RENDERED: December 10, 1999; 2:00 p.m.
NOT TO BE PUBLISHED

Commonwealth Of Kentucky

Court Of Appeals

NO. 1998-CA-002318-MR

AMERICAN CONTINENTAL INSURANCE CO. APPELLANT

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE GEOFFREY MORRIS, JUDGE
ACTION NO. 92-CI-001795

N.K.C. HOSPITALS, INC. APPELLEE

OPINION
AFFIRMING
** ** ** ** **

BEFORE: COMBS, EMBERTON AND GUIDUGLI, JUDGES.

GUIDUGLI, JUDGE. American Continental Insurance Company (ACIC) appeals from an amended opinion and order entered by the Jefferson Circuit Court on August 20, 1998 which awarded judgment in favor of NKC Hospitals, Inc. (NKC).[1] We affirm.

THE GORDON CLAIM

On January 15, 1988 a fire occurred on NKC's premises. Bryan Gordon (Gordon), an employee of a painting contractor hired to do work on the premises, was severely injured as a result of

[1]Although NKC is now Alliant Health Systems, Inc., we will refer to it as NKC for purposes of this appeal.

the fire. John Smither (Smither), NKC's Director of Risk Management, was notified of the fire on the day it occurred.

A field incident report dated January 15, 1988 listed the cause of the fire as ignition of gasoline by a cigarette lighter. An investigator's field report of the same date listed the cause of the fire as being ignition of gasoline vapors by either a cigarette lighter or a spark from the blower or motor of a wall mounted heating unit in the room in which the fire occurred. This report indicated that the heater did not cause the fire because the heater's power switch was in the "off" position and no one questioned during the investigation admitted to turning the heater off.

On January 13, 1989 Gordon filed suit against NKC to recover damages for the injuries he sustained as a result of the fire. In both his deposition and in conjunction with his settlement of a workers' compensation claim, Gordon stated that the fire was caused by a co-worker who used a cigarette lighter to ignite gasoline poured from a clean-up bucket. Following a jury trial which resulted in a verdict in Gordon's favor, judgment was entered against NKC on December 2, 1991 in the amount of $2,983,806.60 plus interest and costs.

Although this court later reversed the judgment, the Kentucky Supreme Court ordered it reinstated. Gordon v. NKC Hospitals, Inc., Ky., 887 S.W.2d 360 (1994). Subsequent to reinstatement of the judgment, NKC paid Gordon $4,200,892.32 on December 7, 1994, said amount representing the original judgment plus accrued interest and costs.

NKC'S RELATIONSHIP WITH ACIC

At the time of the fire, NKC was insured under a "claims made" policy issued by The Travelers Insurance Company. The renewal date for the Travelers' policy was February 1, 1988. For reasons not apparent from the record, it appears that NKC had decided to procure coverage elsewhere.

On January 20, 1988, five days after the occurrence of the fire, NKC submitted an application for Hospital Professional Liability and Comprehensive General Liability insurance and a separate application for Hospital Umbrella Liability Insurance to ACIC. Although NKC was seeking coverage under the terms of the umbrella policy only, ACIC required NKC to fill out applications for both the primary and excess policies.

Although the application for primary coverage asked for "an itemized descriptive breakdown of all Hospital and Comprehensive General Liability losses for the past five years plus this year to date" it is not clear from the record whether NKC complied as there was no attachment to the numerous copies of the application in the record. Under question no. 11 for the excess policy, NKC was asked to state its loss record during the last five years in regard to vehicles, aircraft, water craft and professional general liability. NKC answered "none" next to aircraft and water craft. Neither application asked NKC to disclose any information regarding pending claims, incidents or occurrences which may eventually result in a claim. NKC did not advise ACIC of the occurrence of the fire in either application.

Both applications were sign by Smither on January 18, 1988 in his capacity as Director of Risk Management. Immediately above his signature on the primary application was the following language:

> The applicant represents that the above statements and facts are true and that no material facts have been suppressed or misstated.

Above the signature line on the excess application, the following language appeared:

> We know of no other relevant facts which might affect underwriter's judgment when considering this application.

