

STATE OF MICHIGAN
IN THE SUPREME COURT

RICHARD JAMES,

Plaintiff

and

SAFECO INSURANCE
COMPANY OF AMERICA,

Plaintiff-Appellee

v.

STATE FARM FIRE AND CASUALTY
COMPANY,

Defendant-Appellant,

and

AUTO CLUB GROUP INSURANCE and MARIO
SYLVESTRI,

Defendants,

and

DAVID GASOWSKI,

Defendant-Appellee.

Supreme Court Docket No. 130460

COA Docket No. 262805

St. Clair County Circuit Court
Case No. 03-002466-NZ

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**DEFENDANT, APPELLANT, STATE FARM FIRE AND CASUALTY COMPANY'S,
SUPPLEMENTAL BRIEF ON APPEAL**

ORAL ARGUMENT REQUESTED

PROOF OF SERVICE

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STATEMENT OF QUESTIONS INVOLVED

- I. CAN A JUDGMENT THAT IS PROCURED BY FRAUD BE GIVEN EFFECT, OR IS IT AN AFFRONT TO THE COURTS, AND TO THE PUBLIC POLICY OF THIS STATE, TO ALLOW INVALID JUDGMENTS TO STAND?

- II. FOR PURPOSES OF COLLATERAL ESTOPPEL, WAS THE IDENTITY OF THE JET-SKI DRIVER FAIRLY AND/OR FULLY LITIGATED, AND WAS THERE A FINAL AND FAIR JUDGMENT ON THAT ISSUE?

- III. WAS STATE FARM WAS A PARTY TO THE UNDERLYING LITIGATION OR A PRIVY THERETO, OR DID IT MERELY PROVIDE A DEFENSE SUBJECT TO A RESERVATION OF RIGHTS, AND WOULD ASSERTING ANY CONTROL OVER THE LITIGATION HAVE VIOLATED STATE FARM'S DUTY TO DEFEND ITS INSURED AND CREATE A CONFLICT OF INTEREST FOR THE INSURED'S ATTORNEY?

- IV. SHOULD AN INSURER DEFEND ITS INSURED AS PROVIDED IN THE POLICY UNTIL THE INSURER LEARNS OF SUSPECTED FRAUDULENT CONDUCT AND/OR COLLUSION BETWEEN ITS INSURED AND THE INJURED PARTY, AND, UPON LEARNING OF THE COLLUSION AND/OR FRAUD, SHOULD THE INSURER INSTITUTE A DECLARATORY ACTION TO DETERMINE COVERAGE?

- V. IF THE RELEASE AND SETTLEMENT AGREEMENT WAS BEING USED TO BAR A CLAIM, WOULD STATE FARM HAVE BEEN REQUIRED TO AMEND ITS AFFIRMATIVE DEFENSES IN ORDER TO RAISE THAT DEFENSE. HOWEVER, SINCE THE RELEASE WAS BEING USED AS AN AGREEMENT IN ANTICIPATION OF LITIGATION, WAS STATE FARM REQUIRED TO PLEAD THE RELEASE AS AN AFFIRMATIVE DEFENSE?

STATEMENT OF FACTS

Defendant/Appellant, State Farm Fire and Casualty Company (hereafter "State Farm"), provides the following brief recitation of the facts in order to provide this Court with an overview of what occurred that directly relates to the issues set forth in the Court's June 15, 2007 Order requiring the parties to file supplemental briefs.¹

The captioned litigation stems from a jet-ski accident that occurred on August 31, 2002. The accident occurred when a jet-ski, one of two owned by the Co-Defendant, Mario Sylvestri, collided with a bridge located on the Middle Channel near Harson's Island. At the time of the accident, Mr. Sylvestri's long-time friends, Richard James and David Gasowski, were riding on the borrowed jet-ski. Both men had been consuming alcohol when they climbed aboard.

In this matter, Safeco Insurance Company ("Safeco") alleges State Farm wrongfully withdrew its defense of Mr. James in the action entitled, *David Gasowski v. Richard James, et al.* (St. Clair County Circuit Court Case No. 03-0101-NO (the "underlying action")). The factual dispute as to the identity of the person driving the jet-ski at the time of the accident remains unresolved. Specifically, in the underlying action, State Farm determined that it was not responsible to provide a defense for Mr. James based upon substantial evidence indicating that Mr. Gasowski (the injured party), as opposed to Mr. James, was driving the jet ski at the time of the accident.

Following the accident, statements were secured at the scene, including Messrs. Sylvestri and James'. Based on those statements, the St. Clair County Sheriff's Department prepared an Official Boating Accident Report that identified Mr. Gasowski as the operator of the jet ski. (**Appendix "A"**)

The first statement was obtained by St. Clair County Sheriff's Department, Special Deputy, Marine Division, Samuel Joseph, who testified during Mr. Gasowski's criminal trial related to this accident (for operating the jet-ski while intoxicated). Deputy Joseph testified that he had a conversation with Mr. Sylvestri on the date of the accident, wherein Mr. Sylvestri told Deputy Joseph

¹For the Court's convenience, the documents cited by Appellant in its Application for Leave to Appeal and re-cited here, will not be attached to this brief.

that Mr. Gasowski was the driver of the jet-ski and that Mr. James was the passenger. In addition, Deputy Joseph also testified that he spoke with Mr. James at the scene of the accident, who confirmed that he was the passenger at the time of the accident and Mr. Gasowski was the driver. (May 5, 2003 Trial Trans. of Samuel Joseph, at pp. 461-462 **Appendix "B"**).(Emphasis added).

Further, Deputy Lance Johnson also testified that he interviewed Mr. James on August 31, 2002 (the date of the accident), and that Mr. James told him that he was a passenger on the jet-ski and that David (Gasowski) was driving. Finally, Deputy Johnson spoke with Mr. Sylvestri who also stated that his friend, David Gasowski, was driving the jet-ski. (May 5, 2003 Hearing Trans. of Deputy Lance Johnson, at p.466-467 **Appendix "C"**).(Emphasis added).

State Farm answered the three Complaints filed against it, in the subsequent suits, by denying any allegations that Mr. James was the driver of the jet-ski and that Mr. Gasowski was merely a passenger. State Farm's Affirmative Defenses also provided that there was a lack of coverage in this matter, because Mr. James was not the driver of the jet-ski. (See Complaint filed by James on September 29, 2003 at ¶¶ 7 and 8, State Farm's Answers thereto filed on November 25, 2003 at ¶¶ 7 and 8 and its first Affirmative Defense; Complaint filed by Safeco on August 18, 2004 at ¶¶ 9, 12 and 13, State Farm's Answer thereto at ¶¶ 9, 12 and 13, and its first Affirmative Defense; Complaint filed by Gasowski on November 22, 2004 at ¶¶ 7, 10 and 11, and State Farm's Answer thereto at ¶¶ 7, 10 and 11, and its first Affirmative Defense, **Appendix "D"**).

Within the underlying action, Mr. James subsequently modified his version of events and testified during his deposition and in response to requests for admissions, in the underlying action, that he was driving the jet ski at the time the accident occurred.²

Based upon this "admission," Mr. Gasowski sought summary disposition in the underlying litigation. On June 14, 2002, St. Clair County Circuit Judge, Peter E. Deegan, granted the Motion

²Based upon information and belief, Mr. Gasowski was acquitted of the criminal charge based on Mr. James' admission at the criminal trial that he was driving the jet-ski.(Only Mr. Gasowski's blood-alcohol level was taken at the scene, as he was the one who the police believed was the driver.)

in favor of Mr. Gasowski, stating, “. . . Because the Defendant James has already admitted his negligence, summary disposition is proper on that issue. . . .”

When the declaratory action was initiated between State Farm and Mr. Gasowski, Mr. James was permitted to join that action, because, as Judge Deegan ruled, “. . .I’m allowing [James] into this dec action as a necessary party so that he can get sifted out who was driving and who wasn’t.”(See March 15, 2004 Hearing Trans., at p.20, **Appendix “E”**).(Emphasis added).

