement upheld where insurer did not reserve right to consent to settlement and there was no intent to defraud); *Miller v. Shugart*, 316 N.W.2d 729, 734 (Minn. 1982) (money judgment confessed to by an insured is not binding on the insurer if obtained through fraud or collusion).

The degree of fraud or collusion required to avoid coverage under an insurance policy based on an insured's collaboration with a claimant is not well developed. Under Minnesota law, the elements of actual fraud are:

(1) a representation;
(2) the representation must be false;
(3) the representation must deal with past or present fact;
(4) the fact must be material;
(5) the fact must be susceptible of knowledge;
(6) the representer must know the fact is false or assert it as of his own knowledge;
(7) the representer must intend to have the other person induced to act or justified in acting upon it;
(8) the other person must be induced to act or justified in acting;
(9) that person's actions must be in reliance upon the representation;
(10) that person must suffer damages;
(11) the misrepresentation must be the proximate cause of injury.

Davis v. Re-Trac Mfg. Corp., 276 Minn. 116, 117, 149 N.W.2d 37, 38 (1967) (adopting *Hanson v. Ford Motor Co.*, 278 F.2d 586, 591 (8th Cir.)).

However, the Minnesota Supreme Court has acknowledged that fraud is "a protean legal concept, assuming many shapes and forms." *Florenzano v. Olson*, 387 N.W.2d 168, 172 (1986).

There are no Minnesota cases defining "collusion" in the insurance coverage context. Black's Law Dictionary defines "collusion" as:

> An agreement between two or more persons to defraud a person of his rights by the forms of law, or to obtain an object forbidden by law. It implies the existence of fraud of some kind, the employment of fraudulent means, or of lawful means for the accomplishment of an unlawful purpose.

Black's Law Dictionary (6th ed. 1990).

The difference between actionable fraud and mere "fraud in the air" may ultimately depend upon the nature of the representations made to the insurer by the insured. An insured is more likely to suffer some consequence for its collaborations with a claimant where it fails to disclose such conduct to its insurer when asked. For this reason, an insurer should be timely and thorough in requesting information from its insured.

In evaluating an affirmative defense of collusion, insurers should understand that collusive actions taken by an insured to merely ensure the recovery of insurance benefits properly due and owing from an insurer may not rise to the level of actionable collusion, as the purpose of such conduct is arguably "lawful." For example, under Minnesota law, courts have found that where an insurer refuses to defend a government-mandated cleanup action on the grounds that there is no "suit," the insured's actions in encouraging an adjacent property owner to file suit against the insured seeking the same relief in order to trigger coverage may not violate the insuring agreement where the insurer wrongfully refused to defend the government action in the first instance. Generally speaking, only in those cases where the insured conspires with a claimant to manufacture or enhance coverage for an otherwise uncovered claim may a court be willing to find collusion sufficient to defeat coverage.

IV. Breach of the Duty to Cooperate

Another potential basis for defeating a claim for coverage developed through collusive conduct between the insured and claimant is the duty to cooperate. Liability policies typically include, as a condition to coverage, a provision requiring the insured to cooperate with the insurer. The typical "cooperation" clause states:

> The insured shall cooperate with the company and, upon, the company's request, assist in making settlements, in the conduct of

> suits…; and the insured shall attend hearings and trials and assist in securing and giving evidence and obtaining the attendance of witnesses.

In *Juvland v. Plaissance*, 96 N.W.2d 537 (Minn. 1959), the court described the purpose of the cooperation clause:

> It is a material part of the policy … designed to afford the insurer an opportunity to defend, and to protect it against possible collusion between the insured and persons claiming covered damages, and in the absence of waiver or estoppel, a substantial breach of such provision resulting in the prejudice to the insurer, will relieve it of responsibility for both the insured and the injured parties.

Id. at 541-542. Other cases applying the cooperation clause have held that a breach of the clause may be established through evidence that the insured conspired in bad faith to secure a recovery that was not otherwise justified by the facts. *Preferred Risk Mutual Ins. Co. v. Peterson*, 179 F.Supp. 652, 656 (D. Minn. 1959) (where the claimant and insured "corruptly conspired to work together to secure a recovery not justified by the facts, then there has been a breach of the cooperation clause which may void the policy at the option of the insurer.")

Thus, under *Juvland* and its progeny, the elements of a defense for breach of the cooperation clause are: (1) that the insured was attempting to secure an insurance recovery beyond that to which it would otherwise be entitled; and (2) the insurer was materially prejudiced in its ability to contest the merits of the case by the insured's non-cooperation.

