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# The Arizona Supreme Court Considers The Preclusive Effect of Damron Agreement Stipulations On Subsequent Coverage Disputes

By: Jeff Collins

In *Quihuis v. State Farm Mut. Aut. Ins. Co.*, 748 F.3d 911 (9th Cir. 2014), the Ninth Circuit Court of Appeals recently certified a question to the Arizona Supreme Court that could have a significant impact on insurance law in the state. *Quihuis* involves a coverage dispute. The coverage litigation arose out of the Quihuises' tort claim against State Farm's insureds, the Coxes, following an automobile accident. The Quihuises alleged that the Coxes negligently entrusted their car to the driver. State Farm denied coverage to the Coxes because evidence outside the tort complaint showed the Coxes had actually sold the automobile to the driver prior to the date of the accident. The Coxes argued that State Farm had a duty to defend them because there were disputed facts that could lead to a conclusion that the Coxes still owned the automobile and, therefore, were covered for the negligent entrustment claim.

As a result of State Farm's coverage disclaimer, the Coxes entered into a *Damron* agreement with the Quihuises. The Coxes consented to a default judgment against them and executed an "Assignment of Rights, Agreement Not to Execute." Importantly, in the agreement, the Coxes admitted that they owned the automobile on the date of the accident, and that admitted fact was essential to the finding of liability against the Coxes in the subsequent judgment. The Quihuises, as assignees, then sued State Farm for indemnification and breach of the duty to defend. State Farm removed the case to federal court.

State Farm moved for summary judgment in the coverage case, arguing that the stipulated default judgment did not preclude State Farm from litigating the question of whether the Coxes owned the automobile at the time of the accident. The district court agreed, granting State Farm summary judgment. The Quihuises appealed to the Ninth Circuit. The Ninth Circuit acknowledged that, based on the undisputed evidence, the Coxes were not the owners of the automobile at the time of the accident. But in considering the preclusive effect of the default judgment, the court perceived a conflict in the Arizona cases regarding whether an insurer who declines to defend its insured can be estopped from raising a coverage defense in a subsequent action based upon a default judgment entered pursuant to *Damron*. The Court therefore certified the following question to the Arizona Supreme Court:

> Whether a default judgment against insured defendants that was entered pursuant to a *Damron* Agreement that stipulated facts determinative of both liability and coverage has (1) collateral estoppel effect and precludes litigation of that issue in a subsequent coverage action against the insurer, as held in *Associated Aviation Underwriters v. Wood*, 93 P.3d 572 (Ariz. Ct. App. 2004), or (2) no preclusive or binding effect, as suggested in *United States Automobile Association v. Morris*, 741 P.2d 246 (Ariz. 1987).

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*Morris* noted, in part, that "an insured's settlement agreement should not be used to obtain coverage that the insured did not purchase." *Morris*, 741 P.2d at 253. In *Wood*, the Arizona Court of Appeals held that the settlement agreement and stipulated judgment estopped the insurer from contesting coverage "where the facts essential to liability and coverage overlap," and were stipulated in the tort action. *Wood*, 93 P.3d at 585, 588-89. The Supreme Court's answer to the question will be dispositive in *Quihuis*. If the stipulated fact is binding, then State Farm will lose the coverage case. If the stipulated fact is not binding, then State Farm will win the coverage case as it has been determined the Coxes did not own the automobile.

Arizona has a long line of cases dating back thirty years in which the courts have addressed issues regarding collateral estoppel and insurance disputes. The facts and circumstances differ in each case, as do the various coverage defenses, so there is no "catchall" rule in Arizona that would definitively answer the certified question. But there are some guiding principles. Arizona follows the RESTATEMENT (SECOND) OF JUDGMENTS §58 which provides that an insurer who has refused to defend may still relitigate issues actually litigated in the underlying action if there was "a conflict of interest" between insurer and insured. *Farmers v. Vagnozzi*, 675 P.2d 705 (1983). Such a conflict exists when the plaintiff's claim against the insured is such that it could be sustained on different grounds, one of which is within the insurer's obligation to indemnify and another of which is not. Therefore, "where there is a conflict of interest between an insured and his insurer, the insurer will not be estopped from litigating in a subsequent proceeding those issues as to which there was a conflict of interest, whether or not the insurer defended in the original tort claim." *Vagnozzi*, 675 P.2d at 708. The insurer is estopped from relitigating issues actually litigated in the tort case where there was no conflict of interest between insured and insurer. *Vagnozzi* does not control the outcome in *Quihuis*, though, because in *Vagnozzi* the relevant issues were actually litigated.