On February 12, 1988 Angela Nevels (Nevels), who appears to be an ACIC employee, wrote to NKC's insurance broker, stating:

> One of the conditions of coverage with [ACIC] was the exclusion of all known claims and circumstances. To verify, we need a list of all claims reported to NKC's carriers prior to expiration (known claims and circumstances upon knowledge of binding with [ACIC]).

It appears that NKC complied with this request, but once again the occurrence of the fire and Gordon's injuries were not reported.

ACIC issued a claims-made Hospital Umbrella Liability Insurance Policy to NKC under Policy No. 88L0088. Although the policy period was listed as February 1, 1988 to February 2, 1989 the policy provided a retroactive date for coverage of January 1, 1986. The total policy premium was listed as $902,462.90. Under the terms of the policy, NKC was self- insured up to $2,000,000

per "occurrence" with a yearly aggregate of $5,000,000. The policy further provided that ACIC agreed to

> pay on behalf of [NKC] for ultimate net loss in excess of the underlying limit or retained limit which [NKC] shall become legally obligated to pay . . . for damages because of . . . bodily injury . . . caused by or arising out of an occurrence[.]

The policy also set forth when a claim would be considered to be first made. Under the relevant language, a claim would be considered made at the earlier of the following:

> (a) When [NKC] receives notice that a claim has been made, or
>
> (b) When [NKC] first gives written notice to [ACIC] of a specific OCCURRENCE involving a particular person or situation and stating that it might reasonably be expected to result in a claim. [emphasis in original]

Under the "Exclusions" portion of the policy, the following language appeared:

> [This policy does not apply to] liability of [NKC] for damages resulting from an injury, harm, or loss if, prior to the inception of this policy period, any claim has been made against [NKC] by anyone for such damages or if [NKC] could have reasonably foreseen that such injury, harm, or loss might result in a claim for such damages.

Attached to the policy was a list of 30 claims with dates of occurrence ranging from February 12, 1986 to November 20, 1987 which were designated as being specifically excluded from coverage. The Gordon claim does not appear on this list.

Finally, the policy provided that "whenever it appears that an occurrence is likely to involve this policy, written notice thereof shall be given to [ACIC] or any of its authorized agents as soon as practicable."

The policy was ultimately renewed over the next several years as follows:

YEAR	PREMIUM
1988	$ 847,383
1989	
1990	$1,050,006
1991	$1,457,313

ACIC's coverage of NKC was continuous until the policy expired on April 1, 1991.

ACIC'S DENIAL OF LIABILITY FOR THE GORDON CLAIM

It appears that during each policy renewal period, NKC submitted a list of yearly liability claims to ACIC. The 1989 liability claims list included the Gordon claim. Under the "Indemnity" column of the list, "0" was entered for both "Reserve" and "Paid." A handwritten notation reading "industrial accident" was written on the report in regard to the Gordon listing. In an internal memo dated June 13, 1990, Lori Barreca (Barreca), an ACIC claims consultant, indicated that she had reviewed the current loss run as part of an annual audit.

In another internal memo dated January 13, 1992, Barreca directly addressed the Gordon claim. It appears that several weeks prior to the memo, Smither called her and reported the jury verdict. The memo stated:

> While I cannot put a specific date on day [sic] I had "knowledge" of the event, I do recall discussing

> it with John. I recall it was the opinion of both John and me that the case was not one in which the hospital would be liable. It appeared to be a case of contractor liability. Therefore, the case was not reported to us.
>
> . . .
>
> In June 1990 my audit report states I did review the loss run. Although I do not specifically recall discussing the Gordon case I must have seen it and asked about it. At audits I routinely review each entry on the internal loss run. I did identify two other cases from the loss run which needed to be reported. [emphasis in original]

In a follow-up memo of the same date, Barreca stated:

> I have discovered the handwritten notes taken at the time of the 5/22/90 account visit. On the [NKC] internal loss run I have made a notation next to the Gordon case indicating this was an "industrial accident" and it involved 3 sub-contractors and a fire.
>
> . . .
>
> Therefore on 5/22/90 I was aware of the case as it was discussed at that time. It was thought to be an "industrial" case and therefore not one involving hospital liability.

