BAD FAITH IN KENTUCKY

A DESK REFERENCE FOR ADJUSTERS

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The utterance of the term “Bad Faith” strikes fear in the hearts of some adjusters and pride in the hearts of some Plaintiff’s attorneys. Despite the prevalence of bad faith claims being made, there are very few instances of actionable Bad Faith in Kentucky. This is because the bar for pleading the claim is low while the bar for success is surprisingly high.

Theories of Recovery

Bad Faith Litigation in Kentucky is governed by both statute, regulation, and common law. KRS 304.12-230, generally referred to as “KUCSPA,” provides the following non-exhaustive list of examples of Bad Faith:

> **(1)** Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
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> **(2)** Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
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> **(3)** Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;
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> **(4)** Refusing to pay claims without conducting a reasonable investigation based upon all available information;
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> **(5)** Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;
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> **(6)** Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;
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> **(7)** Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds;
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> **(8)** Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application;
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> **(9)** Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of the insured;
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> **(10)** Making claims payments to insureds or beneficiaries not accompanied by statement setting forth the coverage under which the payments are being made;
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> **(11)** Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the

purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration;

(12) Delaying the investigation or payment of claims by requiring an insured, claimant, or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information;

(13) Failing to promptly settle claims, where liability has become reasonably clear, under one (1) portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage;

(14) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement;

(15) Failing to comply with the decision of an independent review entity to provide coverage for a covered person as a result of an external review in accordance with KRS 304.17A-621, 304.17A-623, and 304.17A-625;

(16) Knowingly and willfully failing to comply with the provisions of KRS 304.17A-714 when collecting claim overpayments from providers; or

(17) Knowingly and willfully failing to comply with the provisions of KRS 304.17A-708 on resolution of payment errors and retroactive denial of claims.

Violation of a provision above allows for an action by a Plaintiff under Kentucky's private action statute found at KRS 446.070. *State Farm Mut. Auto. Ins. Co. v. Reeder*, 763 S.W.2d 116 (Ky. 1988).

Bad Faith can also be premises in some instances on the violation of Kentucky's Consumer Protection Act at KRS 367.110 *et seq. Stevens v. Motorists Mut. Ins. Co.*, 759 S.W.2d 819 (Ky. 1988). That statute generally prohibits deceptive business practices. The common law also provides for claim for Bad Faith. *Curry v. Fireman's Fund Ins. Co.*, 784 S.W.2d 176 (Ky. 1989).

KAR 806-12.095 provides a number of other requirements on an insurer. Under the regulation, an insurer must keep a claims file which allows the claim handling to be "reconstructed." An insurer cannot attempt to make a payment to a policyholder final unless the limits have been exhausted or the payment is a compromise. An insurer must either notify its unrepresented insured that they have 30 days left on their statute of limitations or cease negotiating with the insured. That requirement does not apply to represented insureds or third-party claimants.

In third-party claims, there is some authority, albeit not from a Kentucky court, that a third-party claimant may not proceed without a judgment or settlement triggering an obligation of the insurer to pay. The Kentucky Supreme Court did state in *Holloway* that without a contractual obligation to pay, there can be no Bad Faith, but it did not go so far as to explicitly say that a judgment/settlement must be reached before suit can be filed for Bad Faith.

Elements of Bad Faith

Despite multiple theories of recovery, the elements of Bad Faith are the same:

> (1) the insurer must be obligated to pay the claim under the terms of the policy;
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> (2) the insurer must lack a reasonable basis in law or fact for denying the claim; and
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> (3) it must be shown that the insurer either knew there was no reasonable basis for denying the claim or acted with reckless disregard for whether such a basis existed.

Wittmer v. Jones, 864 S.W.2d 885, 890 (Ky. 1993). The violation may not be a mere technical violation. *Id.* There must be proof of an evil motive or reckless disregard of another's rights leading to outrageous conduct on the part of the insurer which led to damages on the part of the Plaintiff. *Motorists Mut. Ins. Co. v. Glass*, 996 S.W.2d 437, 452 (Ky. 1997). If the insurer's conduct was not worthy of a punitive damages instruction, Bad Faith is not present.

It goes without saying that only an insurer can be liable for Bad Faith. That becomes less obvious in the presence of a self-insured retention. In that case, the insurer is not the decision maker, and Bad Faith cannot be present until the retention has been spent. *Davidson v. American Freightways, Inc.*, 25 S.W.3d 94, 100 (Ky. 2000).

