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Insurance Policy Language Used to Challenge Consent Judgments with Covenants Not to Execute

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A tricky situation faced by insurers is challenging consent judgments coupled with covenants not to execute. An insured's desire to protect his or her personal assets makes entering into a covenant not to execute, and thereby settling without the consent of the insurer, compelling.[1] "The claimant's willingness to give the insured a covenant not to execute against the insured's assets is what makes settling without the insurer's consent so enticing to the insured."[2] If not for the protection afforded by the covenant, there would hardly be any reason for an insured to enter into such an agreement, which generally will require the entry of a judgment establishing liability against the insured, and typically the assignment of the insured's rights against his or insurer to the claimant, including breach of contract and bad faith claims.[3]

Given the potential liability faced by insurers, not only for the amount of the judgments but for potential breach of contract and statutory and common law bad faith claims, the question becomes what, if any, policy language can be used to attack these consent judgments with covenants not to execute? One theory that insurers have used to attack covenants not to execute is the "legally obligated to pay" language contained in most liability policies.[4]

The rationale behind this theory is that the insurer is not liable for the consent judgment because the insured, having executed the covenant not to execute, is no longer legally obligated to pay any amount to the claimant. As discussed below, only a minority of jurisdictions have accepted this argument. Furthermore, the minority rule has been overturned in some jurisdictions where it formerly controlled, evidencing a trend against this position.[5]

Minority Approach: Covenant Not to Execute Is a Release

In a minority of jurisdictions, insurance companies have successfully argued that consent judgments with covenants not to execute constitute a form of release, and therefore, the insured was no longer "legally obligated to pay" the judgment, a necessary condition under the policy to trigger the insurer's duty to indemnify.[6] In other words, because the insured is not legally obligated to pay the judgment, they have not sustained a loss under the terms of the policy.[7]

The leading case on the minority approach is *Freeman v. Schmidt Real Estate & Insurance, Inc.*[8] In *Freeman*, the insured settled an automobile collision suit with the claimant, and as part of that

settlement, assigned his rights against the insurance agent, insurance agency, and insurance company to the claimant, confessed judgment and entered into a covenant not to execute on the judgment.[9] The claimant subsequently brought a suit against the agent, agency, and insurance company for breach of the duty to procure insurance for the insured.[10] Based on its predictions of how Iowa courts would rule,[11] the Eighth Circuit Court of Appeals determined that an insurance policy places no obligation on the on the insurer to pay because an insured protected by a covenant not to execute had no compelling obligation to pay, *i.e.* was not "legally obligated to pay" anything to an injured party. Therefore, because the insured did not suffer any damages, the claimant received no enforceable rights through the assignment.[13]

Majority Approach: Covenant Not to Execute Is a Contract

In the majority of jurisdictions that have considered the "legally obligated to pay" language, a covenant not to execute constitutes a contract, rather than a release, and the insured's tort liability remains, as well as the insurer's obligation to indemnify its insured.[14] Because the covenant not to execute merely operates as an agreement not to collect, rather than a release of liability, the insured remains legally obligated to pay, and the insurer must provide coverage under the policy.[15]

As previously stated, courts have been moving towards the majority rule by overturning prior precedent applying the minority rule. For example, in the recent case of *Brownstone Homes Condominium Association v. Brownstone Forest Heights, LLC*,[16] the Oregon Supreme Court overruled prior precedent[17] that had adopted the minority view. In so doing, the court recognized that its previous decision in Stubblefield was erroneous when it concluded that a covenant not to execute obtained in exchange for an assignment of rights effects a complete release extinguishing an insured's liability, as well as the insurer's liability.[18] The court held that the language "legally obligated to pay" was ambiguous, and therefore, was to be construed against the insurer.[19]

Although it has never addressed the issue directly, the Kentucky Supreme Court found the majority viewpoint persuasive when ruling on a similar issue in *Associated Insurance Service, Inc. v. Garcia*.[20] In *Garcia*, the claimants suffered grievous injuries after a wheelchair lift malfunctioned and crushed their legs when they were in the process of disembarking from a dinner cruise on the Star of Louisville (the "Star").[21] The claimants filed suit against the Star, whose marine insurer provided a defense under a policy with $1,000,000 limit of liability for amounts that the Star "shall have become legally liable to pay and shall have paid" to the claimants.[22] When the marine insurer became insolvent and unable to satisfy any judgment against the Star, the claimants and the Star agreed to arbitrate the dispute, and the Star agreed to arbitrate the amount of damages within a stipulated range, admit to liability, and assign any and all claims it had against the insurance agent and brokers who obtained the coverage to the claimants in exchange for the claimants' forbearance from collecting any judgment from the Star.[23]

In analyzing the validity of the assignment, the court considered the merits of the insurance agent and brokers' claims that because the assignment had no legal effect, as the Star suffered no damages because the agreement insulated it from damages, it had no valid claim to assign.[24] In so doing, the court considered the majority and minority viewpoints from other jurisdictions, and found the majority viewpoint's distinction between a covenant not to execute and a release to be persuasive.[25] The court held that the assignment was valid because where "liability is not completely extinguished, the assignment is valid because the tortfeasor is still subject to some amount of liability."[26] Thus, if presented with the issue of the meaning of "legally obligated to pay" within the scope of a covenant not to execute and consent judgment, the Kentucky Supreme Court would likely follow the majority approach.

