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# Commonwealth Of Kentucky

# Court Of Appeals

NO. 2000-CA-001008-MR

SPHERE DRAKE INSURANCE
COMPANY, UNIONAMERICA
INSURANCE COMPANY, CNA
INTERNATIONAL REINSURANCE
COMPANY, AND UNDERWRITERS
AT LLOYDS, LONDON APPELLANTS

v.

APPEAL FROM FAYETTE CIRCUIT COURT
HONORABLE GARY D. PAYNE, JUDGE
ACTION NO. 98-CI-03151

FOURTH STREET TOBACCO
WAREHOUSE, K. GREGORY HAYNES,
AND KEVIN P. CROOKS APPELLEES

## OPINION
## AFFIRMING

** ** ** ** **

BEFORE: GUDGEL, CHIEF JUDGE; COMBS AND KNOPF, JUDGES.

KNOPF, JUDGE: In early February 1998, a storm blanketed much of central Kentucky beneath two feet of heavy snow and sleet. The massive snowfall caused several portions of the roof of the Fourth Street Tobacco Warehouse in Lexington to collapse, and the collapse in turn caused additional damage to the building’s walls, floor, and support system. Fourth Street, which is in the business of storing and selling tobacco, notified its insurers of the damage and in due course claimed losses totaling almost 2.5 million dollars, the limit of its coverage.  The insurers--Sphere Drake Insurance Company, UnionAmerica Insurance Company, CNA International Reinsurance Company, and Underwriters at Lloyds London--did not dispute that the storm damage was covered under Fourth Street's policies.  They valued the claim, however, at only slightly more than 1.5 million dollars.  They paid Fourth Street that amount and refused its demand for any more.  A jury trial ensued, and by judgment entered January 18, 2000, the Fayette Circuit Court awarded Fourth Street damages, interest, and attorney fees of almost 1.5 million dollars for the insurers' breach of contract and for their violation of KRS 304.12-230, the Unfair Claims Settlement Practices Act.  Appealing from that judgment, the insurers contend that the trial court erroneously deemed them to have waived a contract provision conditioning their liability.  They also contend that the evidence did not support either the finding that they had acted in bad faith or the conclusion that they should pay interest and attorney fees. Unpersuaded by these allegations of error, we affirm the trial court's judgment.

In the months immediately following the snow storm, Fourth Street demolished the damaged warehouse and prepared the site for a new building.  Fourth Street's president testified that he had hoped to have a new building completed by the fall of that year to be ready for the 1998 tobacco harvest and sales season.  When the insurers refused to pay more than 1.5 million dollars, however, the company suspended its rebuilding plans and made other arrangements. It filed suit against the insurers in August 1998. It alleged that the insurers' valuation of the loss was inadequate and that they had not arrived at it or relied upon it in good faith. At the time of trial, in October 1999, Fourth Street still had not rebuilt or replaced its warehouse.

At the close of Fourth Street's proof and following their own proof, the insurers moved for a directed verdict. They renewed the motion in their post-trial pleadings. The insurers argued that, by the plain terms of the policy, Fourth Street's rebuilding or replacing the warehouse was a condition precedent to the insurers' duty to pay functional-replacement-cost benefits. Ruling that the insurers had waived reliance on that condition, the trial court denied their motions. The insurers have appealed from that ruling and contend that the trial court erred by deeming them to have waived their right to rely on the condition precedent. We disagree.

Fourth Street's insurance policies each provided in pertinent part that

> [i]n case of loss of or damage to property insured hereunder, the basis of adjustment shall be as follows: . . .
> e. All other property [aside from several exceptions not material to this case] at the actual cash value immediately prior to the loss.