On December 23, 1991, Smither wrote to Jeff Troyer, who replaced Barreca as claims consultant, regarding the Gordon claim and jury verdict. In the letter, Smither indicated that the claim had not been formally reported but was listed on the loss runs. Smither further stated that while he had set a legal reserve of $20,000, there was no reserve established for liability. Smither further stated that the claim had never been

formally reported because it did not meet ACIC's reporting requirements.

Troyer responded by letter dated January 9, 1992. Although Troyer acknowledged receipt of written notice, he further indicated that "your verbal and written notice . . . was given to me outside your active policy period." Under the terms of the letter, ACIC reserved its rights in regard to any potential coverage of the Gordon claim.

On March 16, 1992 ACIC filed a declaratory judgment action with the trial court regarding its liability for the Gordon claim. In an initial opinion and order entered by the trial court on February 19, 1998 following a bench trial, the trial court held that ACIC was indeed liable to pay the excess amount of the Gordon claim over $2,000,000 plus interest at the rate of 12% from December 2, 1991, the date judgment was entered on the Gordon claim. The trial court further held ACIC liable for payment of NKC's costs and legal expenses incurred from the date of the jury verdict in the Gordon claim.

In regard to ACIC's argument that NKC intentionally failed to report the Gordon claim on its January 18, 1988 applications, the trial court found that ACIC failed to bring forth any evidence regarding whether the omission was intentional. Although the trial court stated that "common sense would dictate an injury of this proportion should have been included" on the application, the trial court held that ACIC had failed to show that a material misrepresentation occurred because

it failed to show that the omission was intentional, material and fraudulent.

The trial court also found that ACIC had been given proper notice of the Gordon claim. The trial court noted that under the terms of the policy, notice was to be given "whenever it appeals that an occurrence is likely to involve this policy," and further held:

> Given the fact that all parties overlooked this claim, NKC was under no duty to give formal written notice until after they realized that the case was in excess of the two million dollar . . . coverage.

The trial court reasoned that because NKC could not anticipate that the claim would exceed $2,000,000 until after the jury returned its verdict, its notice of December 31, 1991 was adequate under the language of the policy. The trial court further found that ACIC did, in fact, have notice of the claim prior to NKC's written notice by virtue of the loss run reports and Barreca's memos, stating:

> The fact that [ACIC] chose either to do nothing about this claim or, more importantly, agreed with NKC as to the merits of Mr. Gordon's claim leads to the exposure they now claim was NKC's fault.

As to ACIC's argument that NKC breached the agreement because it failed to report the claim after the policy expired, the trial court found that there never was a gap in coverage because ACIC "continued to cover NKC through 1991." The trial court further found that NKC did not breach its duty to cooperate under the terms of the policy.

Following motions by both NKC and ACIC for further clarification of the court's order, the trial court entered an amended opinion and order on August 20, 1998. Under the amended opinion, the trial court omitted its earlier statement that common sense dictated that the Gordon claim should have been reported on the application. The major change in the amended opinion was that the trial court specifically undertook to calculate the damages payable to NKC under the terms of the policy. The trial court held that under the definition of "ultimate net loss" as set forth in the policy, the sum that NKC actually paid to Gordon in December 1994 was the proper measure of damages. Furthermore, the trial court held that because NKC was entitled to payment from ACIC of "all expenses incurred," it was proper to award litigation costs. The trial court further held that the 12% interest which accrued from the date of the judgment was also properly included as "ultimate net loss." The trial court ultimately entered judgment in favor of NKC as follows: (1) $2,200,892.32 representing ACIC's share of the amount paid by NKC under the judgment in the Gordon claim; (2) legal fees in the amount of $107,266.07 incurred by NKC in defending the Gordon claim; and (3) pre-judgment interest at the rate of 8& from December 7, 1994 to the date of entry of this judgment and post-judgment interest of 12% compounded annually until paid. This appeal followed.

