SUPREME COURT OF KENTUCKY
NO.: 2002-SC-001044

KENTUCKY FARM BUREAU MUTUAL INSURANCE COMPANY — **APPELLANT**

-v-

TINA RODGERS (now JOHNSON) — **APPELLEE**

BRIEF FOR AMICUS CURIAE UNITED POLICYHOLDERS

****

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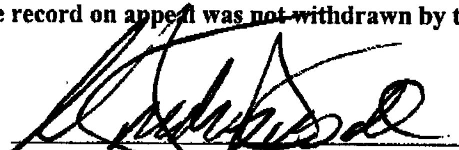
BY: 

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KENTUCKY SUPREME COURT
No. 2002-SC-001044

KENTUCKY FARM BUREAU MUTUAL INSURANCE COMPANY — APPELLANT

ON REVIEW FROM COURT OF APPEALS
2001-CA-000152
LINCOLN CIRCUIT COURT NO. 98-CI-00274

TINA RODGERS (now JOHNSON) — APPELLEE

BRIEF OF *AMICUS CURIAE* UNITED POLICYHOLDERS

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INTRODUCTION

This appeal is an appeal by an insurance company (Kentucky Farm Bureau Mutual Insurance Company) from a jury verdict in a third-party bad faith action in which the policyholder (Ms. Rodgers) was awarded $30,000 in compensatory damages and $1,000,000 in "extra contractual" damages. The insurance company purports to raise issues concerning the trial court's admission of evidence and the Court of Appeals' review of the punitive damage award.

United Policyholders as *Amicus Curiae* respectfully suggests that the appeal be denied and that the decision of the Court of Appeals be affirmed.

INTEREST OF *AMICUS CURIAE*

See motion for leave to file *amicus* brief.

STATEMENT OF THE CASE

Plaintiff and policyholder, Tina Rodgers Johnson, was injured on October 26, 1997, when her car was rear-ended by Peal Snow. Ms. Johnson had purchased a policy of insurance from appellant, Kentucky Farm Bureau Mutual Insurance Company ("Insurance Company"), which promised $50,000 in underinsured motorist ("UIM") benefits.

The Insurance Company contends the trial court committed four errors. The Insurance Company claims error in admitting evidence of Mabel Raines' unrelated third-party claim against another Insurance Company policyholder. Second, the Insurance Company claims the trial court erred in allowing an expert witness to give an opinion about the value of Ms. Johnson's claim in Lincoln County, even though the expert had no direct experience with claims in Lincoln County. Third, the Insurance

Company claims that the trial court erred in giving an instruction stating that the Insurance Company had refused to pay Ms. Johnson claim.

I. THE INSURANCE COMPANY'S ATTACK ON THE PUNITIVE DAMAGE JUDGMENT FAILS AS A MATTER OF FACT

The Insurance Company failed to offer proof at the trial that the judgment against it was constitutionally infirm. In fact, the jury in this case awarded extra-contractual damages. The Insurance Company says it treats these extra-contractual damages as "punitive damages" and therefore they are constitutionally infirm.

The Insurance Company offered no proof at the trial that the extra contractual damages were punishment or punitive.

Insurance companies regularly deduct punitive damages for Federal Income Tax purposes. The Internal Revenue Service ("IRS") considers punitive damage awards deductible if the award resulted from conduct perpetrated in the normal course of the defendant's business. *See* Rev Rule 80-211, 1980-2 Cum Bull 57.

The Eight Amendment protects people from being disproportionately punished or penalized relative to the crime committed. Punitive damages cannot be a penalty or punishment within the meaning of the Eighth Amendment and still they qualify as tax deductions. The Supreme Court has explicitly stated that public policy should bar a tax deduction when: (1) there is a statutory fine or penalty, or (2) when expenses are incurred to exert undue influence over federal legislation. *See Commissioner v. Heininger*, 320 U.S. 467 (1943). The Insurance Company cannot have it both ways. If punitive damage awards are fines or penalties within the meaning of the Eighth Amendment, then *Heininger* prohibits them from being tax deductible. The Insurance Company offered no proof at the trial that the jury award in this case was not

an ordinary and necessary business expense. That is a failure of proof. This Court should not "fill-in" the facts.

Second, the Insurance Company failed to prove at the trial that the jury award against it was not "insured" and "reinsured". The common wisdom is that punitive damages are not insurable. The Insurance Company failed to prove that it did not have valid and collectible insurance, reinsurance or both for the amounts awarded by the jury. That is a failure of proof.

