BAD FAITH LAW IN KENTUCKY

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An Overview

Kentucky bad faith law is a product of both the common law and statute and is significant because it is one of a minority of states that still recognizes both first party and third party bad faith. The current bad faith law in the Commonwealth requires an analysis of both common law and statutory law cases to be analyzed under the same test whether or not one or both are at issue.

The Common Law

The most significant Kentucky bad faith case was *Georgia Casualty Co. v Mann* where the court found an insurer could be liable for amounts in excess of its policy limits, if the insurer failed to settle in bad faith.[1] Modern bad faith law in the Commonwealth of Kentucky began in the 1960's when the Kentucky Supreme Court recognized a bad faith refusal by the insurance carrier to settle a claim within the policy limit of the insurance policy in the context of a third party action resulting in an excess verdict against the insured.[2] This cause of action was derivative whereby a liability Plaintiff was assigned the right to the bad faith claim by the insured in order to recover the verdict in excess of the policy limits. In this type of action, no punitive damages were recoverable because it was considered only a breach of contract action.

The test for bad faith in this type of action was whether the failure of an insurer to settle with the liability plaintiff exposed the insured to an unreasonable risk of having a judgment rendered in excess of the policy limits. The Court found the factors to be considered for common law bad faith:

(1) Whether the Plaintiff offered to settle for the policy limits or less,

(2) Whether the insured made a demand for settlement on the insurer, and

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[1] *Georgia Casualty Co. v Mann,* 242 Ky. 447 (Ky. App. 1932)

[2] *State Farm Mutual Automobile Insurance Company v. Marcum* 420 S.W.2d 113 (Ky. 1967) overruled on other grounds, *Manchester Insurance & Indemnity Company v. Grundy* 531 S.W.2d 493 (Ky. 1975) cert. denied, 429 U.S. 821, 97 Sup. Ct. 70, 50 Lawyer's Edition 2d 82 (1976).

(3) The probability of recovery and of a jury verdict which would exceed the policy limits.[3]

Subsequently Kentucky courts began recognizing both first and third party bad faith without the derivative assignment necessary.[4] The Kentucky Supreme Court recognized an insured's recovery against his own insurer of consequential and punitive damages for bad faith in a breach of a business insurance policy based on common law principles.[5]

The Statutes

In addition to a common law action for bad faith the Kentucky Supreme Court has recognized bad faith arising from statute under both the Unfair Claims Settlement Practices Act[6] and the Consumer Protection Act in the late 1980's[7].

The purchase of an insurance policy is a service intended to be covered by the Consumer Protection Act and the Statute allows for the direct action:

> *(1) Any person who purchases or leases goods or services primarily for personal, family or household purposes and thereby suffers any ascertainable loss of money or property real or personal, as a result of the use or employment by another person of a method, act or practice declared unlawful by KRS § 367.170 may bring an action under the rules of civil procedure in the Circuit Court in which the seller or leasor resides or has his principle place of business or is doing business, or in the Circuit Court in which the purchaser or leasor of goods resides, or where the transaction in question occurred, to recover damages. The Court may in its discretion award actual damages and may provide such equitable relief as it deems necessary or proper. Nothing in the Subsection shall be construed to limit a person's right to seek punitive damages where appropriate.*

KRS 367.170 describes unlawful acts under The Consumer Protection Act:

> *(1) Unfair, false, misleading or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful.*

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[3] *Id.* at 500.
[4] *Feathers v. State Farm Fire & Casualty Company* 667 S.W.2d 693 (Ky. App. 1983) overruled by *Federal Kemper Insurance Company v. Hornback*, 711 S.W.2d 844 (Ky. 1986) which in turn was overruled by *Curry v. Fireman's Fund Insurance Company* 784 S.W.2d 176 (Ky. 1989).
[5] *Curry v. Fireman's Fund Insurance Company, Id.*
[6] UCSPA 304.12-230
[7] CPA 367.110

(2) For the purposes of this section, unfair shall be construed to mean unconscionable.

A Consumer Protection Act violation was determined to be an unlawful act from which bad faith could arise in *Stevens v. Motorist Mutual Insurance Company*.[8]

The Kentucky Supreme Court also found in the same year it decided the *Stevens* case, a violation of the Unfair Claims Settlement Practices Act in the context of a third party claim could also create a private cause of action for bad faith against the insurer in *State Farm Mutual Auto v. Reeder*.[9]

The Unfair Claims Settlement Practices Act states it is an unfair claims settlement practice to commit any of the following actions or omissions:

(1) Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;

(2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;

(3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;

(4) Refusing to pay claims without conducting a reasonable investigation based upon all available information;

(5) Failing to affirm or deny coverage of claims within a reasonable period of time after proof of loss statements have been completed;

(6) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;

(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;

(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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[8] *Stevens v. Motorist Mutual Insurance Company* 759 S.W.2d 819 (Ky. 1988).
[9] *State Farm Mutual Auto v. Reeder* 763 S.W.2d 116 (Ky. 1989).

