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CASE NO. 06-6168

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

NATIONAL SURETY CORPORATION

Plaintiff-Appellant,

-vs-

HARTFORD CASUALTY INSURANCE COMPANY

Defendant-Appellee.

Appeal from the United States District Court
For the Western District of Kentucky

PROOF BRIEF OF APPELLANT NATIONAL SURETY CORPORATION

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Defendant-Appellee.

Disclosure of Corporate Affiliations and Financial Interest

Pursuant to 6 Cir. R. 26.1, National Surety Corporation makes the following disclosures:

1. Is said party a subsidiary or affiliate of a publicly owned corporation?

Yes. National Surety Corporation is a wholly owned subsidiary of Fireman's Fund Insurance Company, a California corporation. Fireman's Fund Insurance Company is a wholly owned subsidiary of Allianz Global Risks US Insurance Company, a California corporation. Allianz Global Risks US Insurance Company is a wholly owned subsidiary of Allianz of America, Inc., a Delaware corporation, which is a wholly owned subsidiary of Allianz Aktiengesellschaft (Allianz AG.)

2. Is there a publicly owned corporation, not a party to the appeal, that has a financial interest in the outcome of the appeal?

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Yes. Allianz AG is a publicly held company that indirectly holds 10% or more of Fireman's Fund Insurance Company (and its subsidiaries, including National Surety.)

____
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Statement in Support of Oral Argument

National Surety respectfully requests oral argument in this case and believes argument will assist the Court in resolving the issue on appeal.

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I. Jurisdictional Statement

A. Basis of District Court's Jurisdiction

Plaintiff-Appellant National Surety Corporation ("National") asserted jurisdiction under 18 U.S.C. § 1332. National is an Illinois corporation licensed to transact the business of insurance in the Commonwealth of Kentucky. Defendant-Appellee Hartford Casualty Insurance Company ("Hartford") is organized and domiciled in the state of Indiana, and also is licensed to transact the business of insurance in Kentucky. The amount in controversy in the matter exceeded and continues to exceed $75,000.

B. Basis of Court of Appeals' Jurisdiction

National invokes this Court's jurisdiction under 28 U.S.C. § 1291 as this appeal is from a final order from the United States District Court for the Western District of Kentucky.

C. Filing Dates

On August 18, 2006, the United States District Court for the Western District of Kentucky sustained Hartford's motion to dismiss under Fed.R.Civ.P. 12.[1] National filed this Notice of Appeal on September 5, 2006.[2]

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[1] R20, Order; JA ____
[2] R21, Notice of Appeal; JA ____

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D. Assertion of Appeal From Final Order

The District Court's Order of August 18, 2006 dismissed all of National's claims with prejudice; therefore, this appeal is from a final Order and Judgment.[3]

II. Issues Presented for Appeal

The issue on appeal is whether, under Kentucky law, an excess insurance carrier can state a subrogation claim against a primary insurer for that insurer's failure to properly defend both carriers' mutual insured, or the failure to settle a claim against that insured within the primary carrier's policy limits.

III. Statement of the Case

Hartford and National both insured Sufix, Inc. ("Sufix), a company that manufactured products that included a trimmer head for weed eaters. Hartford was the primary carrier and National the excess. When a Sufix trimmer head injured a man in 1998 Hartford hired counsel to defend the company. But Hartford failed to notify National of the claim against their mutual insured until two weeks before that case was to be tried, in May 2002. Hartford also rejected offers to settle the claim against Sufix within its $1,000,000 policy limits. (National's excess limits were $10,000,000.)

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[3] R20, Order; JA ____

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Notified so late of the impending trial, National could do little but monitor the outcome. The jury returned a verdict against Sufix of $6,486,588.44. National then assumed the defense of Sufix, and prosecuted an unsuccessful appeal. After that appeal National paid the judgment over Hartford's $1,000,000 limits.

On February 24, 2006 National sued Hartford in the United States District Court for the Western District of Kentucky, alleging that it was subrogated to Sufix's rights against Hartford for failing its duty to provide a proper defense to Sufix, including the failure to settle within its policy limits. Hartford's Answer asserted that Kentucky law does not recognize such a claim for an excess carrier. The parties agreed that although Kentucky law recognizes both conventional and equitable subrogation, it has never applied either to a case in which an excess insurer invoked them against a primary carrier. The parties also agreed that the District Court should decide this legal issue before discovery proceeded on National's claims, as if Hartford had filed a Motion to Dismiss under Fed.R.Civ.P. 12(b)(6). In fact, Hartford proceeded to file such a motion.

After the parties briefed the issue the District Court determined that Kentucky law does not permit an excess carrier to bring a subrogation action against a primary insurer. National appeals from that Order because Kentucky law does recognize subrogation claims, and its stated public policy requires that an

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excess carrier be permitted to assert its insured's claims against a primary carrier which fails to comply with its statutory and common law duties of good faith.