This provision was modified by the following endorsement:

> A. Functional Replacement Cost replaces Actual Cash Value in the VALUATION Loss Condition for the property described in the Schedule or the Declarations. Functional Replacement Cost means the cost to replace the property with similar property intended to perform the same function when replacement

> with identical property is impossible or unnecessary.
>
> . . .
>
> C. Functional Replacement Cost does not apply to the following even when attached to a building:
>
> 1. Awnings or floor coverings;
> 2. Appliances for refrigerating, ventilating, cooking, dishwashing or laundering; or
> 3. Outdoor equipment or furniture.
>
> D. We will not pay on a Functional Replacement Cost basis for any loss or damage:
>
> 1. Until the lost or damaged property is actually repaired or replaced; and
> 2. Unless the repairs or replacement are made as soon as reasonably possible after the loss or damage.
>
> E. We will not pay more for loss or damage on a Functional Replacement Cost basis than the least of:
>
> 1. The Limit of Insurance applicable to the lost or damaged property;
> 2. The cost to replace, on the same premises, the lost or damaged property with other property used for the same purpose; or
> 3. The amount you actually spend that is necessary to repair or replace the lost or damaged property.

Fourth Street’s functional-replacement-cost policy is a variety of replacement cost coverage. Such coverage

> was devised to remedy the shortfall in coverage which results under a property insurance policy compensating the insured for actual cash value alone. That is, while a standard policy compensating an insured for the actual cash value of damaged or destroyed property makes the insured responsible for bearing the cash difference necessary to replace old property with new property, replacement cost insurance allows recovery for the actual value of property at the time of loss, without deduction for deterioration, obsolescence, and similar depreciation of the property’s value.[1]

[1] Randy R. Koenders, Annotation, *Construction and Effect of Property Insurance Provision Permitting Recovery of Replacement Cost of Property,* 1 ALR 5th 817, 827-28 (1992).

Lest coverage beyond the actual cash value of the loss create a moral hazard, however,[2] replacement-cost policies such as Fourth Street's typically limit "all replacement cost recovery [] to actual cash value until repair or replacement is complete."[3]

These policies also typically provide, again as did Fourth Street's, that the insurer's liability is limited to the least of the policy limits, the appraised costs, or the actual costs to repair or replace the damaged building.

> The first measure, of course, limits the amount available for replacement to policy limits, while the second relates to a theoretical or hypothetical measure of loss: that is, the replacement cost of rebuilding the identical structure[4] as one limit of the company's liability. This particular limitation does not require repair or replacement of an identical building on the same premises, but places that rebuilding

[2] The insurance industry created replacement cost policies in response to the threat of arson arising from the difference between actual cash value and replacement cost. Replacement cost policies provide for coverage up to the face amount of the policy only upon replacement, limiting recovery to cash value if the structure is not replaced. The goal of these policies is to remove the incentive for arson. (An older structure purchased for $100,000 that would cost $200,000 to replace and is insured for $200,000 presents a grand incentive for arson if the full $200,000 is recoverable whether or not the structure is replaced.)

McGlone v. Midwestern Group, 573 N. E. 2d 92, 97 (Ohio, 1991) (dissenting opinion by J. Wright).

[3] Hilley v. Allstate Insurance Company, 562 So. 2d 184, 189 (Ala., 1990) (citations and internal quotation marks omitted); Higgins v. Insurance Company of North America, 469 P.2d 766 (Ore., 1970).

[4] Fourth Street's coverage was for functional as opposed to regular replacement cost. Under a functional replacement cost policy, the insurer's liability is limited by the replacement cost of rebuilding not an identical structure, but a structure which is the functional equivalent of the damaged one. This permits repair or replacement with designs and materials less expensive than the originals provided the substitutions do not impair the structure's usefulness.