(9) Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of the insured;

(10) Making claims payments to insureds or beneficiaries not accompanied by statement setting forth the coverage under which the payments are being made;

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

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

The Test

In 1993 the Supreme Court finally set out principles under which a bad faith claim would be analyzed, whether it arose from the common law, or statutorily under either the Unfair Claims Settlement Practices Act or the Consumer Protection Act. The Court concluded in *Wittmer v. Jones,* both first and third party claims under the common law, Unfair Claims Settlement Practices Act or the Consumer Protection Act were to be addressed under the same principles with the analysis requiring three (3) elements:

(1) The insurer must be obligated to pay the claim under the terms of the policy;

(2) The insurer must lack a reasonable basis in law or fact for denying the claim; and,

(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 claim existed.[10]

The *Wittmer* court pointed out there was no such thing as a "technical violation" of the UCSPA establishing a private cause of action for tortious misconduct. The court required, before a cause of action existed, there had to be evidence sufficient to warrant punitive damages. The *Wittmer* court stated:

> "The essence of the question as to whether the dispute is merely contractual or whether there are tortious elements justifying an award of punitive damages depends first on whether there is proof of bad faith and next whether the proof is sufficient for the jury to conclude there was conduct that is outrageous because of the defendant's evil motive or his reckless indifference to the rights of others."[11]

The court found, if there was sufficient evidence of either intentional misconduct or reckless disregard of the rights of the insured, the jury may award both consequential and punitive damages but the award of punitive damages was discretionary with the jury.[12]

Subsequently, there have been a number of cases decided by the Kentucky Appellate Court as well as the Kentucky Supreme Court applying the *Wittmer* test. Those cases have found a mere delay in payment does not amount to outrageous conduct resulting in a finding of bad faith, absent some affirmative act of harassment or deception.[13] There must be proof supporting a reasonable inference the purpose of the delay was to extort a more favorable settlement or to deceive the insured with respect to the applicable coverage.[14] It is not bad faith for an insurer to

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[10] *Wittmer v. Jones* 864 S.W.2d 885, 890 (Ky. 1993) quoting the dissent in *Federal Kemper Insurance Company v. Hornback, supra* at 846-47 incorporated by reference in the majority opinion in *Curry v. Fireman's Fund, supra* at 178.

[11] *Wittmer, Id.* citing Restatement 2d Torts § 909(2) (1979), as quoted and applied in *Horton v. Union Light, Heat & Power Company*, 690 S.W.2d 382, 388-390 (Ky. 1985); *Federal Kemper, supra* 711 S.W.2d at 848.

[12] *Wittmer, Id.*

[13] *Motorist Mutual Insurance Company v. Glass,* 1996 S.W.2d 437, 452 (Ky. 1997) citing *Zurich Insurance Company v. Mitchell*, 712 S.W.2d 340 (Ky. 1986).

[14] *Motorist Mutual, Id.* at 453.

offer to settle for less than the policy limits, especially when the claimant never demanded payment of the policy limits or any other sum prior to retaining an attorney.[15]

The Supreme Court determined in *Motorist Mutual Insurance Company v. Glass* the failure to make a correct evaluation of the claim or failure to make any evaluation at all would not constitute conduct that was outrageous because of the Defendant's evil motive or reckless indifference to the rights of others. The Supreme Court explained:

> The UCSPA does not require that a claim be evaluated, or that it be evaluated correctly. It only requires that payment of the claim not be refused without conducting a reasonable investigation based on all available information, KRS 304.12-230(4), and that a good faith attempt be made to effectuate a prompt, fair and equitable settlement. KRS 304.12-230(6).[16]

The *Glass* court stressed the dissenting opinion in *Federal Kemper Insurance Company* as quoted in the *Wittmer* case, "an insurer is entitled to challenge a claim and litigate it if the claim is debatable on the law or the facts".[17]

The Burden of Proof

The Kentucky Court of Appeals pointed out in *United States Auto Association v. Bult* that *Wittmer* "defines and prescribes the nature of the evidence that must exist in order for a matter to be properly submisable to a jury" pointing out the proof must be "sufficient for the jury to conclude that there was conduct that is outrageous, because of the defendant's evil motive or reckless indifference to the rights of others".[18] The *Bult* court set out the burden of proof that must be carried to recover on a claim of bad faith:

> The evidentiary standard is high indeed. Evidence must demonstrate that an insurer has engaged in outrageous conduct toward its insured. Furthermore, the conduct must be driven by evil motives or by an indifference to its insured's rights. Absent such evidence of egregious behavior, the tort claim predicated on bad faith may not proceed to a jury. Evidence of mere negligence, or failure to pay a claim in a timely fashion will not suffice to support a claim for bad faith.

