

Kentucky High Court Upholds Bad Faith Determination Despite Reservation of Rights Defense and Filing Declaratory Judgment

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James Demetre carried liability insurance on his vacant lot, which was previously a gas station. Demetre was notified that a family occupying a nearby residence was bringing environmental claims against him stemming from the alleged migration of petroleum from his property. Indiana Insurance Company provided a defense under a reservation of rights, sought declaratory judgment on its coverage dispute, and ultimately indemnified Demetre in relation to the final settlement. Nevertheless, Demetre sued Indiana Insurance for bad faith breach of his insurance contract. These claims went to trial and Demetre was awarded \$925,000 in emotional distress damages and \$2.5 million in punitive damages. The resultant question is: how is such a result possible?

Indiana Insurance Company v. Demetre

Demetre obtained liability coverage on his Campbell County property (the vacant lot formerly a gas station) in 2006 through Indiana Insurance Company. In 2008, Demetre received a letter from an attorney informing him the Harris family (nearby residential tenants) had suffered injuries due to gasoline emissions from the Campbell County property. Shortly thereafter, Indiana Insurance agreed to handle the matter under a reservation of rights. Indiana Insurance directed its investigatory team to interview Demetre and conduct an investigation of the Campbell County property. It soon became clear, however, that Indiana Insurance was pouring its efforts into investigating Demetre and its insurance coverage rather than investigating the Campbell County property and the claims from the Harris family. Indiana Insurance did not attempt to speak with any Harris family member, did not request medical records, did not seek medical exams, did not inspect or sample the soil near the residence, and did nothing to determine the validity and nature of the claims.

About six months after the initial claims were made, Indiana Insurance assigned a new claims adjuster to the matter. She only stayed on the matter for about six months, but subsequently admitted to not seeking information about the Harris family and could not recall speaking with Demetre. Harris filed suit alleging trespass, nuisance, and negligent claims against Demetre in August 2009. As part of that suit, Harris also filed a "third party bad faith claim against Indiana Insurance." The second adjuster engaged Attorney Tim Schenkel to defend against the claims filed against Demetre, but never spoke to him during the management of the case. She retained separate counsel to defend Indiana Insurance against the third-party bad faith claim.

A new (third) adjuster was put on the case about one year after the matter's origination. Around this time, Schenkel engaged an environmental expert to analyze the Harris family claims. This expert prepared a memorandum of his findings and concluded that the claims were likely illegitimate. Somehow, however, this memorandum never made it to Indiana Insurance's claims file. During this same time, Indiana Insurance remained focused on denying coverage. About fifteen months after the matter's origination, it claimed to still be defending under a reservation of rights because coverage had yet to be determined.

Finally, nearly two years after the matter's origination, Demetre filed his own counter-claim alleging bad faith against Indiana Insurance. In response, Indiana Insurance sought a declaratory judgment ruling it had no duty to defend or indemnify. The trial court denied the declaratory judgment after concluding that "Indiana [Insurance] is essentially asking the [trial court] to adopt factual defenses in order to grant judgment in their favor." The trial court further concluded that there was no question but that the policy covered the type of loss alleged or that there was a duty to defend. The trial court also ruled that Kentucky had not adopted the known loss or loss-in-progress rules, but even if it had, Indiana Insurance could not prevail on its summary judgment motion. Demetre then filed a motion to discharge Schenkel as counsel and proceed with independent counsel. It was at this time that Indiana Insurance decided to abandon its insurance coverage defenses and resolve all doubts in favor of Demetre.

While Demetre's change of counsel motion was pending, Indiana Insurance decided to retain three attorneys from a new law firm to represent Demetre. Within a matter of weeks, these attorneys took depositions, obtained medical records, had independent medical exams conducted, and inspected the Harris residence. They then concluded this was merely a "nuisance value case" and there was no evidence the Harris family had suffered or would suffer harm from any substances associated with the Campbell County property. These conclusions were similar to the environmental expert's conclusions provided (but not included in the claims file) nearly two years earlier. As a result of the new defense firm's conclusions, Indiana Insurance decided to settle the claims for \$165,000 and fully indemnified Demetre.

Despite the resolution of the liability case, Demetre proceeded on his bad faith claims. He claimed to have personally spent nearly \$400,000 on legal fees and expenses. He also claimed to have suffered from emotional stress during this lengthy process. He testified he "was scared to death. I was looking at all this money. Where was it going to come from? ... I am looking at bankruptcy ... when you're about to lose whatever these figures come out, ten million, three million, it does cause a lot of havoc. Past four years have been a total hell to me."

In addition, counsel for Demetre put on evidence at the bad faith trial which seemed to demonstrate that Indiana Insurance's coverage defenses were weak to non-existent. He also presented expert testimony that "Indiana Insurance violated its common law and statutory duties of good faith and fair dealing, its fiduciary duties, and the Unfair Claims Settlement Practices Act" while also acknowledging that the company could properly "defend under a reservation of rights" and resolve coverage issues by filing a declaratory judgment action. Even so, he was "sharply critical of Indiana Insurance's conduct" which violated Kentucky's Unfair Claims Settlement Practices Act. Indiana Insurance presented its own expert witness who defended the company's handling of this complex environmental claim.

The jury ruled in favor of Demetre on the Unfair Claims Settlement Practices Act, violation of the consumer Protection Act, and breach of the contract claims. The jury awarded Demetre \$925,000 in emotional distress damages and \$2.5 million in punitive damages. This verdict was appealed to Kentucky's Supreme Court, which affirmed.

The Supreme Court noted that in Kentucky, the test is the same whether the bad faith claim is common law or statutory or first-party or third-party. The elements are: "(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 basis existed."

The court then held that defending under a reservation of rights and filing a declaratory action did not automatically absolve an insurance company of bad faith. Rather, this case involved "a sustained effort on the part of Indiana Insurance to deny coverage long after it could and should have determined that it was legally obligated under its contract with Demetre." Further, "the evidence readily supports Demetre's contention that Indiana Insurance was far more interested in denying coverage than defending its insured against the Harris family's claims." Therefore, the court concluded that a reasonable jury could find that Indiana Insurance engaged in bad faith by lacking a reasonable basis to delay its coverage determination, failing to implement reasonable standards for the prompt investigation of claims, and failing to attempt in good faith to settle the claim after liability had become reasonably clear.

Ultimately, it did not matter that the insurer proceeded under a reservation of rights and sought a declaratory judgment on coverage. The insurer was held liable for bad faith for placing its primary focus on its coverage dispute, rather than defending its insured. One more thing to note: Kentucky authorized the recovery of emotional distress damages in a statutory bad faith claim without requiring expert testimony as long as there was "clear and satisfactory" evidence allowing the jury to "infer that anxiety or mental anguish in fact occurred." The court found there was such evidence.

The dissenting justice would have ruled differently on nearly every issue. However, his six fellow justices completely disagreed.