ACIC contends that NKC's failure to either identify the Gordon claim or the fact that a fire resulting in injuries occurred on its application for insurance constituted a material

misrepresentation which would allow it to deny coverage of the claim. In support of its argument, ACIC relies on the language contained in the application for excess coverage above Smither's signature regarding NKC's knowledge of relevant facts which might affect underwriter's judgment in deciding whether to accept the risk. ACIC also points to the correspondence from Nevels to NKC's insurance agent. Finally, ACIC relies on KRS 304.14-110, which provides:

> All statements and descriptions in any application for an insurance policy or annuity contract, by or on behalf of the insured or annuitant, shall be deemed to be representations and not warranties. Misrepresentations, omissions, and incorrect statements shall not prevent a recovery under the policy or contract unless either:
> (1) Fraudulent; or
> (2) Material either to the acceptance of the risk, or to the hazard assumed by the insurer; or
> (3) The insurer in good faith would either not have issued the policy or contract, or would not have issued it at the same premium rate, or would not have issued a policy or contract in as large an amount, or would not have provided coverage with respect to the hazard resulting in the loss, if the true facts had been made known to the insurer as required either by the application for the policy or contract or otherwise. This subsection shall not apply to applications taken for workers' compensation insurance coverage.

Having reviewed the insurance applications and the relevant case law, we agree with the trial court that NKC did not make a representation which would allow ACIC to deny coverage for the Gordon claim.

Our review of the applications for coverage submitted by NKC shows that ACIC failed to ask NKC to disclose claims or incidents which had the potential to ripen into claims at a later date. While NKC was asked to disclose its actual loss record for the last five years in the application for excess coverage it was not asked to divulge any information pertaining to claims, incidents or pending matters at the time it submitted the application. We believe that the failure on ACIC's part to request this information precludes application of KRS 304.14-110 and forecloses ACIC's ability to deny coverage for the Gordon claim.

In Niagra Fire Ins. Co. v. Layne, Ky., 172 S.W. 1090 (1915), the insurer issued a fire insurance policy on a building and merchandise stored therein. Although the policy stated that it would become void should the merchandise become subject to a chattel mortgage, the application did not ask any questions pertaining to whether the property was encumbered. When the building and its contents were destroyed by fire, the court was asked to decide:

> the effect of the failure of an applicant for insurance to communicate to the insurer the fact of an incumbrance on the property to be insured, where no inquiry is made concerning the subject, and where the policy has a forfeiture clause similar to the one sued on.

Layne, 172 S.W. at 1091. In holding that the failure of the insured to disclose the encumbrance was not a misrepresentation, the court stated:

> [W]here no inquiry is made and answered concerning incumbrances on the property sought to be insured, and no voluntary statement is made concerning the existence or nonexistence of incumbrances, there is no representation or statement in the application for the insurance which will render applicable section 639, Kentucky Statutes.[2]
>
> Where one applying for insurance does make answer to inquiries, or makes statements voluntarily, this court has consistently held that section 639 controls, and that, if the fact be material and the answer untrue, the policy is avoided, whether the applicant knew the statement to be untrue or not, and regardless of any fraud or intent to mislead or deceive the insurer. [citations omitted]
>
> But where no inquiry is made and answered concerning incumbrances, and no voluntary statement in regard thereto is made by the applicant for insurance, an avoidance of the policy will not be declared unless the insured has fraudulently failed to disclose the fact of an incumbrance material to the risk assumed by the company.

Layne, 172 S.W. at 1091-1092. The court further stated:

> [T]he rule in this state is that, if no inquiry is made and answered concerning incumbrances and no voluntary statement is made by insured in regard thereto, the failure to disclose the existence of incumbrances on the property sought to be insured will not be grounds for avoidance of the policy, unless: (1) The insured fraudulently failed to make such disclosure; and (2) unless the

[2]This appears to be a forerunner of KRS 304.14-110. [footnote added]

> incumbrance was material to the risk assumed by the company.

Id. at 1092-1093.