Thereafter, in October of 2004, the parties to the underlying litigation entered into a Release and Settlement Agreement (hereafter, the “Release” **Appendix “F”**), to resolve that action, by agreeing that the three insurance companies involved (State Farm, Safeco and ACIA), would split the cost of the medical bills (\$600,000.00) and determine the identity of the driver within the related declaratory action. Among other terms encompassed within the document, the parties specifically agreed as follows:

* * *

2. If it is determined in the Declaratory Action that Richard W. James was the driver of the jet ski at the time of the August 31, 2002 occurrence, following the entry of a final order, then Plaintiff shall receive an additional One Hundred Thousand and 00/100 (\$100,000.00) Dollars to be paid equally by each of the three Insurers, to wit: Thirty Three Thousand Three Hundred Thirty Three and 33/100 (\$33,333.33) Dollars within ten (10) days of the issuance of the Final Order.
3. However, if it is determined in the Declaratory Action that Richard W. James was not the driver of the jet ski at the time of the August 31, 2002 occurrence, then Plaintiff shall not receive any further monies from the Defendants or their Insurers.

(Release at p. 4, **Appendix “F”**).(Emphasis added).³

It is this Release that served as the basis for Mr. Gasowski’s Motion for Summary Disposition, based upon the doctrine of collateral estoppel in the declaratory action lawsuit. Specifically, Mr. Gasowski asserted that the identity of the individual operating the jet ski at the time

³The case of *Gasowski v. State Farm* was settled for the additional \$100,000.00.

of the accident was determined in the underlying litigation. Safeco filed a concurrence to the Motion.⁴

State Farm responded in opposition to the Motions asserting that it was not barred from litigating the identity of the driver since it was not a party to the underlying action – it merely paid for a defense on behalf of Mr. James (for a period of time prior to the withdrawal of its defense) and Mr. Sylvestri. State Farm additionally asserted that the resolution of the underlying litigation resulted from collusion between the long-time friends and parties to that action. To use the fruits of that collusion to now bar State Farm from litigating the identity of the driver would be improper.

Furthermore, State Farm submitted a copy of the Release to Judge Deegan for review at the hearing on the Motions for Summary Disposition and promoted that the document alone precluded the relief sought by the Appellees. State Farm argued that the Release specifically contemplated that there would be a determination of who the driver of the jet-ski was at time of the accident.

After listening to the arguments of the parties, Judge Deegan granted the Motions for Summary Disposition, stating as follows:

Now in this case, State Farm denies that it had a full and fair opportunity to litigate the issue as it was not a party to the earlier case. However, the Court notes that the insured under the policy, Mr. Sylvestri, was a party to the action and was afforded a defense by State Farm. State Farm also represented Defendant James in the underlying action during its initial stages.

This Court acknowledges the extensive discovery completed on these cases and the fact that this Court on March 15 of 2004 allowed Gasowski to be reinstated as a Defendant solely for the purposes of litigating the question of fact as to who was driving the jet ski at the time of the accident.

This Court recognizes at the time of the jet ski, jet ski accident just, two people were involved and were both injured. One was the driver and one was the passenger. In Case Number 03-0101, Gasowski versus James, this Court ruled that Gasowski was not the driver. This Court finds that Doctrine of Collateral Estoppel applies in this case, in the case of James versus State Farm.

⁴If the three friends intended on using the Release as a sword for collateral estoppel purposes, as opposed to the true intent of the Release, suggests the Release was entered into in bad faith.

(April 11, 2005 Hearing Transcript, at pp. 16-17, **Appendix "G"**).(Emphasis added).

The Court of Appeals affirmed this decision, and an Application for Leave to Appeal to this Court was filed. Thereafter, this Court ordered the parties to submit supplemental briefs addressing the following issues:

- (1) Whether State Farm, by failing to plead release as an affirmative defense in this declaratory relief action, waived its right to oppose plaintiffs attempt to invoke offensive collateral estoppel as inconsistent with the terms of the parties' Release and Settlement Agreement in the underlying action;
- (2) Whether, for purposes of collateral estoppel, the identity of the jet-ski driver was actually litigated and determined by a final judgment in the underlying action;
- (3) Whether, for purposes of collateral estoppel, State Farm was a party, or in privity with a party, to the underlying action;
- (4) How should an insurer proceed when it believes its insured is committing fraud to invoke coverage, and does that depend on whether the insurer learns of the conflict of interest during the course of litigation; and
- (5) If an adverse judgment procured by fraud of the insured is entered, whether the insurer is estopped from contesting liability.

LAW AND ARGUMENT

- I. **ANY JUDGMENT THAT IS PROCURED BY FRAUD CANNOT BE ALLOWED TO REMAIN, AS IT IS AN AFFRONT TO THE COURTS, AND TO THE PUBLIC POLICY OF THIS STATE, TO ALLOW INVALID JUDGMENTS TO STAND.**

INTRODUCTION

Appellant begins its supplemental brief with this issue, as it is the overriding issue involved in this litigation. The allegation of fraud and/or collusion between the parties concerns the issue of whether the parties were adverse and whether State Farm was provided with a full and fair opportunity to litigate the issue (collateral estoppel). Further, the issue of whether the insured, the injured party, and the “admitted” driver were involved in a fraudulent scheme to procure insurance coverage, permeates all of the issues that this Court ordered the parties to address. Therefore, the issue of judgments procured through fraud will be addressed first.

A. There Are Allegations that the Insured and His Long-Time Friends Engaged in Fraud to Procure Insurance Coverage for the Injured Party.

Although Mr. Gasowski was in fact the driver of the jet-ski on the date of the accident (as told to two police officers after the accident, *supra*), Mr. James reversed his earlier position and subsequently claimed to be the driver in order to procure insurance coverage for Mr. Gasowski’s medical expenses. Specifically, it is alleged that Messrs. James, Sylvestri and Gasowski agreed to obtain a fraudulent judgment against State Farm, by agreeing that Mr. James would claim to be the driver of the jet-ski.⁵ This agreement did not adversely affect them in any manner. By the time their stories had changed, the level of alcohol Mr. James had consumed on the day of the accident could not be tested and determined. Therefore, the threat of criminal charges against him was moot. Instead, they obtained judgments based on that agreement, wherein Mr. Gasowski ultimately received \$700,000.00 for his injuries. (\$300,000.00 from State Farm and \$200,000 each from ACIA and

⁵The three friends would have known the need to manipulate their stories, and, exactly what needed to be “admitted,” as Mr. James is employed at Auto Club Insurance Agency.

Safeco). This fraud upon the Court cannot be allowed to be validated.

B. Courts in This State Have Consistently Held that Extrinsic Fraud Perpetrated Upon the Court is Against this State's Public Policy.

Appellate Courts throughout this state have consistently held that judgments procured by fraud, whether the fraud is intrinsic (perjury) or extrinsic (relating to obtaining the judgment), will not be given effect.⁶ In *Fawcett v Atherton*, 298 Mich 362, 365; 299 NW 108 (1941), this Court held that, “[B]efore allegations of fraud will allow interference with a prior judgment, however, the fraud alleged must have actually prevented the losing party from having an adversary trial on a significant issue.”(Emphasis added). See also, *Daoud v De Leau*, 455 Mich 181, 193; 565 NW2d 639 (1997); *Cramer v Metropolitan Sav Ass’n*, 125 Mich App 664, 672; 337 NW2d 264 (1983); *Rogoski v Muskegon*, 107 Mich App 730, 736; 309 NW2d 718 (1981). This Court also concluded in *Grigg v Hanna*, 283 Mich 443, 456; 278 NW 125 (1938), that, “[T]he fraud which warrants equity in interfering with a judgment must be fraud in obtaining the judgment.” See also, *Kita v Matuszak*, 55 Mich App 288, 293-294; 222 NW2d 216 (1974); *Berar Enterprises, Inc v Harmon*, 101 Mich App 216, 229; 300 NW2d 744 (1969).

In *Banner v Banner*, 45 Mich App 148, 154; 206 NW2d 234 (1973), the Michigan Court of Appeals considered at what point is a fraud perpetrated upon the court. The Court of Appeals determined that, “[A] fraud is perpetrated upon a court when some material fact is concealed from that court or when some material misrepresentation is made to that court.” *Banner*, 45 Mich App at 154, citing *DeHaan v DeHaan*, 348 Mich 199; 82 NW2d 432 (1957); *Berar Enterprises*, 101 Mich App at 229. See also, *Baum v Baum*, 20 Mich App 68, 72; 173 NW2d 744 (1969).