The Insurance Company failed to establish at the trial that the jury award was not simply "Extra Contractual Cover" which was covered by insurance or reinsurance purchased by the Insurance Company. That is a failure of proof. This Court should not surmise or guess about what the facts are or might be. A Constitutional defense in the context of this case is an affirmative defense. Just because the Insurance Company says that this silk purse is a sow's ear does not make it a sow's ear.

II. THE INSURANCE COMPANY'S ATTACK FAILS AS A MATTER OF LAW

A. Insurance companies Pay Punitive Damages in the Ordinary Course

If an insurance fails to settle a claim within policy limits it may incur liability in excess of policy limits. These extra-contractual payments are not treated as punitive damages and, of course, in the insurance industry payments are not called punitive damages. The insurance industry rule seems to be that a rose by any other name would not smell the same.

The excess of limits payments in this case does not implicate the 8th Amendment simply because the insurance companies do not consider them to be in the nature of excessive fines or punishments.[1]

B. Insurance Companies Buy Insurance To Cover Punitive Damages, but Do Not Call It Punitive Damages Insurance - Primary Insurance

Insurance companies regularly purchase insurance policies providing punitive damage coverage for potential liability arising out of their own bad faith conduct. This is called extra contractual coverage ("ECO"). Extra-contractual coverage means payments beyond the insurance policy limits by the insurance company for wrongful conduct, but it is carefully not called punitive damage insurance.

Since the late 1950's, ceding insurance companies have demanded that reinsurance policies contain ECO provisions, in order to expand the scope of reinsurance policies. *See* 14 Eric Mills Holmes, *Holmes' Appleman On Insurance 2d* Section 102.5 at 51 (2d ed. 2000). The widespread use of such coverage is because "'bad faith is to insurance companies what product liability is to manufacturers.' Accordingly, [] ECO coverages are in reality much like a claims department errors and omissions insurance policy sold directly by the reinsurer to the ceding insurer." *Id.* At 53 (*citing* Robert J. Prahl, *Liability Claim Concepts and Practices* 164 (1985) and *Ott*). The insurance industry is not inhibited by the common wisdom that punitive damages are not insurable.

A typical and common reinsurance provision covers a ceding insurance company's punitive damages and related expenses and defines loss as follows:

[1] "This situation typically arises when a liability insurer is guilty of 'bad faith' in refusing to settle a claim against its policyholder within its direct policy limits." 14 Eric Mills Holmes, *Holmes' Appleman On Insurance 2d* § 102.5(F)(1) at 49 (2d ed. 2000).

(c)(2) equal to 100% of the amount paid by [MCCC] for punitive, exemplary, or compensatory damages awarded to the insured and arising out of the conduct of [MCCC] in the investigation, trial or settlement of any claim or failure to pay or delay in payment of any benefits under any policy if [ERC] has, in advance of any such conduct by [MCCC] counseled with [MCCC] and concurred in [MCCC's] course of conduct.

Employers Reinsurance Corp. v. Mid-Continental Casualty Co., 202 F.Supp.2d 1221, 1226 (D. Kan. 2002).

ECO provisions were designed to deal with a loss incurred by a policyholder in excess of the policy limits and/or outside the scope of the underlying coverage. *Ott v. All-Star Ins. Co.*, 299 N.W.2d 839, 847 (Wis. 1981). Such common ECO clauses are intended to protect cedents from bad faith tort liability to their policyholders. *Id.* At 846. Appleman concurs that such losses generally include punitive damages assessed against the ceding insurance company for bad faith conduct against its policyholder. The scope of the provision was addressed in *Ott.*

> The Judgment in Excess of Policy Limits Clause is relatively widely used and provides the reinsurer will participate in such excess verdicts but not to exceed the reinsurance contract limits
>
> The Judgment in Excess of Policy Limits Clause is often the repository of specific extra-contractual, including punitive damage, exclusion language . . .

Ott, supra at 845-46.

A ceding insurance company's tortuous conduct covered under an ECO clause includes the denial of a policyholder's claim based on an inadequate investigation; intentional misrepresentations of claims or policy terms; false accusations by the ceding insurance company against its policyholder; failure to disclose the policyholder's rights; unfair marketing practices; the ceding insurance company's unreasonable rejection of a

settlement offer within policy limits in a case against the policyholder; agent misrepresentation or fraud; or other acts of bad faith that expose a policyholder to liability beyond its policy limits. Larry P. Schiffer & William Bodkin, *Caveat Reinsurer: Reinsuring Punitive Damages Under ECO Clauses*, 37 TORT & INS. L.J. 147, 159 (2001).

C. Insurance Companies Buy Insurance To Cover Punitive Damages, but Do Not Call It Punitive Damages Insurance - Reinsurance

The ECO provisions in reinsurance contracts are not reinsurance in the literal sense of the word because they operate as direct liability insurance running from the reinsurance company to the ceding insurance company for its liability in handling claims of its policyholders. *See OTT v. All Star Ins. Co.*, 299 N.W.2d 839, 846 (Wis. 1981).

