SMITH FREED & EBERHARD P.C.

OREGON LAW UPDATE

case in point...

Oregon Court Clears the Path for Covenant Judgments

From the desk of Jack Levy: In this game changing decision, the Oregon Supreme Court made two key decisions affecting insurance coverage for stipulated (covenant) judgements. It: (1) overruled the *Stubblefield* decision which for the past forty years held that a plaintiff cannot collect a covenant judgment from an insurer if its insured is no longer exposed to legal liability, and (2) clarified that the coverage assignment statute, ORS 31.825, allows an insured to assign bad faith claims but only when the insurer's failure to settle results in an excess judgment, and only after the judgment is rendered. The Court did not address how anti-assignment provisions in insurance policies fit into this mix. Nonetheless, this and other recent court decisions indicate a trend towards liberalizing Oregon coverage law.

Claims Pointer: An insurer can no longer avoid liability for a covenant judgment against its insured by arguing that the plaintiff's agreement not to collect the judgment from the insured eliminates the insurer's legal obligations.

Brownstone Homes Condo. Assn. v. Brownstone Forest Hts., 358 Or 223 (2015).

Following a settlement strategy which is often used in the state of Washington, it is becoming more common in Oregon construction defect cases for the plaintiff homeowner to resolve its claims with the defendant contractor in exchange for a covenant judgment. This typically involves an agreement to do the following:

(1) Settle for some amount of money;

(2) The homeowner releases the contractor and agrees not to collect (covenants not to execute) the judgment from the contractor itself;

(3) The homeowner takes over the contractor's negligence or "bad faith" claims against the contractor's insurer (i.e. for denying coverage or refusing to defend); and

(4) The homeowner agrees to collect the judgment only against the insurer.

In the *Brownstone* case, this setup involved the Brownstone Condominium Association's settlement of its construction defect claim against A&T Siding. A&T was insured by Capitol and Zurich. Capitol and Zurich both initially agreed to defend A&T, but Capitol later backed out of the defense. Brownstone then settled with A&T and Zurich for a $2 million covenant judgment of which Zurich agreed to pay $900,000. A&T assigned its claims against Capitol to Brownstone for Brownstone to collect the remaining $1.1 million. Brownstone agreed not to collect the judgment against A&T, A&T agreed to cooperate with Brownstone in any suit against Capitol, and Brownstone released all claims except for those between Brownstone and Capitol.

Brownstone then attempted to collect the $1.1 million from Capitol by garnishing Capitol's policy. Garnishment is the legal process by which the judgment creditor (Brownstone) goes to court to recover the assets of the judgement debtor (A&T) which are being held by a third party (Capitol). Capitol argued that the covenant judgment was not valid under the *Stubblefield* rule because A&T was not "legally obligated to pay" anything to Brownstone. The *Stubblefield* case involved a similar garnishment case which was decided by the Oregon Supreme Court in 1973. It held that the insurance company was not liable to pay insurance proceeds to satisfy a covenant judgment. *Stubblefield*'s holding was premised on the logic that since the insurance policy states that the insurer is only required to pay for damages that the insured is "legally obligated to pay"; where the plaintiff releases the insured from liability for the

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judgment, the insured is not legally liable to pay anything. On the other hand, Brownstone argued that *Stubblefield* did not apply because, after *Stubblefield* was decided, the legislature passed the coverage assignment statute, ORS 31.825. Brownstone argued that the statute abrogated (replaced) the *Stubblefield* rule. The trial court and the Court of Appeals, both relying on *Stubblefield*, rejected Brownstone's arguments.

The Supreme Court reversed the Court of Appeals decision, overruling *Stubblefield* in the process. The Court first held that ORS 31.825 does not abrogate the *Stubblefield* rule. ORS 31.825 states that defendants "against whom a judgment has been rendered" can assign their claims to the plaintiff and that a covenant not to execute will not eliminate any claims against the insurer. The Court held that the statute was only intended to apply to assignments of excess judgments that occur after a judgment has been rendered. In Brownstone's case, the assignment (the settlement agreement between A&T and Brownstone) occurred before a judgment was entered.