In addition, the Michigan Court Rules specifically grant courts the power to relieve parties from judgments if there is fraud (intrinsic or extrinsic), misrepresentation, or other misconduct of

⁶Intrinsic fraud has been found not to be an exception to a claim of res judicata. However, extrinsic fraud is an exception that allows a second litigation between the same parties. See *Sprague v Buhagiar*, 213 Mich App 310. However, both intrinsic and extrinsic fraud are grounds for relief from a judgment. See MCR 2.612(C)(1)(c).

an adverse party. MCR 2.612(C)(1)(c). Further, the Court Rule provides that, “[T]his subrule does not limit the power of a court to entertain an independent action to relieve a party from a judgment . . . or to set aside a judgment for fraud on the court. MCR 2.612(3).

Based upon the foregoing, it is clear that courts in this State view judgments procured by fraud as invalid. Courts are permitted to then void those judgments because equity demands that fraudulent judgments not be enforced.

C. Courts in Other Jurisdictions View Judgments Procured by Fraud/Collusion with Similar Contempt.⁷

Uniform with this State’s treatment of judgments procured by fraud/collusion, other jurisdictions that have addressed the issue have similarly refused to afford those judgments any credence. The First Circuit Court of Appeals has reasoned that, “public policy considerations . . . disfavor fraudulent or collusive settlements, such as those in which an insured concedes liability in situations where it is not liable . . .” *Bucci v Essex Ins Co*, 393 F3d 285, 294 (CA1,2005), citing *Couch on Insurance* §202:9, at 202-236. The Court in *Bucci* also discussed that one of the exceptions to the rule binding insurers to judgments in situations where the insurer breaches its duty to defend is when, “. . . the underlying judgment is procured by fraud or collusion of the insured and the injured party.” *Bucci*, 393 F3d at 294, citing *Couch on Insurance* §202:12, at 202-42. (Opinion attached as **Appendix “H”**).

Further, State appellate courts have also addressed this issue and determined that fraudulent judgments are void and that, “[A] void judgment, order, or decree may be attacked at any time or in any court either directly or indirectly.” *Tomm’s Redemption, Inc v Park*, 333 Ill App3d 1003, 1008; 777 NE2d 522 (2002)(Opinion attached as **Appendix “H”**). See also *Hawkins v Howard*, 97 SW3d 676, 679 (Tex App, 2003)(A judgment obtained by fraud is voidable and may be set aside)(Opinion attached as **Appendix “H”**); *Ellet v Ellet*, 35 Va App 97, 100; 542 SE2d 816 (2001)(A final and

⁷Although these opinions are not binding on the Court, State Farm submits that the opinions are instructive.

conclusive judgment that is void, however, may be attacked in any court, at any time, directly or collaterally. . . A void decree is one that has been obtained by extrinsic or collateral fraud . . .”(Opinion attached as **Appendix “H”**); *Espinal v Liberty Mutual Ins Co*, 47 Mass App Ct 593, 598; 714 NE2d 844 (1999)([I]t has always been the law of this Commonwealth that a surety or indemnitor could avoid a judgment rendered against the principal or indemnitee, by showing that it was procured by collusion or fraud . . . [i]t would be a reproach to the law if a court of equity could not prevent the enforcement of a judgment against a third person when it has been shown that such judgment was procured by fraud or collusion for the purpose of defrauding such third person)(Opinion attached as **Appendix “H”**); *Airway Underwriters v Perry*, 362 Mass 164, 168; 284 NE2d 604 (1972)(Ruled that an insurer is bound by the judgment in such action as to all material facts decided therein including their determination of ownership is inapposite in cases where the judge finds that the judgment was procured by fraud or collusion).(Opinion attached as **Appendix “H”**).

Based on the examples of the cases cited above, it is clear that, as in this state, courts around the country are more than willing to allow direct and/or collateral attacks on judgments that are procured by fraud or collusion. It is clear from these decisions that these fraudulent judgments are to be afforded no weight, and it would be a further affront to the courts and the public to allow a judgment procured by fraud to be used to then bind a subsequent litigant to the fraudulently determined facts.

D. It is Clear that Public Policy In this State Disfavors Judgments Procured by Fraud.

Whether the judgments that were entered into in this matter are the product of fraud or collusion, address issues of fairness, and concern matters of public policy in this State. If insureds and injured parties are permitted to agree to defraud and collude against insurance companies in order to obtain coverage where none otherwise exists, the potential of insurers not writing bodily-injury coverage, is present.

Bodily injury claims already present a greater opportunity for fraud and collusion, because in many instances, the injured party and the insured know one another, coupled with the difficulty

of proving collusion based on the lack of cooperating witnesses, as well as a potentially non-cooperating insured, may lead insurers to suspend that coverage altogether. Otherwise, the insurers face unlimited liability for injuries that they have not contracted to insure against. The purpose of bodily injury coverage is to protect visitors who are injured while on an insured's property. It is not intended to present insureds and their friends with a blank check to obtain money from insurance companies for non-covered losses if everyone agrees to participate in a scheme to defraud.

Therefore, if it is determined that the underlying action in this case is determined to have been procured by fraud or collusion, the facts that were "fraudulently litigated" should bear no weight in a subsequent action, regardless of whether the parties in the second action are found to be parties or privies with the parties in the first action. As the courts around the country have concluded, a judgment procured by fraud or collusion is void, and should be treated as a nullity which can be voided upon bringing it to a courts attention.⁸

II. FOR PURPOSES OF COLLATERAL ESTOPPEL, THE IDENTITY OF THE JET-SKI DRIVER WAS NEVER FAIRLY AND/OR FULLY LITIGATED, DUE TO THE COLLUSION OF THE OTHER PARTIES, SUCH THAT THERE WAS NOT A FINAL AND FAIR JUDGMENT ON THAT ISSUE.

A. Judge Deegan Ruled that There Was A Full and Fair Opportunity to Litigate the Issue of Who was Driving the Jet-ski and that the Parties Were Adverse in the Underlying Action.

Judge Deegan, in granting Mr. Gasowski's and Safeco's Motions for Summary Disposition, ruled that the issue of the identity of the jet-ski driver had been litigated in the underlying action. Therefore, it ruled that State Farm was collaterally estopped from litigating the identity of the jet-ski

⁸The timing aspect of alerting courts to fraud in these cases will not be problematic. The Michigan Court Rules provides for relief from judgment based on fraud (intrinsic and extrinsic) . . . or other misconduct of an adverse party, if the motion is brought within one-year after judgment, order or proceeding was entered or taken. MCR 2.612(C)(1)(c) and (2). Due to the public policy concerns of allowing fraudulent judgments to have effect, State Farm contends that a fraudulent judgment should be allowed to be attacked at any time. However, State Farm is cognizant that in most cases, after a party pays a judgment, it is unlikely to attack the judgment as the money will have already been spent.

driver in the *Gasowski versus State Farm* declaratory action case. (See Hearing Transcript dated April 11, 2005, at pp. 16-17, **Appendix “G”**). However, while Judge Deegan ruled that collateral estoppel barred State Farm’s argument in the declaratory judgment action, it ignored the fact that there was evidence that the underlying judgment forming the basis for the collateral estoppel, was procured by fraud. Therefore, even assuming State Farm was a party to the underlying litigation (something State Farm denies, see Section III, *infra*), it did not have a full and fair opportunity to litigate the issue of who was driving the jet-ski. In addition, the prior judgment was invalid because of the fraud and collusion. For these reasons, collateral estoppel should not bar State Farm from litigating the issue of who was driving the jet-ski.

B. Collateral Estoppel Requires a Full and Fair Opportunity to Litigate the Issue of Who Was Driving the Jet-Ski at the time of the Accident.

As this Court has determined:

Generally, for collateral estoppel to apply three elements must be satisfied: (1) “a question of fact essential to the judgment must have been **actually litigated** and determined by a **valid** and final judgment”; (2) “the same parties must have had a **full [and fair] opportunity to litigate the issue**”; and (3) “there must be mutuality of estoppel.” *Monat v State Farm Ins Co*, 469 Mich 679, 682-684; 677 NW2d 843 (2004)(Emphasis added), citing *Storey v Meijer, Inc*, 431 Mich 368, 373 n. 3; 429 NW2d 169 (1988).