The scope of ECO reinsurance provisions effectively dilutes, if not completely eradicates, the intended punishment of a punitive damage award levied against an insurance company for bad faith conduct. The ability of insurance companies to pass along punitive damage liability illustrates the fundamental difference between a punitive damage award against an automobile manufacturer and an insurance company. Insurance companies may not only anticipate that an award could be levied against them for certain conduct, but may make risk shifting agreements for the payment of those punitive awards. In fact, the process the insurance company can deduct the reinsurance premium as an ordinary and necessary business expense.

PUNITIVE DAMAGES
AND CAMPBELL CASE --
MCCARRAN-FERGUSON ACT

In Campbell the United States Supreme Court was writing about a Utah accident and the conduct of State Farm virtually nationwide. This case involves a Kentucky policyholder, a Kentucky accident, claims handling in Kentucky and a Kentucky insurance company.

The McCarran-Ferguson Act restored to the states broad authority to tax and regulate the insurance industry. *United States Department of Treasury v. Fabe,* 508 U.S. 491 (1993). It sets forth a special insurance-related anti-preemption rule. That rule provides that a federal law will not pre-empt a state law enacted "for the purpose of regulating the business of insurance" - unless the federal statute "specifically relates to the business of insurance." 15 U.S.C. 1012(b) There is no federal law or preemption issue in this case, therefore the McCarran-Ferguson Act is irrelevant. Campbell barred Utah from applying its laws to regulate auto claims practices that affect both Utah and non-Utah residents. The trial court here correctly applied the law of the state where the defendant chose to be domiciled, the state where the illicit claims practices happened, the state where the policyholder lived and where she acquired the insurance policy.

THE TESTIMONY OF MABEL RAINES AND DAVID DUNCAN

Geocentricism
<u>David Dunham Testimony</u>

The Insurance Company's argument is that Mr. Dunham worked on the wrong side of the tracks. Is this Court incompetent to decide this case because not a single member is from Lincoln County?

Insurance adjusting is not rocket science. Insurance company adjusters and supervisors are not limited geographically.

A serious response to the Insurance Company argument would be for this Court to hold that no insurance company adjuster <u>or supervisor</u> should be permitted work outside a single county. Such a holding would bring forth a chorus of moans and cries.

United Policyholders respectfully suggest that the objection does not pass the laugh test.

<u>Mabel Raines Testimony</u>

The Insurance Company has argued that Mr. Dunham is "too encompassing." Regarding Ms Raines it says "that she is not encompassing enough." Neither position was supported at the trial by factual or expert testimony. This makes judges underwriters by hindsight. The policyholder's lawyer was no fool. He could have countered facts at the trial. The policyholder should not be required to counter fantasy, supposition and speculation on appeal.

The Insurance Company's lawyer's arguments do not weigh in as facts.

This Court should not act in hindsight as an adjuster, an underwriter or an insurance company defense lawyer.

B. PUBLIC SERVICE NATURE OF INSURANCE

I. Insurance Is Special

Insurance companies hold themselves out to the people of Kentucky, the public, insurance regulators, legislators, courts and public officials as public service organizations. Based upon their claimed roles as public servants and protectors against death, disaster, destruction, disability and disease, the insurance industry gets the benefit of very special treatment from the public, insurance regulators, legislators, courts and public officials. The instances of the insurance industry receiving special treatment not afforded to other corporations or citizens are legion.

The public service benefits promised by the insurance industry include:

a. jobs for citizens of Kentucky;
b. support for businesses in the State via investments;
c. safety studies;
d. safety programs;
e. safety legislation;
f. promoting safety;
g. education programs;
h. protecting the public; and
i. eliminating hazards.

Dean Roscoe Pound, over 80 years ago in The Spirit of the Common Law (1921), noted:

> [W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public.[2]

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[2] Roscoe Pound, The Spirit of the Common Law 29 (Marshall Jones Co. 1921). (Add. 4)

A standard textbook used to train insurance industry personnel has emphasized the need to monitor and enforce the special duties of the insurance industry:

> Notwithstanding the often stated opinion that the insurance contract is a contract affected with a public interest, insurers often view their policies as simple contractual obligations between parties. While an insurance policy does represent a contractual commitment, the attitudes of the general public, the legislatures, and the courts make clear that the insurance agreement is viewed as having broader ramifications than a mere contract. The public has a definite interest in the reliability of the insurance product. Insurance involves an obligation that affects the public interest as well as the policyholder and therefore is necessarily subject to certain restrictions.[3]