The Court then overruled *Stubblefield* by essentially concluding that *Stubblefield* did not follow the normal process for interpreting insurance policies, and because it was not a well-reasoned opinion. The Court then surveyed the legal decisions from other states on this issue and concluded that the phrase "legally obligated to pay," (as used in the *Stubblefield* policy, the Capitol policy, and most other liability insurance policies) "*if undefined in the insurance policy, is ambiguous and, as a result, must be construed against the insurer.*" To arrive at this conclusion, the Court verbally parsed out the difference between a "covenant not to execute" and a "release." The particulars of how the Court arrived at its decision are less important than the conclusion itself: Brownstone's release of A&T did not automatically relieve Capitol of liability.

Whether or not *Stubblefield* was well reasoned, in the scheme of things, it is significant that the Court overturned forty years of precedence on this issue. It is also noteworthy that Brownstone is the latest in a trend of Oregon cases liberalizing insurance coverage for policy holders. In 2014, in *FountainCourt Homeowners' Ass'n v. FountainCourt Dev., LLC,* the Oregon Court of Appeals issued another game changing opinion, holding that two insurers were potentially liable to pay for the same damages because, in water intrusion cases, liability for property damage may be the same in every triggered policy period. *FountainCourt* signaled a departure from some precedence and conventional thinking that an insurer is only obligated to pay for damages which occur during its coverage period. *FountainCourt* is currently being reviewed by the Oregon Supreme Court. In 2015, the Oregon Court of Appeals decided the *W. Hills Dev. Co. v. Chartis Claims, Inc.* case which held that a developer was entitled to additional insurance coverage under a contractor's policy for a construction defect claim made years after the project was completed, even though the additional insurance endorsement in the contractor's policy was limited to the contractor's ongoing operations. The *W. Hills* decision also goes against conventional thinking and standard insurance handling practices.

These cases indicate a definite trend in liberalizing insurance coverage law in favor of policy holders. While policy holders may initially see these as favorable developments, it begs the question of what benefits

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contractors actually receive by getting together with the plaintiff lawyers. From our experience, the covenant judgement process allows for collusive behavior and inflated settlement values. We don't know the underlying facts of *Brownstone* and the opinion did not discuss any evidence of collusion or whether the judgment value was unreasonable. However, a recent Washington case, *Water's Edge Homeowners Ass'n v. Water's Edge Associates*, highlighted how highly egregious this process can get. In *Water's Edge* the court rejected an $8.75 million covenant judgment and held that the reasonable settlement value for the case was $400,000. In going through the facts that proved that there was collusion, the *Water's Edge* court held that it was suspect and troublesome for a case to shift abruptly from litigation to collaboration on a covenant judgment; a joint effort to create, in a non-adversarial atmosphere, a resolution beneficial to both parties, yet highly prejudicial to the insurer: "The adversary system assumes an honest and actual antagonistic assertion of rights to be adjudicated; a safeguard essential to the integrity of the judicial process." The *Brownstone* decision also commented on this potential concern: "We leave for another day the issue whether collusion or fraud in a settlement might supply grounds for rejecting a stipulated or consent judgment given in exchange for a covenant not to execute."

No doubt, insurance companies are and should be held responsible for acting in good faith and for dealing fairly with their insureds. However, the overall cost of the covenant judgment process – to someone - is undeniable. It may be an indirect cost to the contractor in terms of higher premiums on renewal or the potential for increased frequency of litigation; if plaintiff lawyers make good money from this process they are inclined to sue contractors more often. Or the cost to the contractor may be direct if coverage is not renewed. Perhaps these resources would be better spent if contractors and their insurers, either directly or through their respective industry associations, work collaboratively to defeat inflated claims and to improve overall risk management and quality on construction projects. In the end, the money would be better spent on constructive solutions rather than lining the pockets of plaintiff lawyers.

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