Further, this Court has concluded that, “[I]n analyzing whether an issue was ‘actually litigated’ in the prior proceeding, the Court must look at more than what has been pled and argued. We must also consider whether the party against whom collateral estoppel is asserted has had a full and fair opportunity to litigate the issue. *People v Gates*, 434 Mich 146, 156-157; 452 NW2d 627(1990)(emphasis added) citing, *Blonder-Tongue Laboratories, Inc v Univ of Illinois Foundation*, 402 US 313, 329; 91 SCt 1434 (1971); See also, *Kowatch v Kowatch*, 179 Mich App 163, 168; 445 NW2d 808 (1989).

The United States Supreme Court has also addressed the issue, writing, “[A] judgment of a court having jurisdiction of the parties and of the subject-matter operates as *res judicata*, in the absence of fraud or collusion, even if obtained upon a default.” *Morris v Jones*, 329 US 545, 550-

551; 67 SCt 451(1947)(Emphasis added), citing *Riehle v Margolies*, 279 US 218, 225; 49 SCt 310 (1929); See also, *Rice v Liberty Surplus Ins Corp*, 113 Fed Appx 116, 122; 2004 WL 2413393, at p. 6 (CA6,2004)(Opinion attached as **Appendix “I”**); *American Life Ins Co v Balmer*, 238 Mich 580, 584; 214 NW 208 (1927).

Based on the evidence that the parties to the underlying lawsuit were colluding against State Farm, and fraudulently changed their testimony in order to obtain coverage that otherwise would not have existed, it is not possible to conclude that State Farm (assuming it was a party to the underlying litigation), had a “full and fair opportunity” to litigate the issue of who was driving the jet-ski. By agreeing to “admit” that he was driving the jet-ski, against the weight of the evidence, Mr. James denied State Farm the opportunity to bring forth witnesses and produce documents that would have disputed Mr. James’ admission. Had this information been litigated at trial, and, after weighing all of the evidence, the jury concluded that Mr. James was the driver, that would have at least protected State Farm from being bound by a judgment that was invalid. (However, it would have forced Mr. James’ original attorney and Mr. Sylvestri’s attorney into an impossible conflict of interest, see Section IV, *infra*).

Therefore, State Farm should not have been bound by the underlying judgment. The facts disputing Mr. James’ admission that he was the driver should have been presented to a jury.

C. Gasowski, James, and Sylvestri Were Not Adversaries in the Underlying Lawsuit.

In addition to requiring the party against whom collateral estoppel is alleged to have a full and fair opportunity to litigate the issue, appellate courts in this state have also required that the parties in the first action be adversaries. In *York v Wayne County Sheriff*, 157 Mich App 417, 426; 403 NW2d 152 (1987), the Michigan Court of Appeals reasoned that, for purposes of res judicata, the parties to the underlying litigation must be adverse. See also, *Gomber v Dutch Maid Dairy*, 42 Mich App 505, 511; 202 NW2d 566 (1972).⁹

⁹Similarly to collateral estoppel, this Court has held that, “[T]he doctrine of res judicata is employed to prevent multiple suits litigating the same cause of action. The doctrine bars a second,

The Court in *York* defined “adverse parties” as, “those who, by the pleadings, are arrayed on opposite sides.” *York*, 157 Mich App at 426. This definition appears to be too narrow. Black’s law dictionary defines an “adverse party” as, “ [A] party whose interests are opposed to the interests of another party to the action.” Black’s Law Dictionary 1144 (7th ed. 1999). The dictionary definition provides a truer statement of what is meant by the adversarial nature of litigation; two parties with competing interests who are on opposite sides of an issue. Once the parties begin working together, and against another party, they are not adversaries, they are co-parties.

In the underlying action, the plaintiff (Gasowski) and the defendants (James and Sylvestri) were not “adverse parties.” Instead, their interests were aligned. They agreed to misstate the truth and claim that Mr. James was the driver of the jet-ski, when in reality, Mr. Gasowski was driving. This collusion led to a fraudulent judgment being entered, and, even assuming State Farm was a party or a privity with a party in the underlying action, the parties were not adverse and the judgment should not have been afforded any preclusive effect in the declaratory judgment action.

subsequent action when (1) the prior action was decided on the merits, (2) both actions involve the same parties or their privies, and (3) the matter in the second case was, or could have been, resolved in the first. *Washington v Sinai Hosp of Greater Detroit*, 478 Mich 412; ___ NW2d ___ ; 2007 WL 1829402, at *2 (2007), citing *Sewell v Clean Cut Mgmt, Inc*, 463 Mich 569, 575, 621 NW2d 222 (2001). See also, *Adair v Michigan*, 470 Mich 105, 121; 680 NW2d 386 (2004).

III. STATE FARM WAS NOT A PARTY TO THE UNDERLYING LITIGATION OR A PRIVY THERETO, AS ANY INVOLVEMENT OF STATE FARM IN THE LITIGATION, EXCEPT TO PROVIDE A DEFENSE SUBJECT TO A RESERVATION OF RIGHTS. ASSERTING ANY CONTROL OVER THE LITIGATION WOULD HAVE VIOLATED STATE FARM'S DUTY TO DEFEND ITS INSURED AND CREATED A CONFLICT OF INTEREST FOR THE INSUREDS' ATTORNEY.

A. State Farm's Duty to Defend Its Insureds, Did not Place State Farm in Control of the Underlying Litigation and the Reservation of Rights Letters Informed the parties that it was contesting coverage.

As stated above, from the outset of the underlying litigation, State Farm placed the other parties on notice that it was providing a defense to both Mr. Sylvestri and Mr. James, but that it had concerns as to coverage because the issue of who was driving the jet-ski at the time of the accident was in dispute. This reservation of rights, while providing a defense to Messrs. James and Sylvestri in the underlying lawsuit, was State Farm's only involvement in the underlying litigation (as an interested party), with the exception of agreeing to the Release, of which the policy requires that it must be advised.

However, at no time did State Farm control the underlying litigation. In fact, had State Farm asserted any control over the course of the litigation, its interests would have been adverse to its insureds' interests, and would have created an impossible conflict of interest to the State Farm provided attorney, who would have been asked to serve two masters with different and competing interests.

When agreeing to defend Mr. Sylvestri and, initially, Mr. James, State Farm gave the benefit of the doubt to both. It erred on the side of caution by providing a defense before the issue of coverage had been determined. However, upon learning of the existence of substantial and independent evidence indicating that Mr. James was not the driver of the jet-ski, State Farm withdrew its defense of Mr. James. State Farm was poised to file its own declaratory action when Mr. Gasowski filed a declaratory action against State Farm. State Farm anticipated the opportunity to litigate the issue of the identity of the driver and the related coverage as a result thereby.

B. Estoppel and Waiver in General.

In *Smit v State Farm Mut Auto Ins Co*, 207 Mich App 674, 679-681, 525 NW2d 528 (1994), the Court of Appeals explained the development of waiver and estoppel law regarding insurance disputes, explaining:

In *Lee v Evergreen Regency Cooperative*, 151 Mich App 281; 390 NW2d 183 (1986), this Court explained the principles of law applicable in this case. The general rule is that once an insurance company has denied coverage to an insured and stated its defenses, the company has waived or is estopped from raising new defenses. *Id.* at 285. However, as noted in *Lee*, the Supreme Court limited the application of waiver and estoppel in *Ruddock v Detroit Life Ins Co*, 209 Mich 638; 177 NW 242 (1920). In that case, the Court explained that the cases applying the "doctrine of waiver and estoppel" had primarily been ones that involved the insurer's assertion that the contract had been forfeited because of noncompliance with conditions of the contract. The Court distinguished those cases and held that waiver and estoppel are not available where their application would result in broadening the coverage of a policy, such that it would "cover a loss it never covered by its terms ... [and] create a liability contrary to the express provisions of the contract the parties did make." *Id.* at 654.

