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Insurer Not Liable for Excess Default Judgment Where Claimants and Insureds Colluded by Falsely Declaring the Insureds Had No Prior Knowledge of the Claim

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Applying California law, the United States District Court for the Northern District of California has held that an insurer that breaches its duty to defend is not bound by an excess default judgment where the undisputed facts show that the underlying claimants and the insureds colluded by agreeing to a judgment amount that was vastly inflated from the original demand and by falsely declaring that the insureds had no knowledge of the claim prior to the inception date of their errors and omissions insurance policy. *Carlson v. Century Surety Co.*, 2012 WL 601707) (N.D. Cal. Feb. 23, 2012).

The underlying claimants listed their home for sale with the insured real estate firm. After a potential sale fell through, the purchaser and the homeowners signed a document pursuant to which the purchaser agreed to release a $1,000 deposit. The next day, the homeowners returned to the firm's offices and stated that they had signed the deposit papers in error, and that they actually wanted $5,000. After it became clear that the $1,000 had never been deposited into escrow, the homeowners filed suit against the insured, demanding over $65,000 in damages.

The firm's professional liability insurer denied defense and indemnity coverage for the underlying lawsuit based on the prior knowledge condition in the policy. The insurer based its denial on the contents of the firm's file, and specifically on a pre-inception-date letter from the homeowners to the firm indicating that the homeowners might file a $65,000 claim against the firm. The letter was attached to a certificate

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of service stating the document was sent by mail prior to the policy's inception, but that (i) did not confirm that postage was affixed to the letter and (ii) incorrectly stated the name of the firm. The firm's principal responded to the denial of coverage by claiming that she did not recall receiving the letter prior to the policy's inception and requesting reconsideration. The carrier denied coverage again without further investigation.

The homeowners and the firm ultimately entered into a settlement agreement pursuant to which the insureds agreed to allow a default judgment to be taken against them in exchange for a promise by claimants not to file a writ of execution on the judgment. The firm also assigned all of their claims against the carrier to the homeowners. The trial court then entered a default judgment in favor of the homeowners in the amount of $3.33 million dollars.

In the coverage litigation that followed, the court first held that the carrier had breached its duty to defend because, by virtue of the firm's denial of having received the homeowner's letter prior to the policy's inception, the insureds had satisfied their burden to show the *potential* for liability. The court further held, however, that it was not unreasonable for the insurer to have relied on the "mail presumption" and the certificate of service to conclude that the insured had, in fact, received the pre-inception-date letter. Thus, although its denial was incorrect, the insurer had not violated the implied covenant of good faith and fair dealing.

Turning to the issue of damages, the court held that even though the carrier had no bad faith tort liability, the carrier's contractual liability was not necessarily limited to the policy's $500,000 limits. Rather, the court held that a carrier can be liable for all detriment proximately caused by a breach of the contractual duty to defend, including excess settlements or judgments—except where such judgments or settlements are the product of fraud or collusion.

Based on the evidence offered by the insurer (and the homeowners' ineffective attempts to rebut such evidence), the court concluded that the insurer met its burden to prove, by a preponderance of the evidence, that the settlement agreement was collusive and thus non-binding. Among other things, the court found collusion based on: (i) the deposition testimony by the firm's principals and other documentary evidence indicating that the insureds knew that the homeowners might file a lawsuit against the firm prior to the policy's inception; (ii) the evidence showing that although both the firm and the homeowners recognized that the prior knowledge condition in the policy had not been satisfied, they nonetheless conditioned the settlement agreement on the firm's principals providing "satisfactory" sworn declarations stating that they were unaware of the homeowners' claim prior to the policy's inception; and (iii) the "skyrocket[ing]" of the homeowners' claimed damages from approximately $70,000 to a $3.3 million default judgment. The court ordered additional briefing by the parties on whether the homeowners are entitled to *any* damages as a result of the carrier's breach of the duty to defend.