The same result was reached by this Court in First Federated Life Insurance Company v. Citizens Bank & Trust Company, Ky. App., 593 S.W.2d 97 (1980). In that case, the insured, who had previously been diagnosed with leukemia, purchased a truck on an installment contract. Although it is not clear from the facts, it appears that the insurer issued a credit life insurance policy to the insured with the bank as beneficiary to cover the outstanding balance on the truck. Neither the dealership, the bank, or the insurer knew of the insured's condition, nor did the policy require evidence of the insurability of the insured, a medical exam of the insured, or any representation as to the insured's health. When the insured ultimately died with the balance of the installment contract due and owing, the insurer refused payment under the policy, arguing that "[k]nowledge of the insured of his terminal illness at the time of the procurement of the subject policies of credit life insurance precludes recovery under said policies." First Federated, 593 S.W.2d at 98-99. In holding that the insurer had a duty to pay the proceeds in accordance with the terms of the policy, the Court held:

> [T]he issuance of insurance is predicated upon a borrower's request and payment of a premium. There is no evidence of prerequisite oral or written representations in regard to application for the insurance so as to raise a defense or bar recovery under K.R.S. 304.14-110. Insofar

> as appellant required no statement of health condition, examination or application, it should therefore bear the greater of the risks of the debtor, being of unsound health at the time of issuance of the credit life policy. The policy of insurance issued in this case was absent a requirement for furnishing satisfactory evidence of insurability, and there is no policy provision affecting the validity of the policy in the event the insured was of unsound health at the time the policy was issued.

Id. at 99.

In Roess v. St. Paul and Marine Insurance Company, 383 F.Supp. 1231 (M.D. Fla. 1974), a statute identical to KRS 304.14-110 was construed to reach the same result. In ruling that an insured's failure to disclose the pendency of a taxpayers' suit to the insurer did not void the policy, the Court explained:

> [T]he statute simply does not apply to concealment or other species of fraud not related to questions asked or representations made either on an application form or during the course of other special negotiations preceding issuance of the policy. In the circumstances of this case, therefore, since the subject of pending litigation was not broached in the application form nor otherwise discussed in any separate negotiations, one must look beyond the statute to the common law in order to determine the rights and obligations of the parties.
>
> The modern rule seems to be that the insurer has a duty to make inquiry concerning matters deemed by it to be material to the risk, and the insured is entitled to a presumption that information not requested is deemed immaterial. Thus, where no inquiry is made

> about matters alleged to have been concealed, the insurer may avoid the policy only by proving that the concealment was in fact material and, further, that the withholding of such information was intentional and fraudulent. [citations omitted]
>
> In summary, therefore, the non-disclosure by Roess of the pendency of the taxpayers' suit at the time the policy was issued was not a 'concealment' within the meaning of Florida Statute [Sec.] 627.409 since no inquiry was made of him concerning that subject matter. On the other hand, if the insurer could allege and prove that the pendency of the suit was material to the risk from an underwriting standpoint (overcoming the adverse presumption arising from the lack of inquiry); and could further prove that the nondisclosure of such fact was an intentional and fraudulent concealment by Roess, it would then be entitled to relief under the traditional common law rule. [citation omitted]

Roess, 383 F.Supp. at 1236-1237.

Based on the foregoing, because KRS 304.14-110 does not apply, ACIC must show that NKC's failure to divulge information concerning the fire on its application was both fraudulent and material to the risk. We agree with the trial court that ACIC has failed in its burden of proof as to these two requirements.

First, ACIC makes no argument in its brief on appeal that NKC acted fraudulently in failing to disclose the occurrence of the fire. Instead, ACIC has chosen to base its arguments on the allegation that NKC's failure to disclose was an intentional misrepresentation as opposed to a fraudulent one.

Secondly, ACIC has failed to show that the fact that the fire occurred would have been material to the risk insured against. The facts of this case clearly show that both NKC and ACIC, as soon as it was informed of the claim as established by Barreca's testimony, believed that the Gordon claim would result in no liability to NKC, and that even if it did no one anticipated that it would exceed NKC's self-insured reserve of $2,000,000. It is also clear from ACIC's actions once it had knowledge of the Gordon claim that it did not believe it to be material to the risk insured against because it kept renewing NKC's policy for several years after the fire. In light of the fact that ACIC kept renewing NKC's policy and received substantial premiums for doing so despite the fact that it had full knowledge of the Gordon claim, it cannot not be heard to claim that the occurrence of the fire was a fact which was material to the risk insured against.