The limitation on the application of waiver and estoppel discussed in *Ruddock* has not been applied without exception. In *Lee* 151 Mich App at 287; 390 NW2d 183, this Court identified two classes of cases decided since *Ruddock* in which estoppel or waiver was applied to bring within coverage risks not covered by policy terms or expressly excluded from the policy:

... The first class involves companies which have rejected claims of coverage and declined to defend their insureds in the underlying litigation. In these instances, the Court has held that the insurance company cannot later raise issues that were or should have been raised in the underlying litigation. *Morrill v Gallagher*, 370 Mich 578; 122 NW2d 687 (1963); *Dickenson [Dickinson] v Homerich*, 248 Mich 634; 227 NW 696 (1929). These cases are closely akin to the principle behind collateral estoppel....

The second class of cases allowing the limits of a policy to be expanded by estoppel or waiver despite the holding of *Ruddock* involves instances where the inequity of forcing the insurer to pay on a risk for which it never collected premiums is outweighed by the inequity suffered by the insured because of the insurance company's actions. . . As examples of cases falling in the second category, *Lee* cites situations in which the insurance company misrepresented the terms of the policy to the insured or defended the insured without

reserving the right to deny coverage.¹⁰

The Court in *Smit* stated that the plaintiffs right to recover in the second-action “depends on their status as garnishees . . . which required a showing that the insured would have been entitled to recover against [the insurer]. In their status as judgment creditors, plaintiffs are entitled to recover against the garnishee-defendant, [the insurer], only to the extent that the principal defendant . . . could recover against [the insurer].” *Smit*, 207 Mich App at 683. The Court also distinguished, *Industro Motive Corp v Morris Agency, Inc*, 76 Mich App 390; 256 NW2d 607 (1977), where the plaintiff, before the loss, acted in reliance on misrepresentations concerning the terms of a policy. (Emphasis added).

Similarly, in this case, the other insurance companies (Safeco and Auto Club) only have a right to recover against State Farm, if at all, if the injuries to Mr. Gasowski were covered under the State Farm policy. Based on the reservation of rights letters, and the Release (see Section V, *infra*), the parties were aware of State Farm’s intention to determine coverage, so there can be no prejudice in permitting State Farm from determining if the injuries to Mr. Gasowski stem from a covered event.

C. Reserving its Rights, While Providing a Defense, Permits an Insurer to Contest Coverage in a Later Action.

Upon commencement of this litigation, State Farm provided an attorney to represent both Mr. Sylvestri (its Insured) and Mr. James (who claimed to be an Insured by definition). However, on November 22, 2002, State Farm notified Messrs. Sylvestri, James and Gasowski, that, “[T]here was a question as to whether [State Farm] is obligated under the policy . . . because [A] question exists as to whether or not there has been a material misrepresentation as to the facts and circumstances including the extent of this loss.” (See letters to Sylvestri, James and Gasowski dated November 22, 2002, **Appendix “J”**). From that date forward, the parties to this lawsuit were on notice that State

¹⁰In *Smit*, the Court determined that the case did not belong in either of the above-described classes because the insured did not argue that she would be prejudiced if the insurer was allowed to establish the exclusion.

Farm intended to contest whether there was coverage for these injuries under its boatowners policy.

However, as coverage had not been determined, State Farm gave its insured (and its possible insured by definition) the benefit of the doubt, choosing to err on the side of coverage, and continued to provide a defense to both Messrs. James and Sylvestri. As stated above, State Farm intended to have its responsibility, if any, determined in the declaratory action. Once the collusion was discovered, and Mr. James was no longer an insured by definition (because he was the passenger), State Farm withdrew its defense of him in the underlying action.

This Court, in *Kirschner v Process Design Associates*, 459 Mich 587; 592 NW2d 707 (1999) held that, an insurer, who provides its insured notice that it is providing a defense subject to a reservation of rights, a judgment creditor could not assert a waiver or estoppel argument. The Court discussed that, generally, estoppel/waiver will not be used to extend coverage beyond what the parties agreed to in the contract. The Court went on to discuss that, “. . . in some instances, courts have applied the doctrines to bring within coverage risks not covered by the policy . . . [including when the insurer] defended the insured without reserving the right to deny coverage . . .” *Kirschner*, 459 Mich at 595. (Emphasis added). However, in that case, this Court found that, based on the letters sent to the insured reserving the insurer’s right to contest coverage, the doctrines were inapplicable. See also, *Havens v Nationwide Ins Co*, 139 Mich App 64, 67; 360 NW2d 186 (1985)(An insurer may, however, raise an exclusionary clause as a defense if that issue has been preserved. In the instant case, [the insurer] agreed to defend the original action while specifically reserving the right to contest coverage. [The insurer] may now contest coverage.”(Internal citation omitted).

Further, courts in this state have held that insurers have two options when asked to defend an action brought against its insured. Option one is that, “[I]t can undertake the defense with notice to the insured that it is reserving the right to challenge its liability on the policy. The second alternative for the insurer is to repudiate liability, refuse to defend and take its chances that there will be a showing that there is no coverage for the insured’s liability.” *St Paul Ins Co v Bischoff*, 150 Mich App 609, 613; 389 Nw2d 443, citing *Elliot v Cas Ass’n of America*, 254 Mich 282, 285; 236 NW 782 (1931); *Detroit Edison Co v Michigan Mut Ins Co*, 102 Mich App 136, 145; 301 NW2d 832

(1980).

The Court in *Bischoff* even went as far to hold that the insurer's failure to defend in that case **did not preclude it from showing that it was not liable under the policy**. In *Bischoff*, the insurer chose to not defend and repudiated liability. The insured was found to have been entitled to be defended, and the insurer was ordered to pay for that defense. However, the Court still permitted the insurer to argue (successfully) that the claimed injury was not covered under the policy, reasoning that the duty to pay and the duty to defend are separate and distinct. "That an insurer may ultimately be found not liable, therefore, is a matter separate and apart from its obligation to defend the insured. *Bischoff*, 150 Mich App at 612-613.(Emphasis added), citing *Detroit Edison* and *Elliot, supra. Id.* at 612-613.

As stated above, the parties were on notice that State Farm would be contesting the coverage issue. From the outset of the underlying litigation, State Farm informed the parties that coverage had not been determined, and was being investigated. Therefore, whether the duty to defend was breached as to Mr. James or not, State Farm should have been permitted to contest coverage in the declaratory action.

D. Treatment of this Issue in Other Jurisdictions.¹¹

The Indiana Court of Appeals recently decided a case that addressed the issue of collateral estoppel stemming from a third-party insurance dispute. In *Bruce v State Farm Fire and Cas Co*, 868 NE2d 831(2007), the Indiana Court of Appeals was faced with a similar issue that is before this Court. In *Bruce*, the dispute arose out of a third-party claim arising out of a molestation claim by patrons of a day care run by [the insurer's] insureds. Upon receiving notice of the suit, [the insurer] reserved its right to deny coverage if it was determined that the claim arose out of childcare services provided by the insured, which was excluded by the policy. After investigating the claim, [the insurer] determined that there was no coverage. After the plaintiffs and the insureds entered a

¹¹Although these opinions are not binding on the Court, State Farm submits that the opinions are instructive.

consent judgment against the insureds, the plaintiffs commenced litigation against [the insurer] for payment of the judgment.

The Indiana Court of Appeals described the issue on appeal as, “whether [the insurer] was collaterally estopped by the agreed judgment from raising contractual defenses under the policy.” *Id.* at 838. In answering that question, the Indiana Court of Appeals determined that, “[t]he law in this jurisdiction is well-settled that where an insurer’s independent investigation of the facts underlying a complaint against its insured reveals a claim patently outside of the risks covered by the policy, the insurer may properly refuse to defend.” *Id.*(Emphasis added). The Court went on to discuss that, [the insurer], “promptly and consistently opined that the [plaintiffs] were not covered under the policy . . .” *Id.* (Emphasis added). Therefore, [the insurer] was not estopped from asserting policy defenses.(Copy of the Opinion attached as **Appendix “K”**).

Further, the Supreme Court of Alabama, in *Ala Farm Bureau Mut Cas Ins Co, Inc v Moore*, 349 So2d 1113 (1977)(Opinion attached as **Appendix “K”**) has also addressed the issue of whether an insured who did not defend its insured in the underlying action is barred by collateral estoppel from asserting policy defenses in a subsequent action against the insurer. In concluding that the insurer is not estopped, the Court ruled, in part, that:

It is true, as a general rule, that a judgment or decree is binding on parties and privies; but, technically speaking, there can be no privity, where there is not an identity of interests.