> amount as one of the measures of damage to apply in calculating liability under the replacement cost coverage.  The effect of this limitation comes into play when the insured desires to rebuild either a different structure or on different premises. In those instances, the company's liability is not to exceed what it would have cost to replace an identical structure to the one lost on the same premises. Although  liability is limited to rebuilding costs on the same site, the insured may [spend] that amount and build a structure on another site, or use [that amount] to buy an existing structure as the replacement, but paying any additional amount from his or her own funds.
>
> Finally, the third limitation of liability strengthens the requirement that liability of the company does not exist until repair or replacement is made.  The purpose of this limitation is to limit recovery to the amount the insured spent on repair or replacement as yet another measure of the loss liability of the insurer. This third valuation method is intended to disallow an insured from recovering, in replacement cost proceeds, any amount other than that actually expended.[5]

It is by now well-established in the jurisdictions where these issues have been addressed that replacement-cost policies are generally valid and are to be enforced according to their plain terms.[6]  In particular, absent a sufficient reason to the contrary, the condition that Fourth Street repair or replace its warehouse should have been enforced.

Is there a sufficient reason to the contrary?  Fourth Street argues that there is, that the insurers waived their right

[5] Hess v. North Pacific Insurance Company, 859 P. 2d 586, 588 (Wash., 1993) (quoting from Jordan, What Price Rebuilding?, 19 The Brief 17, 19-20 (Spring 1990)).

[6] *See, for example,* Miller v. Farm Bureau Town & Country Insurance Co. of Missouri, 6 S.W.3d 432 (Mo. App., 1999); Maryland Casualty Company v. Knight, 96 F.3d 1284 (9th Cir. 1996); National Tea Company v. Commerce and Industry Insurance Company, 456 N. E.2d 206 (Ill. App., 1983); *see also* Snellen v. State Farm Fire and Casualty Company, 675 F. Supp. 1064 (W.D. Ky., 1987).

to assert the condition precedent. The trial court agreed and so held. As Fourth Street correctly notes, waiver is among those grounds on the basis of which a court may refuse to enforce provisions of an insurance contract.[7] Waiver in this context has been characterized as

> a voluntary and intentional relinquishment of a known, existing right or power under the terms of an insurance contract. It is the expression of an intent not to insist upon what the law affords. The intention may be inferred from conduct and knowledge and may be actual or constructive, but both intent and knowledge are essential elements of waiver. . . .[8]

Where, as here, the underlying historical facts are not in dispute, whether there was a waiver of contract terms is a question of law, which this Court reviews *de novo*.[9]

We agree with the trial court that, under the facts of this case, the insurers waived their right to insist upon the repair-or-replace condition precedent. As Fourth Street notes, from February 1998 until the commencement of trial in October 1999, the insurers gave no indication that they disputed Fourth Street's claim for any reason other than its amount. On the contrary, they tendered what they themselves characterized as

[7] Edmondson v. Pennsylvania National Mutual Casualty Insurance Company, Ky., 781 S.W.2d 753 (1989); United States Fidelity & Guaranty Company v. Miller, 237 Ky. 43, 34 S.W.2d 938 (1931). The doctrine of waiver has been applied most readily to formal conditions of the contract, such as technical proof-of-claim requirements. *See, for example,* State Automobile Mutual Insurance Co. v. Outlaw, 575 S.W.2d 489 (1978).

[8] Edmondson, 781 S.W.2d at 755.

[9] Morganfield National Bank v. Damien Elder & Sons, Ky., 836 S.W.2d 893 (1992).

functional-replacement-cost benefits despite the fact that Fourth Street had not yet replaced anything.

The contract, moreover, provides not only that damaged property must actually be repaired or replaced, but also that the repairs or replacement be "made as soon as reasonably possible after the loss or damage." The insurers' denial of Fourth Street's claim, by rendering uncertain the resources available to Fourth Street for rebuilding, made it impossible for Fourth Street to decide in a timely manner whether to rebuild. It is a fundamental rule of contract law, however, that

> [o]ne who prevents or makes impossible the performance or happening of a condition precedent upon which his liability by the terms of a contract is made to depend cannot avail himself of its nonperformance.[10]

Several courts have refused to enforce a replacement-cost policy's repair-or-replace condition where the insurer prevented the insured from satisfying it.[11]

This result is particularly appropriate where the insurer's interference with the satisfaction of the condition is the result of bad faith. Although made many years ago and although referring to a different condition precedent, the following statement by the Court in Continental Insurance Company

[10] 17 Am. Jur. 2d *Contracts* § 703 (1991). *See also* Restatement (Second) of Contracts § 245 (1981).