Third-Party v. First-Party Damages

Unlike some states, Kentucky recognizes a cause of action for third-party Bad Faith under the KUCSPA but not the Consumer Protection Act. *State Farm Mut. Auto. Ins. Co. v. Reeder*, 763 S.W.2d 116 (Ky. 1988); *Motorist Mut. Ins. Co. v. Glass*, 996 S.W.2d 437, 447 (Ky. 1997).

Third parties cannot recover attorney's fees. KRS 304.12-235(3). *Glass*, 996 S.W.2d at 455. First-party claimants can only recover attorney's fees when a specific statute was violated and that statute provides for an award of fees. The best example is KRS 304.12-235 which proscribes a 30 day time frame for making a payment that is due under the terms and conditions of the policy. Failing to make a required payment subjects the insurer to 12% interest per annum, and if the delay in payment was without a reasonable foundation, attorney fees shall be awarded. KRS 304.12-235.

Punitive damages are available in both first-party and third-party Bad Faith cases. *Wittmer v. Jones*, 864 S.W.2d 885, 890 (Ky. 1993). In fact, the threshold for punitive damages of intentional misconduct or reckless disregard for the rights of others must be present for Bad Faith to be found.

Consequential damages are also available. *Curry v. Fireman's Fund Ins. Co.*, 784 S.W.2d 176 (Ky. 1989); *Wittmer v. Jones*, 864 S.W.2d 885 (Ky. 1993). In the case of a failure to defend, attorney fees and costs of defense for the underlying action could be recoverable. Emotional damages are also recoverable regardless of whether there was intent to cause the distress. *Motorists Mut. Ins. Co. v. Glass*, 996 S.W.2d 437 (Ky. 1997); *Ind. Ins. Co. v. Demetre*, 527 S.W.3d 12 (Ky. 2017). Emotional damages need not be supported by expert proof, and consortium damages are also available.

Bad Faith Failure to Settle

The settlement practices of an insurer after the commencement of litigation, but not its counsel's litigation tactics, can serve as a basis for bad faith liability under the KUCSPA. *Knotts v. Zurich Ins. Co.*, 197 S.W.3d 512, 514 (Ky. 2006).

Bad Faith experts are sometimes utilized by Plaintiffs, but those can be excluded if they lack knowledge of jury verdicts in the location of the underlying suit. *Motorists Mut. Ins. Co. v. Glass*, 996 S.W.2d 437, 452 (Ky. 1997). Generally speaking, expert testimony is not required to establish the standard of care for an insurance carrier, but in practice, Plaintiff's prefer to hire favorable experts in hopes of eliciting a higher award from a jury.

Institutional Bad Faith is not considered a separate type of Bad Faith in Kentucky. Recovery for Bad Faith does not require showing patterns of practice by the insurer, but such evidence is potentially relevant in certain cases. *Ky. Farm Bur. Mut. Ins. Co. v. Troxell*, 959 S.W.2d 82 (Ky. 1997).

A jury award of more than the last offer before trial is not automatic Bad Faith as some Plaintiff's lawyers have been led to believe. The key is whether the value of the claim was "fairly debatable," and if so, did the insurer debate the value fairly. *Farmers Mut. Ins. Co. v. Johnson*, 36 S.W.3d 368, 375–76 (Ky. 2000).

Bad Faith Failure to Defend

According to jury verdict statistics, the more dangerous Bad Faith claim is one pursued by the policyholder against the insurer for failing to defend. That claim can be pursued even if the defense was provided under a Reservation of Rights. *Guaranty Nat'l Ins. Co. v. George*, 953 S.W.2d 946 (Ky. 1997); *Ind. Ins. Co. v. Demetre*, 527 S.W.3d 12 (Ky. 2017). A third party, may only bring such an action if the first-party has assigned its rights. *Manchester Ins. & Indem. Co. v. Grundy Ins. Co.*, 531 S.W.2d 493 (Ky. Ct. App. 1975). This practice is not uncommon in situations where the insured is subject to an excess judgment.

Perhaps this is because the duty to defend is broader that the duty to indemnify. In Kentucky, an insurer has a duty to defend if there is any allegation which possibly or potentially might come within the coverage of the policy. *James Graham Brown Found., Inc. v. St. Paul Fire & Marine Ins. Co.*, 814 S.W.2d 273, 279 (Ky. 1991). If one claim within the Complaint triggers coverage, then all claims must be defended. Terms are given their ordinary meaning, and only when an ambiguity is present are the reasonable expectations of the insured relevant. *True v. Raines*, 99