* * *

the concept of privity assumes identity of interests. . .¹²

Moore, 349 SO2d at 1115-1116.(Opinion attached as **Appendix “K”**). Because proving that the insured intentionally caused the injury would harm the insured’s case, while also precluding coverage, the Court determined that the insurer and the insureds interests were not aligned. Therefore, collateral estoppel was inapplicable regarding the coverage issue, despite the insurer’s

¹²The Court in *Moore* also reasoned that, in that case, the issue of whether the injury was excluded by the policy as expected or intended was not litigated in the prior action.

refusal to defend the insured in the underlying suit.

California, in addressing the issue has gone as far as enacting a statute requiring insurers to provide independent counsel when a conflict of interest arises in a duty to defend situation. See Cal Civ Code §2860, (**Appendix “K”**). The independent counsel is often called *Cumis* counsel based on *San Diego Navy Federal Credit Union v Cumis Ins Society, Inc*, 162 Cal App3d 358; 208 Cal Rptr 494 (1984) superceded by §2860.(**Appendix “K”**).¹³

In this case, based on the first judgment being procured by fraud, and that the parties entering into the agreement were not “adverse,” State Farm should not have been collaterally estopped from litigating whether there was coverage under its policy.

Whether it breached its duty to defend Mr. James or not, State Farm consistently informed the parties that it was contesting coverage. Allowing the underlying judgment to be given preclusive effect, would expand the terms of the policy beyond the parties agreement and reward the parties for their collusion and fraud.

E. State Farm Did Not Control the Underlying Litigation.

State Farm initially had a duty to defend its insured (Mr. Sylvestri) and its insured by definition (Mr. James) in the underlying lawsuit. State Farm provided defense counsel to its insureds and, therefore, only monitored the file because it was possible that, at some point, State Farm would have had to indemnify its insureds. However, once it became apparent that Mr. James was not driving the jet-ski and was not an insured by definition, State Farm withdrew paying for his defense. However, at that point, it still had a potential duty to defend Mr. Sylvestri as it was his jet-ski that was involved in the accident.

Because it was still supplying a defense for Mr. Sylvestri, State Farm (as a non-party) could not advance theories that would accuse its insured of wrongdoing in the collusion as to who was

¹³State Farm understands that it is the responsibility of the Legislature and not the Courts to enact statutes and only references the California Code as an illustration of the difficulty states have in addressing these types of situations.

driving the jet-ski at the time of the accident. The attorney provided by State Farm, who was reporting the progress to it, was principally responsible for advancing his clients (Mr. Sylvestri's) interests, who was agreeing to the story that Mr. James was the driver (despite his earlier statements) . Had State Farm forced Mr. Sylvestri's attorney to argue that Messrs. Sylvestri, James and Gasowski were misstating that Mr. James was driving, the attorney would have been acting against his clients wishes and contrary to his interests.

In *Smit v State Farm Mut Auto Ins Co*, 207 Mich App 674; 525 NW2d 528 (1995), the Court of Appeals discussed, among other things, the potential conflict of interest that can arise in situations where the insurer and its insured have adverse interests. As the Court discussed:

Any attorney for [the insurer] representing [the insured] in the underlying action might have faced a conflict of interest if an attempt had been made to introduce evidence of the employment relationship . . . [where] if proven, would not be a valid defense to the claim against [the insured], but it might exclude coverage for her, which would be against her interests. *Smit*, 207 Mich App at 682.

In this case, unlike *Smit*, while the evidence that, if proven, would have shown that Mr. Gasowski was driving the jet-ski, would benefit both Messrs. James and Sylvestri, as well as State Farm, because there was collusion and fraud being perpetrated against State Farm, the attorney for Mr. Sylvestri was put in an impossible situation. He was duty-bound to advance his clients interests, even at the expense of the entity's interest who was paying his fee.

The Alabama Supreme Court, in *Moore*,¹⁴ *supra*, stated it plainly:

. . . [the insurer] was caught between a rock and a hard place, as its interests were in one way adverse to those of the insured. Its interests could be protected by proving that the injuries were intentionally inflicted while [the insured's] liability would be increased by such proof. *Moore*, 349 So2d 1115. (**Appendix "K"**).

In *American Postal Workers Union Columbus Area Local v US Postal Service*, 736 F2d 317, 319 (CA6, 1984), the Sixth Circuit Court of Appeals, applying Ohio law, concluded that, in order for res judicata to apply to a nonparty, there must be a showing that the nonparty's involvement in

¹⁴Although this opinion is not binding on the Court, State Farm submits that the opinion is instructive.

the first action was at least as great as would be reasonably expected from a co-party. (Opinion, **Appendix “L”**). The Court reasoned that, “. . . identity of interests, without more, will not suffice to bar a suit by a nonparty. *Id.* at 318 (CA6,1984), citing *McKinney v Alabama*, 424 US 669, 675-76;96 SCt 1189 (1976).(Opinion attached as **Appendix “L”**).

Clearly, State Farm in the *Gasowski v James* case was certainly not as involved as it would have been if it was a co-party and did not have an identity of interests with the parties who were colluding against it. “Co-party” suggests that the two parties, while maybe not working together, are not adverse. It certainly does not envision the situation where two parties on supposed opposite sides of the case would fraudulently collude against a third-party.

Furthermore, the November 22, 2002 letters to Messrs. James, Gasowski and Sylvestri, placed all of the parties on notice that State Farm was defending the *Gasowski v James* lawsuit, while reserving its right to contest coverage (which it did in the declaratory action). Collateral estoppel should not have barred litigation of who was driving the jet-ski in the *Gasowski v State Farm* suit. State Farm properly reserved its right to contest coverage, was not aligned with its insureds in the underlying action, and did not control the underlying action. Therefore, it should not have been estopped from asserting coverage defenses in the *Gasowski v State Farm* declaratory action.

IV. AN INSURER MUST DEFEND ITS INSURED AS PROVIDED IN THE POLICY UNTIL THE INSURER LEARNS OF SUSPECTED FRAUDULENT CONDUCT AND/OR COLLUSION BETWEEN ITS INSURED AND THE INJURED PARTY. UPON LEARNING OF THE COLLUSION AND/OR FRAUD, THE INSURER SHOULD INSTITUTE A DECLARATORY ACTION TO DETERMINE COVERAGE.

Due to the collusion and fraud perpetrated by its insureds, State Farm, as well as the insureds’ attorney, were placed in an untenable situation. Had State Farm intervened in the action and began asserting that the driver was really Mr. Gasowski, the attorney for the insureds, provided by State Farm, would be forced to argue against State Farm, who was paying his bills, or compromise his client’s interests. State Farm, instead, chose the best option available; it rescinded coverage for Mr. James, allowing him to obtain his own counsel, and was prepared to institute a declaratory action to

determine the identity of the driver, but was beaten to the courthouse by Mr. Gasowski's declaratory action filed against it. Judge Deegan was aware of State Farm's belief that collusion was occurring, but allowed the fraudulent judgment to occur and to be given preclusive effect in the declaratory action anyway.

An insurer is required to defend its insured upon commencement of the underlying suit. An insurer's ". . . duty to defend is broader than[,] and independent of the duty to pay for covered liabilities. The duty to defend is triggered whenever the facts set forth in the pleadings would require coverage, or an 'unpleaded fact or set of facts [known by the insurer to be true] would bring the claim within the coverage of the policy.'" *Frankenmuth Mut Ins Co, Inc v Continental Ins Co*, 450 Mich 429, 447; 537 NW2d 879 (1995), citing *Guerdon Industries v Fidelity & Casualty Co of New York*, 371 Mich 12, 18; 123 NW2d 143 (1963); *Kangas v Aetna Casualty & Surety Co*, 64 Mich App 1, 5; 235 NW2d 42 (1975).