*Associated Aviation Underwriters v. Wood* distinguished scenarios in which "'the unresolved coverage issue . . . [is] related to the 'nature or characterization of the insureds' conduct and not to other issues of fault, causation or damages,' from those where litigating coverage inherently requires the relitigation of issues necessary to liability." *Quihuis*, 748 F.3d at 917. According to the Ninth Circuit in *Quihuis*, "Where coverage issues 'hinge on facts and law bearing directly on the insureds' liability, and those issues were completely subsumed in the consent judgment,' those issues have preclusive effect." Id., citing *Wood*, 98 P.3d at 585. The only issue in *Quihuis* relevant to the coverage analysis was the ownership of the automobile – the exact issue that gave rise to the claim against the insured in the underlying tort action. Thus, if *Wood* applies, State Farm would appear to be precluded from contesting the stipulated fact, even though the Ninth Circuit acknowledged the Coxes did not own the auto based on the undisputed facts.

The Ninth Circuit has questioned whether "*Wood* should be interpreted narrowly and confined to its facts in light of *Morris* and general Arizona collateral estoppel law, or whether *Wood* established a rule of general applicability for situations where there is overlap of factual issues determinative of both liability and coverage." *Quihuis*, 748 F.3d at 917. It is unclear how *Wood* could be interpreted "narrowly" and confined to its facts given that its seemingly broad holding has been applied to cases involving consent judgments and facts determinative of liability and coverage (like the ownership issue in *Quihuis*). Therefore, it would appear that the Supreme Court's options are to either overrule *Wood*, or somehow reconcile it with *Morris*.

The Supreme Court could reconcile *Wood* with *Morris* based on the fact that the issue really was not squarely before the court in *Morris*. The stipulation in *Morris* was that the insureds were either negligent or intentional. Since only the latter would result in a lack of coverage, the insurer was still able to contest coverage. The Supreme Court could also limit *Wood* to admissions of facts relevant to both liability and coverage, but not to stipulations regarding conduct or legal theories creating coverage. On the other hand, the Court could overturn *Wood* on the ground that it would unfairly allow parties to "create" binding coverage through stipulations that might be contrary to undisputed facts, as in *Quihuis*, without allowing the insurer to litigate the dispositive issues. The insurer would lose the coverage case even though it properly denied coverage and the insured stipulated to facts ultimately proven wrong. The Court could also reason that *Wood* is contrary to general principles of collateral estoppel and the requirement that the particular issue be resolved by litigation. The insured gains no benefit or added protection by allowing stipulating to critical coverage facts. He or she is protected by the covenant not to execute and that is really all that should matter. And the plaintiff, with the assignment, should not be relieved of the burden of proving coverage due to such admissions.

If the Court preserves the *Wood* decision, the ramifications would be significant. Before denying coverage outright, an insurer would need to conduct a detailed analysis as to whether its insured's alleged liability is intertwined with facts also dispositive of coverage, and whether a "conflict of interest" under the RESTATEMENT § 58 exists. If no § 58 conflict exists, and the determinative liability and coverage facts overlap, the insurer might be bound by the insureds' admissions giving rise to judgment, and unable to litigate the issue in a separate coverage action. The practical effect would be that insurers would be forced to defend uncovered claims and litigate the coverage issue while somehow avoiding a *Morris* Agreement (which would have the same preclusive effect as a *Damron* agreement).

Practically speaking, these exact circumstances might not arise that often, but *Quihuis* is that "perfect storm" that could result in a finding of coverage when the insurer was absolutely correct about the absence of coverage. The insurer's risk in being "wrong" is its exposure above the policy limits – which is significant and one that insurers certainly consider when evaluating the strength of the coverage position. The risk of allowing the insured to effectively bind coverage where there is none, as part of a *Damron* agreement, seems beyond what the cases other than *Wood* have contemplated, and is contrary to principles of fairness behind collateral estoppel. All eyes will be on the Arizona Supreme Court when it issues its decision in this matter, and clarifies this important insurance law issue.

## ABOUT THE AUTHOR

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