Insureds tend to interpret the cooperation clause narrowly, contending that it only applies to situations where the insurer has in fact accepted the defense, thereby necessitating the insured's cooperation in order to defend the claim and prevent the imposition of false damages. Other cases, such as *Elliot v. Metropolitan Casualty Ins. Co. of New York*, 250 F.2d 680 (10th Cir. 1957), suggest that the insured's duty to cooperate can be violated by conduct occurring outside of the actual defense of a lawsuit.

V. <u>Collusive Settlements</u>

The right of an insured to enter into a settlement with an underlying claimant on terms that set up a claim against its insurer is well established under Minnesota law. Minnesota law generally permits agreements in which a defendant admits liability and consents to having a judgment entered against it on the express condition that the claimant will satisfy the judgment only out of proceeds from the defendant's insurance instead of proceeding against the defendant personally. *Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982).

In *Miller v. Shugart*, the Minnesota Supreme Court held that an insured that was abandoned by its insurer had the right to consent to entry of judgment against it in return for plaintiff's releasing the insured from personal liability. An insurer under these circumstances is generally bound by the settlement of its insured so long as the settlement was reasonable and was not obtained by fraud or collusion. The situation is somewhat analogous to the use of loan receipts between an insured and insurer to facilitate subrogation and recoveries against other parties. Courts generally justify those arrangements on the well-established principle that parties are free to contract in any lawful manner. *NAD, Inc. v. Eighth Judicial District*, 976 P.2d 994, 997-98 (Nev. 1999).

Minnesota cases in which insureds were found to violate the *Miller-Shugart* doctrine through collusive settlements include the following:

- In *St. Paul Fire and Marine Insurance Co. v. Green Lake State Bank*, 2000 WL 228408 (Minn. App.) the court affirmed the trial court's finding that the underlying settlement was the product of collusion where the plaintiff, as a condition of its settlement with the insured, agreed to file an amended complaint adding claims for wrongful eviction and belittlement in an attempt to trigger coverage that did not exist under the claims as previously pled. The insured's lawyers in that case actually drafted the amended complaint.

- In *Independent School District No. 197 v. Accident & Casualty Insurance Co. of Winterthur*, 525 N.W.2d 600 (Minn. App. 1995) the court held there was a question of fact as to collusion where the insured confessed judgment for $18 Million, assigned its insurance claims and advanced the plaintiff $9 Million to prosecute its claims, and provided plaintiff with its national counsel at no cost.

- In *Burbach v. Armstrong Rigging and Erecting, Inc.*, 560 N.W.2d 107 (Minn. App. 1997), the court held that a settlement under which the insured and one of its insurers settled with the claimant, who agreed to only seek recovery from a second insurer, was not a valid *Miller- Shugart* settlement and therefore unenforceable.

VI. Breach of the Duty of Good Faith and Fair Dealing

Collusion between an insured and claimant may also give rise to a claim or defense of breach of the duty of good faith and fair dealing.

Many jurisdictions recognize a reciprocal duty of good faith running between an insured and insurer. In *Kaiser Foundation Hospitals v. North Star Reinsurance Corp.*, 90 Cal.App.3d 786, 153 Cal. Rptr. 678 (1979), the court held that the insured's position that it had the exclusive power to determine dates of loss, however detrimental such determination may be to its insurers, "simply

does not square with the covenant of good faith and fair dealing which forms a part of every insurance contract." The court observed:

> "The covenant is not a one-way street but requires that neither party, not the insured, nor the insurer, will do anything to injure the right of the other to receive the benefits of the agreement."

Kaiser, 153 Cal.Rptr. at 682. The application of bad faith doctrine to collusive conduct is supported by the Seventh Circuit decision in *Lockwood International v. Volm Bag Company, Inc*, which recognized that "[t]he duty of good faith is read into every insurance contract,... in order to prevent opportunistic behavior by the contracting party that has the whip hand." 273 F.3d 741, 745 (7th Cir. 2002).

Examples of insured bad faith conduct may include misrepresentation, concealment, secretiveness, lack of serious damage negotiations, attempts to affect the coverage, and attempts to harm the insurer's interests. *See*, Steven R. Schmidt, *The Bad Faith Setup*, 29 Tort & Ins. L. J. 705-721 (1994).

VII. Conclusion

In deciding whether to accept or refuse a tender of defense, a liability insurer must understand the implications the latter decision may have on its ability to prevent and challenge future collusion by its insured. An insurer that suspects that its insured's claim is the product of fraud or collusion should act diligently to establish an evidentiary basis for its potential defenses and plead such defenses with specificity in any ensuing coverage action. Failure to fully commit to and support collusion-based defenses at the outset of a case will impact an insurer's ultimate opportunity for success on those grounds.

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