State Farm's initial responsibility upon commencement of the underlying suit was to provide a defense for its insured (and its insured by definition). Absent any fraud or collusion, State Farm's interests would have aligned with its insureds, and the evidence that it was the injured party who was the person driving that caused the accident, would have alleviated State Farm and its insureds from liability. However, State Farm was supplying a defense for parties whose interests did not align with State Farm. Rather, they aligned with the injured party against State Farm by changing their stories. At that time, State Farm still defended its insured, but, as it was learned that Mr. James was not the driver, meaning he was no longer an insured by definition, his defense was withdrawn. A declaratory action was commenced to determine if there was coverage under the State Farm policy.

Judge Deegan knew of the collusion concerns and the fact that the issue of the identity of the driver was in dispute. As Judge Deegan stated, ". . . I'm allowing [James] into this dec action as a necessary party so that he can get sifted out who was driving and who wasn't." (See March 15, 2004 Hearing Trans., at p.20, **Appendix "E"**).

However, knowing these facts, Judge Deegan permitted the collusion and fraud to be

perpetrated on the Court, and denied State Farm from using the proper means in addressing this kind of situation: (1) defend its insured; (2) upon learning of possible collusion, file a declaratory action; (3) resolve issue of coverage; and (4) if appropriate, continue defense of insured. It would also be helpful to have had a stay of further proceedings issued in the underlying action, until the question of coverage is determined. See, i.e., *Espinal, supra*, at 848, **Appendix "H."**

Using that method, the insured, the insurer, and the attorney, are provided with the most protection. The insured is provided the defense he is entitled to under the policy. The insurer is permitted to determine if it is responsible for providing that defense, and the attorney is not caught in a situation where his client and the entity paying his fee have competing interests. Issuing the stay also precludes collateral estoppel from being used in cases where there is suspected collusion between the insured and the injured party. Once the issue of coverage is litigated (first) then the insurer-provided defense can proceed, if appropriate, with the issue of coverage having been resolved.

V. IF THE RELEASE AND SETTLEMENT AGREEMENT WAS BEING USED TO BAR A CLAIM, STATE FARM WOULD HAVE HAD TO AMEND ITS AFFIRMATIVE DEFENSES IN ORDER TO RAISE THAT DEFENSE. HOWEVER, SINCE THE RELEASE WAS BEING USED AS AN AGREEMENT IN ANTICIPATION OF LITIGATION, IT WAS NOT REQUIRED TO BE STATED AS AN AFFIRMATIVE DEFENSE.

A. Background of the Release and Settlement Agreement.

During the underlying litigation, the three insurance companies entered into an agreement wherein each would pay an equal amount of Mr. Gasowski's medical bills in order to not hold up payment for the medical expenses he required. Therefore, it was agreed that each insurance company (State Farm, Safeco and ACIA) would pay \$200,000.00 to end that litigation. Further, it was agreed that, if Mr. James was found to be the driver of the jet-ski at the time of the accident, each insurer would pay an additional \$33,333.33. (Release, **Appendix "F"**). If however, Mr. Gasowski was found to have been the driver, the insurance companies would owe no additional money.

Therefore, the Release was not a traditional release, where the parties are abandoning their

rights, and could thereafter, use the document as a shield against further liability. Instead, it was an agreement by the parties stating their intent to litigate the issue of who was driving the jet-ski, and then determine the responsibility of the insurers after that issue was resolved. For Safeco to enter into that agreement, knowing the intent of the Release, and then attempt to use the agreement as a sword for collateral estoppel purposes, suggests that it entered into that Release in bad faith.

State Farm agrees with the Court of Appeals that, if the Release was intended to be used as a shield, thereby excusing it from further liability, it would be required to be raised as an affirmative defense. (State Farm contends that if it was required, its pleadings were sufficient, see Section D, *infra*). However, in this situation, although the document is titled "Release and Settlement Agreement," it was not a release, but instead, an agreement memorializing the need for further litigation on the central issue. It was not, therefore, required to be raised in State Farm's Affirmative Defenses.

B. Release in General.

Black's Law Dictionary defines "Release" in part as, ". . . the act of giving up a right or claim to the person against whom it could have been enforced. Black's Law Dictionary 1292 (7th ed. 2003). See also, *Matics v Fodor*, 1999 WL 33451700, at *1 (unpublished per curiam opinion of the Michigan Court of Appeals, April 2, 1999)(Black's Law Dictionary (6th ed), defines "release" in part as an "[a]bandonment of claim to party against whom it exists, and is a surrender of a cause of action and may be gratuitous or for consideration," citing *Melo v National Fuse & Powder Co*, 267 F Supp 611, 612 (D Colo 1967)(Opinions attached as **Appendix "M"**), and also as the "giving up or abandoning of a claim or right to person against whom claim exists or against whom right is to be exercised," citing *Adder v Holman & Moody, Inc*, 288 NC 484, 492; 219 SE2d 190 (1975)(Opinion attached as **Appendix "M"**); see also *Larkin v Otsego Memorial Hospital Ass'n*, 207 Mich App 391, 393; 525 NW2d 475(1994)(distinguishing between releases and covenants not to sue, concluded that a covenant not to sue does not abandon the right and does not extinguish the cause of action).

In this case, the document entitled "Release and Settlement Agreement" was not an

abandonment of a right or intended to extinguish the subject matter of the litigation. Instead, it was an agreement to engage in further litigation regarding who was driving the jet-ski at the time of the accident. Therefore, it was not a typical release as contemplated by the Court Rules and did not need to be pled in State Farm's Affirmative Defenses or be deemed to have been waived.

C. The Intent of the Release is Clear.

“The scope of a release is governed by the intent of the parties as it is expressed in the release. If the text in the release is unambiguous, the parties' intentions must be ascertained from the plain, ordinary meaning of the language of the release. A contract is ambiguous only if its language is reasonably susceptible to more than one interpretation.” *Cole v Ladbroke Racing Michigan, Inc*, 241 Mich App 1, 13-14; 614 NW2d 169 (2000); citing *Rinke v Automotive Moulding Co*, 226 Mich App 432, 435; 573 NW2d 344 (1997). [Also, in an unpublished opinion, the Court of Appeals found that the doctrine of offensive collateral estoppel, based on a release, was inapplicable in a legal malpractice case where defendants did not have a “full and fair” opportunity to litigate the issue in the underlying medical malpractice case (they were not parties to that lawsuit) See *Cook v Shensky*, 2004 WL 1335884 at * 4, (unpublished per curiam opinion of the Court of Appeals, decided June 15, 2004, **Appendix “N”**)¹⁵].

As discussed above, due to the collusion between the long-time friends, State Farm was not afforded a full and fair opportunity to litigate the identity of who was driving the jet-ski. (See, Section II, B, *supra*). Therefore, the use of offensive collateral estoppel against State Farm (whether they are determined to have been a party to the underlying litigation or not), is improper. The intent of the Release was not to bar a claim or to shield a party from future litigation. Rather, the obvious intent of the Release, as understood by the parties, was to divide the amount of Mr. Gasowski's medical costs between the parties, and then, in the declaratory action, litigate the issue of who was driving the jet-ski. The clear language of the Release provides:

* * *

¹⁵Although not binding on this Court, State Farm submits this opinion is instructive.

2. **If it is determined in the Declaratory Action that Richard W. James was the driver of the jet ski at the time of the August 31, 2002 occurrence**, following the entry of a Final Order, then Plaintiff shall receive an additional One Hundred Thousand and 00/100 (\$100,000.00) Dollars to be paid equally by each of the three Insurers, to wit: Thirty Three Thousand Three Hundred Thirty Three and 33/100 (\$33,333.33) Dollars within ten (10) days of the issuance of the Final Order.
3. **However, if it is determined in the Declaratory Action that Richard W. James was not the driver of the jet ski at the time of the August 31, 2002 occurrence**, then Plaintiff shall not receive any further monies from the Defendants or their Insurers.

(Release and Settlement Agreement at p. 4, **Appendix "F"**).(Emphasis added).

The only possible way to read the above paragraphs is to conclude that the parties intended to engage in further litigation to determine the identity of the jet-ski driver. The clear intent and unambiguous language of the Release should bind the parties. See *Cole, supra*. Judge Deegan erred when it granted summary disposition against State Farm in the declaratory action based on collateral estoppel.