It is important to note that several jurisdictions have distinguished between releases and covenants not to execute. For example, the Iowa Supreme Court firmly held in *Red Giant Oil Co. v. Lawlor*,[27] that a covenant not to execute is a contract and not a release, such that the insured would have a remedy against the claimant if the claimant attempted to collect against him. Therefore, because the insured's tort remedy remains, and he is still legally obligated to the claimant, the insurer "must still make good on its policy promise to pay, if there is coverage."[28] However, in *Clock v. Larson,*[29] the Iowa Supreme Court distinguished *Red Giant*. In *Clock*, the claimant was injured when she fell from an unprotected catwalk in a barn.30 The insurer provided a defense under a policy with $100,000 of liability coverage.[31] The insured claimed that he requested his agent to obtain a $1,000,000 umbrella liability policy with the insurer, but no policy was ever obtained.[32] The insurer provided a defense for the insured after the claimant brought suit against him; however, the insured still sued his agent and insurer for breach of contract and negligence for failure to procure the requested coverage.[33]

The claimant and the insured settled the underlying tort action, and under the terms of the agreement, the insured agreed to pay the claimant $110,000, the majority of which was paid by the insurance company, and assign his interest in the lawsuit against the insurer, in exchange for the claimant's agreement not to pursue any claim against the insured arising from the accident.[34] The claimant then attempted to proceed with the insured's lawsuit against the insurer as the insured's assignee.[35] The court recognized that *Red Giant* was different for two reasons: 1) the insurer in *Red Giant* had refused to provide a defense; and 2) the settlement in *Clock* was a release, as the claimant had agreed not to bring any other legal action against him.[36] Therefore, other than a small amount of the settlement paid by the insured to the claimant directly, there was no liability remaining on behalf of the insured.[37]

Conclusion

As these cases demonstrate, attempts to argue that the insurer is not "legally obligated to pay" following an insured's execution of a covenant not to execute with a consent judgment have been relatively unsuccessful. It is important to note, however, the different results that occur when comparing a full release with a covenant not to execute.

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1 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 INS. LITIG. REP. 5 (Jan. 5, 2003).

2 *Id.*

3 *Id.*

4 Justin A. Harris*, Judicial Approaches to Stipulated Judgments, Assignments of Rights, and Covenants Not to Execute in Insurance Litigation,* 47 DRAKE L. REV. 853, 858–59 (1999).

5 *Id.*

6 Sharon D. Stuart & Ashley L. Crank, The Tried, The True, and the New Defenses to Claims of Bad-Faith Failure to Settle, DRI FOR DEF., 60 No. 5 DRI FOR DEF. 56 (May 2018).

7 Employment Practices Liability Insurance Still in Infancy, But Maturing Dynamically, BNA Employment Discrimination Report, Vol. 11 No. 17 (1998).

8 755 F.2d 135 (8th Cir. 1985).

9 *Id.* at 136.

10 *Id.*

11 In *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 532 (Iowa 1995), the Iowa Supreme Court adopted the majority viewpoint, holding that covenant not to execute was an agreement, or contract, rather than a release, which left the insured still liable, and therefore “legally obligated” to the plaintiff.

12 *Id.* at 138.

13 *Id.*

14 Plitt & Plitt, *supra* note 6.

15 Stuart & Crank, *supra* note 7.

16 363 P.3d 467 (Or. 2015).

17 *Stubblefield v. St. Paul Fire & Marine*, 517 P.2d 262 (Or. 1973).

18 *Brownstone Homes*, 363 P.3d at 246.

19 *Id.* at 245.

20 307 S.W.3d 58 (Ky. 2010).

21 *Id.* at 59-60.

22 Id. at 60.

23 Id.

24 Id. at 64.

25 Id. at 64-65.

26 Id. at 66.

27 528 N.W.2d 524, 532-33 (Iowa 1995).

28 Id.

29 564 N.W.2d 436 (Iowa 1997).

30 Id. at 437.

31 Id.

32 Id.

33 Id.

34 Id.

35 Id.

36 Id. at 438.

37 Id.

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