[11] Zaitchick v. American Motors Insurance Co., 554 F. Supp. 209 (S.D.N.Y. 1982), *aff'd.* 742 F. 2d 1441 (2nd Cir.), *cert. denied,* 464 U.S. 851 (1983); Pollock v. Fire Insurance Exchange, 423 N. W. 2d 234 (Mich. App., 1988); Bailey v. Farmers Union Coop Insurance Co., 498 N. W. 2d 591 (Neb. App., 1992); Maine Mutual Fire Insurance Company v. Watson, 532 A. 2d 686 (Me. 1987); Columbia Mutual Insurance Company v. Sanford, 920 S.W.2d 28 (Ark. App., 1996).

v. Vallandingham & Gentry,[12] is applicable to the repair-or-replace clause at issue here:

> This clause of the policy was inserted wholly for the protection of the insurer. The courts have allowed and encouraged it as an inexpensive and not unjust check upon the danger of overvaluation and fraud by dishonest insured property holders who have sustained loss by fire. But the insurer will not be permitted to misuse this clause oppressively, or in bad faith. To prevent such, when the insurer so misuses it, it ought to be held a waiver by it of that provision.

The trial court did not err by so ruling.

We turn next to the insurers' alleged bad faith. Within a day or two of the snow storm, Fourth Street notified the insurers' local agent of the damage. That agent hired an adjuster to investigate. Based on his own examinations and on reports by two structural engineers (one hired by Fourth Street and one by himself), the adjuster found that about 95,000 square feet of the 267,000 square-foot warehouse had collapsed and that the portion left standing had been seriously damaged. The wooden framing had been pulled away from the building's brick facade; the roof had been cracked in many places; and the support systems for both the roof and for an elevated floor had been moved out of alignment and weakened. The engineers recommended that the building be completely torn down and replaced, at a cost estimated by two contractors of about 2.6 or 3.3 million dollars. As an alternative, they and the adjustor estimated that the standing portion could be repaired and the collapsed portion

[12] 116 Ky. 287, 76 S.W. 22, 25 (1903).

rebuilt for about 2.5 million dollars, the full amount of Fourth Street's policy.

Apparently the adjustor advised Fourth Street early on that its claim would probably be valued at its policy limits. Opting to demolish and rebuild rather than attempting to repair, by late February Fourth Street arranged to have the site cleared and to have plans drawn for a new building. In early March, the insurers' local agent learned that Fourth Street had begun to demolish the warehouse. Because the adjustor had not yet filed his report, the agent asked Fourth Street to suspend demolition until an adjustment had been approved.

The adjustor submitted his report declaring the building a total loss near the end of March 1998. This first adjustment exceeded by almost a million dollars the amount the local agent had recommended be reserved for the claim. There was evidence that this discrepancy caused the insurers and the agent considerable distress. Be that as it may, the insurers promptly decided to have the claim readjusted. The evidence further revealed that in arranging for the new adjustment, the local agent informed the adjustor that the insurers regarded the first adjustment as excessive and by how much, and that in hiring an engineer to reexamine the warehouse the new adjustor likely did the same.

The new engineer testified that, given the building's age, its design shortcomings, and the extent of the collapse, demolishing the building and starting again from scratch probably made the most sense. Nevertheless, his report (upon which the new adjustment was based) found that the standing portion of the warehouse had been damaged very little by the snow storm. Whereas the first adjustment had estimated that repairs would cost about $500,000.00, excluding repairs to the roof, the second adjustment allotted $14,000.00 for that purpose, and the engineer admitted that he had not even examined the roof. The new engineer’s report also found that the 95,000-square-foot destroyed portion of the warehouse could be “functionally” replaced with a 68,000-square-foot, metal-framed attachment to what was left of the original wooden structure. The total cost to repair and replace, according to the readjustment, would be slightly more than 1.5 million dollars, just what the insurers had reserved. Near the end of April 1998, as noted above, the insurers tendered this amount to Fourth Street.