D. Pleading Release.

The Michigan Court Rules provide:

- (3) *Affirmative Defenses.* Affirmative defenses must be stated in a party's responsive pleading, either as originally filed or as amended in accordance with MCR 2.118. Under a separate and distinct heading, a party must state the facts constituting
 - (a) an affirmative defense, such as . . . release;

* * *

 - (c) a ground of defense that, if not raised in the pleading, would be likely to take the adverse party by surprise.

MCR 2.111(F)(3)(a) and (c)

However, the above-quoted court rule relates to instances where a release will be used as a shield to prevent a party from paying for the same injury twice, something that is not permitted under Michigan law. See *Great Northern Packaging, Inc v General Tire & Rubber Co*, 154 Mich App 777,

781; 399 NW2d 408 (1986).

As the Court of Appeals has found:

An affirmative defense is a defense that does not controvert the plaintiff's establishing a prima facie case, but that otherwise denies relief to the plaintiff. In other words, it is a matter that accepts the plaintiff's allegation as true and even admits the establishment of the plaintiff's prima facie case, but that denies that the plaintiff is entitled to recover on the claim for some reason not disclosed in the plaintiff's pleadings. For example, the running of the statute of limitations is an affirmative defense. Thus, although the plaintiff may very well have a valid claim and is able to establish a prima facie case, the defendant, as an affirmative matter, may nevertheless establish that the plaintiff is not entitled to prevail on the claim because the defendant can show that the period of limitation has expired and, therefore, the suit is untimely.

In the case at bar, the issue whether defendant's alleged insured was operating an owned or non-owned vehicle at the time of the accident does not constitute a matter of an affirmative defense. That is, the issue does not allow for plaintiff's establishing his prima facie case, with defendant coming forth with some other reason why plaintiff should not prevail on that claim. Rather, it directly controverts plaintiff's entitlement to prevail. Thus, it directly denies that plaintiff can establish a prima facie case by stating that plaintiff will be unable to prove that there exists a policy of insurance issued by defendant that provides coverage for the accident, thereby establishing defendant's liability to pay the underlying judgment. *Stanke v State Farm Mut Auto Ins Co*, 200 Mich App 307, 312-313, 503 NW2d 758 (1993). (Emphasis added).

See also, *Amerisure Ins Co v Graff Chevrolet, Inc*, 257 Mich App 585, 590; 669 NW2d 304 (2003) rev'd on other grounds, 469 Mich 1003; 674 NW2d 379 (2004); *Chmielewski v Xermac, Inc*, 457 Mich 593, 617; 580 NW2d 817 (1998) (Evidence that the decision to terminate the plaintiff was motivated by economic considerations directly controverted this element of the prima facie case and, therefore, by definition did not constitute an affirmative defense); *Prentis Family Foundation v Barbara Ann Karmanos Cancer Institute*, 266 Mich App 39, 46; 698 NW2d 900 (2005).

The Court in *Stanke* went on to conclude that:

we believe that the appropriate interpretation of the court rule is that an answer must be **sufficiently specific so that a plaintiff will be able to adequately prepare his case**, just as the complaint must be sufficiently specific so that the defendant may adequately prepare his defense.

* * *

In the case at bar, defendant's answer, although not laying out in exacting detail every theory defendant could possibly allege regarding why there was no coverage, did plead something more specific than "we are not liable." Namely, defendant's answer specifically denied that [the driver] was an "insured" and further denied that there was coverage under the policy at issue. We view this pleading as being sufficient to satisfy the court rule. Had defendants endeavored to present a defense that involved an issue other than whether there was coverage under the policy, then, perhaps, defendant's answer would have been inadequate to preserve such a defense. *Stanke* 200 Mich App at 318.(Emphasis added).

In this case, State Farm denied the late-coming allegation that Mr. James was the driver in each of its Answers and Affirmative Defenses (See **Appendix "D"**). The Affirmative Defenses it filed further provided that there was a lack of coverage for this injury. (**Appendix "D"**).

Further, State Farm's use of the Release was not to controvert the claims in the various lawsuits, but rather, to litigate the very issue that the Release contemplates will be litigated: the identity of the driver of the jet-ski at the time of the accident. Therefore, it did not need to be pled as an Affirmative defense, and was not waived.

E. Even Assuming The Release Had to Be Pled, State Farm Sufficiently Pled the Issue to Place The Parties on Notice of the Defense.

Even assuming *arguendo*, that the Release was required to be pled, State Farm's answer and affirmative defenses put the parties on notice that the issue of the driver's identity and whether there was coverage under State Farm's policy, was being disputed. For those reasons, the pleading was sufficient to satisfy the requirements of MCR 2.111(F)(3)(a). See *Stanke, supra*. Moreover, State Farm filed three Affirmative Defenses in response to these actions. The first on November 26, 2003; the second on September 8, 2004; and the third on December 21, 2004. (See Wayne County Register of Records, **Appendix "O"**). Significantly, all of the Affirmative Defenses provide that there is a "Lack of Coverage Available to Richard James." Therefore, the Answer and Affirmative Defenses filed by State Farm adequately and sufficiently put the parties on notice that State Farm denied that Mr. James was the driver of the jet-ski, and was instead, the passenger, precluding him from being

considered an insured by definition.

Based on these documents alone, even assuming the Release was required to be pled, the other parties were on sufficient notice that State Farm always intended to contest the fact that Mr. James claimed he was driving the jet-ski at the time of the accident.

In *Hanon v Barber*, 99 Mich App 851, 855-856; 298 NW2d 866 (1980), the Court of Appeals reasoned that, “[T]he general rule of pleading affirmative defenses is governed by GCR 1963, 111.7 [now MCR 2.111(F)(3), See 1 Honigman & Hawkins, Michigan Court Rules Annotated, p 201, comment 3D; see also 1 Martin, Dean & Webster, Michigan Court Rules Practice, p 192, comment 6b as cited in *Canon v Thumudo*, 430 Mich 326, 344; 422 NW2d 688 (1988)]. In essence, it is the intent of the rule to provide for fact pleading sufficient to give plaintiff notice of the affirmative defenses alleged.” (Emphasis added). See also *Paterek v 6600 Ltd*, 186 Mich App 445, 451; 465 NW2d 342 (1990). Further, this Court in *Kewin v Massachusetts Mut Life Ins Co*, 409 Mich 401, 456; 295 NW2d 50 (1980) wrote that, “[T]he function of the pleadings is to act as a guide rope, not as a snare or a hangman's noose.” citing *Olson v Dahlen*, 3 Mich App 63, 72; 141 NW2d 702 (1966).

Clearly, the parties were all placed on notice that State Farm intended to contest the issue of whether coverage existed for this claim. The November 22, 2003 letter as well as the Answer and Affirmative Defenses informed the parties that State Farm denied that coverage existed in this matter. The Release merely confirmed an agreement to litigate that issue. Therefore, assuming that the Release was required to be pled as an affirmative defense in order to prevent the offensive collateral estoppel, State Farm’s responsive pleadings were sufficient to place the parties on notice of its defenses, satisfying the requirement of MCR 2.111(F)(3)(a).

RELIEF REQUESTED

For the above-stated reasons, as well as for the reasons stated in the Application for Leave to Appeal to this Court, the Defendant/Appellant, State Farm Fire and Casualty Company, respectfully requests this Honorable Court to affirmatively decree that:

- a. In this State, judgments procured by fraud are void, can be attacked at any time, and are to be afforded no weight;
- b. The identity of the jet-ski driver was never actually litigated;
- c. State Farm was not provided a full and fair opportunity to litigate the issue of the identity of the jet-ski driver;
- d. State Farm was not a party or in privity with a party in the underlying action, and the judgment is therefore not binding on it;
- e. In order to prevent a conflict, when an insured's attorney is provided by an insurance company, and the insurer believes that its insured is colluding with, and/or committing fraud with the injured party, the insurer should institute, or participate in, a declaratory action to determine its duty to defend under the policy;
- f. Because the Release in this case was not intended to abandon any right or end the litigation, it was not required to be pled in State Farm's Affirmative Defenses; or
- g. If the Release was required to be pled, the parties were on sufficient notice of State Farm's intent to litigate the issue of the identity of the driver of the jet-ski, and that the purpose of the Court Rule, requiring a release to be pled, was satisfied; and
- h. Grant the relief sought in State Farm's Application for Leave to Appeal to this Court.

Respectfully submitted,

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