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[15] *Motorist Mutual, Id.* at 453 citing *Davis v. Home Indemnity Company* 659 S.W.2d 185, 189 (Ky. 1983) and *Manchester Insurance & Indemnity Company v. Grundy*,531 S.W.2d 493 (Ky. 1975), cert. denied, 429 U.S. 821, 97 S. Ct. 70, 50 L. Ed.2d 82 (1976).
[16] *Id.* at 454.
[17] *Id.* at 454.
[18] *United States Auto Association v. Bult* 183 S.W.3d 181, 186 (Ky. App. 2003)

> Inadvertence, sloppiness, or tardiness will not suffice; instead the element of malice or flagrant malfeasance must be shown.[19]

The *Bult* court recognized in order to recover punitive damages, and thus prove bad faith, the Plaintiff must prove "by clear and convincing evidence the defendant from whom such damages are sought, acted toward the Plaintiff with oppression, fraud or malice," citing the Kentucky Punitive Damages statute.[20]

Punitive Damages

The punitive damage statute in Kentucky provides the standard of conduct required for punitive damages is oppression, fraud or malice.[21] "Oppression" means conduct which is specifically intended by the defendant to subject the plaintiff to cruel and unusual hardship. "Fraud" means an intentional misrepresentation, deceit, or concealment of material facts known to the defendant and made with the intention of causing injury to the plaintiff. "Malice" means either conduct which is specifically intended by the defendant to cause tangible or intangible injury to the plaintiff or conduct that is carried out by the defendant both with a flagrant indifference to the rights of the plaintiff and with a subjective awareness that such conduct will result in human death or serious bodily harm.

KRS 411.186 allows for a civil action where claims for punitive damages are included, but the fact finder "shall determine whether punitive damages may be asserted". The statutory test for consideration of punitive damages includes:

> (1) The likelihood at the relevant time that serious harm would arise from the defendant's misconduct;
>
> (2) The degree of the defendant's awareness of that likelihood;
>
> (3) The profitability of the misconduct to the defendant;
>
> (4) The duration of the misconduct and any concealment of it by the defendant; and,

[19] *Id.*
[20] KRS 411.184(2)
[21] *Id.*

(5) Actions by the defendant to remedy the misconduct once it became known to the defendant.

The United States Supreme Court has weighed in on the issue of punitive damages related to bad faith and that case has become the backbone of the decisions in Kentucky having been adopted by the Kentucky Supreme Court in 2005 as authority in the Commonwealth for punitive damage awards.[22] In *State Farm Auto Insurance Company v. Campbell*[23] the United States Supreme Court found "compensatory damages are intended to address the concrete loss that the plaintiff has suffered by reason of the defendant's wrongful conduct". But "punitive damages serve a broader function; they are aimed at deterrents and retribution".[24] Nonetheless, the court found the due process clause of the Fourteenth Amendment prohibited the imposition of grossly excessive or arbitrary punishments on a tortfeasor.

The United States Supreme Court set out previously, and reiterated in *State Farm v. Campbell*, the "three guideposts" in determining punitive damages:

(1) The degree of reprehensibility of the defendant's misconduct;

(2) The disparity between the actual or potential harm suffered by the plaintiff in the punitive damages award;

(3) The difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases.[25]

The court paid particular attention to the reprehensibility guidepost finding it the "most important indicia of reasonableness" of a punitive damages award. The Court set out a five (5) prong test to analyze reprehensibility:

(1) Considering whether the harm caused was physical as opposed to economic;

(2) The tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others;

(3) The target of the conduct had financial vulnerability;

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[22] *Kentucky Farm Bureau v Rodgers* 179 S.W.3e 815 (Ky. 2005)
[23] 538 U.S. 408, 123 Sup. Ct. 1513, 155 L. Ed.2d 585 (2003).
[24] *Id.* citing Restatement 2d of Torts § 903 pages 453-454 (1979) and *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.* 532 U.S. 424, 432 (2001)
[25] *Id.* citing *Gore BMW of North America, Inc. v. Gore* 517 U.S. 559 (1996)

(4) The conduct involved repeated actions or was an isolated incident; and,

(5) The harm was a result of the intentional malice, trickery or deceit or mere accident.[26]

The court stated "the existence of any one of these factors weighing in favor of a plaintiff may not be sufficient to sustain a punitive damages award; and the absence of all of them renders any award suspect".[27]

The Supreme Court refused to set a bright line ratio which a punitive damages award cannot exceed, explaining a lesser ratio in a large verdict case may be sufficient in achieving the goals of deterrence and retribution, but determined that single digit multipliers are more likely to comport with due process.[28] The Court found there must be some relationship between the compensatory damages and the punitive damages awarded.