In the meantime, Fourth Street had resumed demolition of the damaged building. Its contractor had informed it that if the new building was to be operational by the fall of 1998, then the site needed to be cleared and prepared by mid-May. When Fourth Street received the insurers’ rejection of its claim and their tender of only 1.5 million dollars, it insisted that this amount was inadequate. The insurers were adamant, however, so in late May Fourth Street discontinued its rebuilding plans. In August 1998, it filed suit.

Fourth Street alleged that the insurers had not undertaken or carried out the readjustment in good faith, that they had not been justified in valuing the claim on the basis of that readjustment, and that its own inability to replace the warehouse by the fall of 1998 had resulted in lease and related litigation expenses of about $200,000.00. The jury agreed. The jury found that, in rejecting Fourth Street's first-adjustment-based claim, the insurers had breached the insurance contract and had violated their duty to settle the claim fairly and in good faith. The jury awarded damages for the breach and its consequences of almost 1.2 million dollars. To that amount the trial court added interest and attorney fees for a total award of approximately 1.5 million dollars. The insurers challenge each component of this award.

The insurers first argue that, if the condition precedent remains enforceable, then their duty to pay any additional replacement-cost benefits had not ripened. Even though the jury found the insurers' rejection of Fourth Street's full claim to have been in bad faith, Fourth Street had not fulfilled the condition precedent by rebuilding. Consequently, the insurers contend they should not have been found either to have breached the contract or to have violated their duty to settle the claim in good faith. We agree with the trial court, however, that the condition precedent did not remain enforceable, and thus it does not afford the insurers any ground for relief.

The insurers next note that liability for bad-faith failure to settle an insurance claim, as opposed to liability for breach of the contract, requires a showing of intentional misconduct or reckless disregard for the rights of the insured. If the bad-faith claim is to survive a motion for directed verdict, then the alleged misconduct or disregard must be such as to justify an award of punitive damages:

> In order to justify an award of punitive damages, there must be proof of bad faith sufficient for the jury to conclude that there was conduct that was outrageous, because of the defendant's evil motive, or his reckless indifference to the rights of others. If the evidence suffices to justify punitive damages under this standard, the cause of action for statutory bad faith premised on a violation of the UCSPA may be maintained. If not, the cause of action cannot be maintained.[13]

In other words,

> there must be sufficient evidence of intentional misconduct or reckless disregard of the rights of an insured for a claimant to warrant submitting the right to award punitive damages to the jury. If there is such evidence, the jury should award consequential damages and may award punitive damages. The jury's decision as to whether to award punitive damages remains discretionary because the nature of punitive damages is such that the decision is always a matter within the jury's discretion.[14]

The insurers contend that there was insufficient evidence of their intentional misconduct or reckless disregard of Fourth Street's rights to justify an award of punitive damages, and thus that Fourth Street's bad-faith claim must fail. This contention is based largely on the fact that the jury responded in the negative to the following interrogatory: "Are you satisfied from the evidence that an award of punitive damages is justified?" Because the jury answered "no" to this question, the

[13] Motorists Mutual Insurance Company v. Glass, Ky., 996 S.W.2d 437, 452 (1999).

[14] Wittmer v. Jones, Ky., 864 S.W.2d 885, 890 (1993).

insurers maintain that the trial court erred by answering the same question in the affirmative when it overruled their motion for a directed verdict against Fourth Street's bad-faith-based claims. We disagree.

First, a directed-verdict motion is addressed to the trial court, not the jury, and the jury does not sit in review of the trial court's decision. In ruling on such a motion in this context, the appropriate inquiry for the trial court is

> "whether there is sufficient evidence from which reasonable jurors could conclude that in the investigation, evaluation, and processing of the claim, the insurer acted unreasonably and either knew or was conscious of the fact that its conduct was unreasonable."[15]

The fact that these particular jurors did not reach such a conclusion does not make erroneous the trial court's determination that reasonable jurors might have done so.