Insurance protects not only policyholders, but also neighbors, the community, creditors and employees. To the extent insurance does not deliver the promised peace of mind to the policyholder there are and should be legal consequences. Policyholders like Ms. Rodgers should not be the ones to suffer the consequences if entities like the Insurance Company cannot live up to the standards inherent in the insurance policies under which they agree to, and are paid for, administering claims. Another standard insurance textbook, published by the Insurance Institute of America, described the benefits of insurance this way:

> In addition to eliminating or reducing the financial uncertainty of risks to individuals and businesses, insurance benefits society by paying for losses, providing funds for investments, controlling losses, supporting credit, allocating resources, and satisfying legal and business requirements.[4]

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[3] James J. Lorimer et al., The Legal Environment of Insurance 38 (3d ed. American Institute For Property And Liability Underwriters 1987) (emphasis added) (Add. 6)

[4] James J. Markham et al., The Claims Environment 2 (1st ed. Insurance Institute of America 1993) (Add. 7). The Insurance Institute of America is located in Malvern, Pennsylvania and, directly or indirectly, trains tens of thousands of students of insurance. Its textbooks are

Another text used to train insurance industry claims personnel notes that statutes concerning the handling of claims "have been enacted by state legislatures in order to control the activities of the insurance companies and their relationships with policyholders."[5] Yet another text used to train insurance industry professionals states:

> Insurance contracts are different from other commercial contracts because insurance is more a necessity than a matter of choice. Therefore, insurance is a *business affected with a public interest*, as reflected in legislative and judicial decisions.[6]

LITIGATION MACHINES

The insurance industry is unique in its financial structure and in its involvement in legal matters. The insurance industry spends over one billion dollars per year in legal fees in coverage disputes with its policyholders.[7] The insurance industry is far and away the largest user of the United States civil justice system.

When one contracts for a Cadillac, and is tendered a Yugo, the would be purchaser can cancel his or her check and go to another car dealership. A policyholder, however, who is promised Cadillac insurance at the point of sale and receives Yugo insurance at the point of claim cannot "cover" by going back in time and purchasing alternative insurance. In fact, once a loss has occurred, the "event" is no longer insurable. Fortuity now becomes certainty.

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standard works in the field. Insurance benefits no one if valid claims are not administered properly.

5 Id. at 347 (Add. 7)

6 James J. Lorimer, et al., The Legal Environment of Insurance 179 (4th ed. Insurance Institute of America 1993) (emphasis in original) (Add. 8)

7 See Leslie Scism, Tight-Fisted Insurers Fight Their Customers To Limit Big Awards, Wall Street J., Oct. 15, 1996 at 1.

When a loss occurs, a policyholder is at a distinct economic disadvantage. To begin with, the policyholder has already "lost" the premium, *i.e.*, the sum certain paid to insure against future losses. Typically, the very reason for purchasing insurance is to cover losses that a policyholder can not pay for out of its own resources. The plight of the policyholder is compounded when its claim is improperly denied. With resources already depleted by premium payments and under financial pressure from the very catastrophe which led to the claim, the policyholder will have few resources to contest the denial. Many states have recognized that the peculiarities of aleatory insurance transactions require the specter of punitive damages to protect policyholders:

> Insurance is different. Once an insured files a claim, the insurer has a strong incentive to conserve its financial resources.[8]
>
> Generally, the non-breaching party to a contract can replace the performance of the breaching party by simply paying market price for substitute performance.

Further, insurance policies are not physical products, which can be inspected prior to sale and remain constant, but promises, expressed in words that are often uncertain and which can be subject to multiple interpretations. At the point of sale, it is difficult to evaluate the quality of the insurance purchased; one cannot "kick the tires" of an insurance policy. Both the buyer and seller want a new Ford to work. After the sale the insurance company does not want its insurance policy to work. Rather, the quality of the promises in an insurance contract can be evaluated only by the insurance company's future performance.

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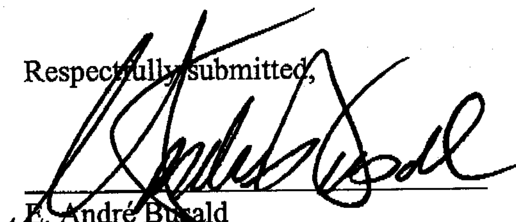
8 *E.I. Du Pont de Nemours & Co. v. Pressman*, 679 A.2d 436, 447 (Del. 1996) (emphasis added).

CONCLUSION

For all of the above reasons, United Policyholders respectfully requests that this Court uphold the jury's verdict and find for Ms. Rodgers.

Respectfully submitted,



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