The Kentucky Appellate Court had the opportunity to apply the U.S. Supreme Court test for punitive damages recently in 2010 in *Ragland v. Digiuro.*[29] Although the *Ragland* case was a civil case involving the murder of a University of Kentucky college student and three (3) of the five (5) guideposts in *Campbell* were found applicable, the court reduced the punitive damages award applying the ratio analysis in *Campbell* in conjunction with the Kentucky first blush rule:

> If it causes the mind at first blush to conclude that it was returned under the influence of passion or prejudice on the part of the jury. [Citations omitted] Even if liberal, in award that does not shock the conscience or is not clearly excessive may not be set aside.[30]

Advice of Counsel Defense

Advice of counsel is not an absolute defense to a bad faith claim according to the Kentucky Supreme Court in *Hamilton Mutual Insurance Company of Cincinnati v. Buttery*.[31] The Court found an insurer could not delegate its duty of good faith and fair dealing to anyone else

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[26] *Id.* citing *Gore* at 576-577
[27] *Id.*
[28] *Id.*
[29] 352 S.W.3d 908 (Ky. App.) 2010 disc. review denied by Supreme Court 12/14/11.
[30] *CSX Transportation, Inc. v. Moody,* 313 S.W.3d 72, 85 (Ky. 2010)
[31] *Hamilton Mutual Insurance Company of Cincinnati v. Buttery* 220 S.W.3d 287 (Ky. 2007)

including its defense counsel. The insurer is responsible for its statutory duty to properly investigate claims and adjust them in harmony with the terms and conditions of the policy. The reliance on advice of counsel must be reasonable, but it is a question for the jury. The *Buttery* court reiterated the *Knotts* holding that general litigation tactics distinguished from evidence of settlement behavior during the course of the litigation, is not generally admissible on the issue of bad faith.

The Continuing Duty of Good Faith

"An insurer is entitled to challenge a claim and litigate it if the claim is debatable on the law or the facts."[32] However, the Kentucky Supreme Court has determined the duty of good faith dealings extends through litigation.[33] The Court reasoned, if "the insurer were immunized for objectionable settlement conduct occurring after the litigation begins, the insured would be left without a remedy".[34] The Court cautioned that evidence regarding post filing conduct by the insurance carrier is not automatically admissible requiring the Court to carefully weigh the probativeness of the proposed evidence against the potential for prejudice as required by the Kentucky Rules of Evidence.[35]

PIP Claims

Neither common law bad faith nor statutory bad faith applies to the personal injury protection coverage benefits. In an automobile collision, the Kentucky Motor Vehicle Reparations Act requires every automobile insurer to provide a minimum Ten Thousand Dollars ($10,000.00) in no fault benefits.[36] In 2006 the Kentucky Supreme Court found the MVRA as the exclusive remedy where an insurance company wrongfully delays or denies payment of the no fault benefits as the statute itself provided interest to be assessed at a statutory rate of twelve percent (12%) per annum except if the delay is without reasonable foundation then the interest rate increases to eighteen percent (18%) per annum.[37]

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[32] *Wittmer,* supra as cited in *Motorists Mutual Ins. Co. v Glass* 996 S.W.2d 437,454 (1997)
[33] *Knotts v. Zurich Insurance Company* 197 S.W.3d 512 (Ky. 2006)
[34] *Id.* 523
[35] *Id.* citing KRE 403 and *Timberlake Construction Company v. U.S. Fidelity & Guarantee Company* 71 Fed.3d 335, 341 (10th Cir. 1995).
[36] KRS 304.39 Kentucky Motor Vehicle Reparations Act
[37] KRS 304.39-210

Conclusion

Bad faith law in Kentucky has evolved since first requiring privity of contract for recovery beyond the policy limits of an insurance policy where the insurer has been found to have allowed an excess verdict against its own insured in bad faith. Current law now exposes the insurance company to multiple vehicles for potential allegations of bad faith for its practices in adjusting a claim with an insured or even with a third party. Although the law requires proof of conduct "that is outrageous because of the [insurers'] evil motive or his reckless indifference to the rights of others" to be proven by a clear and convincing standard, a insurance professional in these times must be cognizant of the duties outlined by the UCSPA and the foregoing case law to help guide the adjustment of claims in Kentucky.