Second, the trial court's decision in this instance was amply supported by the evidence. The insurers are correct, of course, that they had the right to contest a "fairly debatable" claim. But grounds for such a debate must exist prior to and be independent of the contest. The insurers were not allowed to deny the claim and after the fact assert "grounds" they had manufactured for the purpose. A reasonable juror could have believed that the second adjustment of Fourth Street's loss was just such an after-the-fact concoction, intended simply to justify a position the insurers had arbitrarily adopted. A

[15] Farmland Mutual Insurance Company v. Johnson, Ky., 36 S.W.3d 368, 376 (2001) (quoting Zilisch v. State Farm, 995 P.2d 276 (Ariz. 2000)).

reasonable juror could also have concluded that the insurers' low estimate of Fourth Street's functional-replacement costs was oppressive, needlessly and severely complicating Fourth Street's efforts to maintain its business. The trial court did not err by submitting Fourth Street's bad-faith claim to the jury, nor by affirming the jury's award of consequential damages thereunder.

Finally, the insurers contend that the trial court erred by assessing against them pre-judgment interest and attorney fees. The trial court awarded interest on what it believed were the overdue functional-replacement benefits. We are not persuaded that the trial court erred.

The trial court based both the interest and attorney fee awards on KRS 304.12-235, which provides for such liability whenever an insurer fails to make a good-faith attempt to settle a claim within "thirty (30) days from the date upon which notice and proof of claim, in the substance and form required by the terms of the policy, are furnished the insurer." The insurers contend that Fourth Street never furnished a proof of claim and thus that this statute does not apply.

It appears that, in a technical sense, the insurers are correct. Having been made privy at least to the gist and the bottom line of the first adjustor's report, Fourth Street essentially adopted that report as its proof of claim and thus never filed the form of claim contemplated by the contract. The insurers were plainly aware of this deficiency, however, and never objected. As noted in an earlier section of this opinion, it is well-established that an insurer with actual notice of a claim will be deemed to have waived this sort of formal proof-of-claim requirement unless it makes a timely demand for compliance.[16] 806 KAR 14:010, as Fourth Street points out, provides a similar rule. We agree with the trial court, therefore, that the insurers waived any proof of claim other than the first adjustor's report. That report, filed March 25, 1998, was thus a proper basis for the trial court's application of KRS 304.12-235.

In sum, although we agree with the insurers that, in general, a rebuild-or-replace clause validly conditions an insurer's duty to pay replacement-cost benefits, we agree with the trial court that, in this instance, the insurers waived their right to enforce that clause. The insurers' unreasonably low estimate of Fourth Street's claim, their unfair reliance on that estimate, and the delay brought about by the ensuing litigation made it impossible for Fourth Street to comply with the condition precedent. The trial court did not err by deeming the condition unenforceable. Nor did the court err by upholding the jury's award of consequential damages for the insurers' bad faith. There was sufficient evidence of bad faith to permit an award of punitive damages. The fact that this jury declined to award punitive damages under an instruction asking whether punitive damages were "justified" did not negate that evidence or make erroneous the trial court's decision to submit the question of bad faith to the jury. Finally, the trial court did not err by

[16] Westchester Fire Insurance Company v. Gray, Ky., 240 S.W.2d 825 (1951); State Automobile Mutual Insurance Company v. Outlaw, Ky. App., 575 S.W.2d 489 (1979).

awarding pre-judgment interest and attorney fees pursuant to KRS 304.12-235. As the insurers clearly understood, Fourth Street adopted the first adjustor’s report as the statement of its claim. Absent a timely demand by the insurers for a different proof of claim, that report satisfies the statute’s proof-of-claim requirement.

For these reasons, we affirm the January 18, 2000, judgment of the Fayette Circuit Court.

ALL CONCUR.

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