We are also unpersuaded that the correspondence from Nevels placed a duty on NKC to disclose the occurrence of the fire. First, Nevels only requested that NKC disclose all previously reported claims. Under the terms of the policy, the Gordon claim did not become a claim until suit was filed, which did not occur until January 13, 1989. We also believe that the fire was not an "occurrence" which should have been disclosed in answer to Nevels' request. All parties involved chose to treat the Gordon claim as a matter which would not result in liability to NKC, so it does not appear to have been an occurrence which had the potential to ripen into a claim.

Finally, we are unpersuaded by ACIC's argument that the language appearing above Smither's signature on the excess policy application[3] required disclosure of the fire. As we have demonstrated, ACIC's own actions once it had knowledge of the fire show that this did not become a relevant fact until it was called upon to do what it agreed to do under the terms of the policy. We do not believe that the trial court erred in finding that NKC's failure to disclose the fact of the fire was not material, intentional, or fraudulent.

ACIC next argues that there was no coverage for the Gordon claim based on the express language of the policy. In support of its argument, ACIC relies on the following language which provided that coverage under the policy did not extend:

> [t]o liability of the insured for damages resulting from an injury, harm, or loss if, prior to the inception of this policy period, any claim has been made against the insured by anyone for such damages or if the insured could have reasonably foreseen that such injury, harm, or loss might result in a claim for such damages.

Based on the foregoing, ACIC maintains that because NKC could have reasonably foreseen that a claim might be made as a result of the fire there is no coverage. We disagree. Once again, we find that all parties to this lawsuit reasonably believed that no liability to NKC would result from the fire. As NKC illustrates in its brief on appeal, "[b]oth John Smither and ACIC's claim manager, Lori Barreca, concluded, even after suit was filed, that

[3]"We know of no other relevant facts which might affect underwriter's judgment when considering this application."

the Gordon incident did not implicate [NKC] and presented no potential liability on the part of [NKC]. [ACIC's] expert confirmed that it was reasonable for Mr. Smither to believe this incident would not result in a claim for damages against [NKC]."

Finally, ACIC contends that the trial court did not correctly calculate the damages. ACIC's argument is two-fold: (1) should NKC's self insured reserve of $2,000,000 have been deducted after accruing interest, or should interest accrue only on the amount over and above ACIC's self-insured obligation; and (2) should interest accrue at 8% as opposed to 12%.

In regard to the first argument, ACIC maintains that interest should have accrued only on $983,806.60, that figure representing the balance of the original judgment in the Gordon claim once NKC's self-insured obligation of $2,000,000 is subtracted out. ACIC maintains that the effect of the trial court's accrual of interest on $2,983,806.60 is to require it to pay interest on the entire judgment as opposed to the portion of the judgment that NKC argues ACIC is liable to pay. We disagree.

Under the terms of the policy, ACIC agreed to

> pay on behalf of [NKC] for ultimate net loss in excess of the underlying limit or retained limit which [NKC] shall become legally obligated to pay . . . for damages because of . . . bodily injury . . . caused by or arising out of an occurrence[.]

"Ultimate net loss" was defined in the policy as:

> (a) all sums which [NKC] shall become legally obligated to pay as damages arising from an occurrence to which this policy applies; and

> (b) all expenses incurred by [NKC] in the investigation, negotiation, settlement and defense of any such claims or suit seeking such damages excluding only the salaries of [NKC's] regular employees.

We agree with the trial court's finding that based on the definition of "ultimate net loss" contained in the policy, the sum which NKC was "legally obligated to pay as damages" was the sum it actually paid in December 1994.

Having considered the parties' arguments on appeal, the judgment of the Jefferson Circuit Court is affirmed.

ALL CONCUR.

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