S.W.3d 439, 43 (Ky. 2003). Kentucky includes administrative proceedings as a "suit" where a defense must be provided. *Aetna Casualty & Surety Co. v. Commonwealth,* 179 S.W.3d 830, 837 (Ky. 2005). Finally, Kentucky follows a "known facts" analysis where all known facts that affect coverage are relevant, but if the 8-Corners of the policy and complaint trigger coverage, then the duty to defend is present. In other words, known facts must be used to trigger coverage, but an insurer should not investigate its way out of a duty to defend. *Pizza Magia Intern., LLC v. Assurance Co. of Am.*, 447 F. Supp. 2d 766 (W.D. Ky. Aug. 3, 2006). A defense is owed as soon as the insurer is put on notice that the duty to defend might be triggered, and it can only avoid pre-tender defense costs if it can show actual prejudice by the late notice. *Jones v. Bituminous Cas.*, 821 S.W.2d 798, 801–03 (Ky. 1991). Bad Faith failure to defend can result in exposure over the policy limits. *Cincinnati Insurance v. Vance*, 730 S.W.2d 521 (Ky. 1987).

This was the topic of a recent Supreme Court decision in *Ind. Ins. Co. v. Demetre*, 527 S.W.3d 12 (Ky. 2017). Demetre had a liability policy with Indiana Insurance for property that used to house a gasoline station. At the time the policy was taken out, the property was being monitored by Kentucky state environmental agencies. Demetre testified that he told Indiana Insurance about the past existence of the gasoline station. The Harris family moved in next to property, and then claimed that gasoline fumes emanating from the property caused them injury, and decreased the value of their home. Demetre notified Indiana of the claim. After almost a year without a resolution of their claims, the Harris family filed a complaint against Demetre, and a third-party bad faith claim against Indiana Insurance. Indiana Insurance defended Demetre under a reservation of rights. Indiana filed a declaratory judgment action citing established and novel theories. While that was pending, the tort suit moved forward, and the retained attorney did effectively nothing to actually defend the tort claim. Indiana settled with the Harris family, and Demetre sued Indiana for bad faith. He alleged that he had incurred financial costs of fighting the coverage action while also suffering anxiety at the thought of being personally exposed to liability. The jury awarded him damages for both elements as well as punitive damages, and the Supreme Court upheld all three awards.

Currently, there is no Kentucky case which stands for the proposition that an excess carrier can bring an action against the primary carrier under the theory of equitable subrogation. However, at least one federal court believes that Kentucky may adopt that theory as law in that context. *National Sur. Corp. v. Hartford Cas. Ins. Co.*, 493 F.3d 752 (6th Cir. 2007).

Practice and Procedure

In the event of a simultaneous Bad Faith claim, the first motion the insurer should file is one to bifurcate the proceedings and stay discovery. In *Wittmer v. Jones*, 864 S.W.2d 885 (Ky. 1993), the Kentucky Supreme Court held that bifurcation for trial purposes is mandatory in Kentucky. Some courts will allow discovery to take place on the Bad Faith claim even though that would invade the work-product privilege on the underlying claim. Plaintiffs may argue that bifurcation is only required in third-party cases and not first-party cases, but there is unfortunately no direct

authority to combat that argument. Most courts will adhere to the same rule in both cases. See *Federal Kemper Ins. Co. v. Hornback*, 711 S.W.2d 844 (Ky. 1986).

Advice of counsel is not an absolute defense to Bad Faith. *Hamilton Mut. Ins. Co. of Cincinnati v. Buttery*, 220 S.W.3d 287, 294 (Ky. Ct. App. 2007). That said, advice of counsel can be relevant evidence of reasonable foundation. While no Reverse Bad Faith claim exists in Kentucky, an insurer can elicit evidence of the Plaintiff's conduct if it affects the insurer's conduct. *Farmland Mut. Ins. Co. v. Johnson*, 36 S.W.3d 368, 379 (Ky. 2000).

Discovery in Bad Faith actions is onerous and will significantly burden the primary claims handler and the carrier as a while. Kentucky allows for broad discovery in Bad Faith actions. *Grange Mutual Ins. Co. v. Trude*, 151 S.W.3d 803 (Ky. 2004). Under that case, the following is discoverable:

- Information and documents related to similar claims
- Training and policy manuals
- Procedures for setting reserves to a bad faith claim
- Job performance and disciplinary data contained in the personnel files of relevant employees, including carrier's overall compensation scheme
- Advertising carrier used during the relevant policy period
- Internal company newsletters
- Does not allow discovery by third-party claimant into average amount paid on other claims.

Privilege will apply differently in first-party cases. In such a case, the claims file is created for the benefit of the insured. Only communication with coverage counsel would be privileged.

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