IV. Statement of the Facts

Hartford and National both insured a company named Sufix, Inc. ("Sufix"), which manufactured products that included a trimmer head for weed eaters.[4] On May 19, 1998, one of those trimmer heads disintegrated and severely injured the user, Tommy Cook ("Cook").[5]

Cook sued Sufix in May, 1999, alleging that the product was defective.[6] Hartford hired counsel to defend Sufix,[7] and during the course of that defense Cook's attorneys made several demands to settle Cook's claims within Hartford's policy limits of $1,000,000.[8] Hartford refused these demands.[9]

Neither Sufix nor Hartford notified National of the pending lawsuit, or of Cook's settlement demands, until about two weeks before that case went to trial.[10] National carried excess liability insurance for Sufix with policy limits of $10,000,000.[11] That policy provided that Sufix could take over the defense and

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[4] R1-2, Complaint ¶¶ 5-7; JA ____
[5] Id.
[6] Id., ¶ 8; JA _____
[7] Id., ¶ 9; JA, ____
[8] R1-3, Complaint, ¶ 10; JA ____
[9] Id., ¶ 11; JA ____
[10] Id., ¶¶ 12-13; 1-3, JA ____
[11] R1-2, Complaint ¶6; JA _____

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negotiation of a claim if it was not satisfied that the underlying defense was effective.[12] Because of the late notice it received, however, National did not have time to evaluate the claim or exercise its right to assume Sufix's defense.[13]

Cook's case against Sufix went to trial on May 14, 2002, and one week later the jury returned a verdict against Sufix of $6,486,588.44.[14] After an unsuccessful appeal National paid the remaining balance of the judgment over Hartford's $1,000,000 policy limits.[15]

National then filed this lawsuit alleging that Hartford breached contractual duties to Sufix, including the duty to adequately investigate and defend Cook's claims against Sufix, and the duty to settle those claims when the likelihood of an excess verdict became apparent.[16] National also alleged that Hartford breached its common-law duty of good faith to Sufix.[17] Finally, National alleged that it was subrogated to Sufix's rights arising from these breaches based on the subrogation provisions of its excess policy, and upon the doctrine of equitable subrogation.[18]

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[12] R1-21 through R1-22, Complaint, Exhibit A (Policy), pp. 10-11; JA ____
[13] R1-3 through R1-4, Complaint ¶¶ 12-16; JA _____
[14] R1-3 and R1-4, Complaint ¶¶11, 17; JA _____
[15] R1-4, Complaint ¶ 19; JA ____
[16] R1-5, Complaint ¶¶ 23-24; JA ____
[17] R1-5, Complaint ¶26: JA ____
[18] R1-5 and R1-6, Complaint ¶¶ 25 and 27; JA ____

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Hartford moved to dismiss for failure to state a claim[19] and the District Court granted that Motion,[20] leading to this appeal.

V. Summary of Argument

Kentucky has long recognized the doctrine of subrogation, and the general rule that an insurer who pays a loss on behalf of an insured assumes any rights the insured has against a third person who causes the loss. The District Court altered Kentucky's general rule in this case. National's Complaint alleged that Hartford mishandled a claim against Sufix, including rejecting opportunities to settle within its policy limits, thereby causing National to pay more than $5,000,000 to satisfy an excess verdict. By dismissing that Complaint the District Court essentially found that, even if Hartford's mismanagement caused the excess verdict, National could not subrogate to Sufix's rights against Hartford.

Because Kentucky law has never applied the doctrine of subrogation to an excess-primary case, the District Court was charged with predicting how a Kentucky court would rule. It erred by failing to consider Kentucky's public policy. Kentucky courts use subrogation flexibly to ensure that the person who causes a loss ultimately bears responsibility to pay. This same principle has led a majority of American jurisdictions to allow excess carriers to sue a primary carrier

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[19] R14, Motion to Dismiss; JA ____
[20] R20, Order; JA____

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whose conduct has resulted in an excess verdict. These jurisdictions recognize that when primary carriers reject reasonable settlement offers, hoping for a better result at trial, they do not gamble with their own money. Subrogation simply makes the gambler bear the cost of his own losses.

VI. Argument

A. The District Court's dismissal must be reviewed *de novo*

The grant of a motion to dismiss under Fed.R.Civ.P. 12(b)(6) for failure to state a claim must be reviewed *de novo*.[21] Well-pleaded factual allegations in the Complaint must be taken as true and construed in the light most favorable to National.[22]

B. The general rule under Kentucky law is that an insurer who pays on behalf of an insured is subrogated to that insured's rights.

"The general rule is that upon payment of a loss, the insurer is subrogated pro tanto to any right of action which the insured may have against a third person whose negligence or tortious action caused the loss."[23] This right of subrogation is not new to Kentucky, which recognizes two kinds: "Conventional subrogation,"

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[21] *Benzon v. Morgan Stanley Distribs.*, 420 F.3d 598, 605 (6th Cir. 2005).
[22] *Id.*
[23] *Ohio Casualty v. Vermeer Mfg. Co.*, 298 F.Supp. 2d 575, 579 (W.D.Ky. 2004)(citing *Employers Mut. Liability Ins. Co. of Wis. v. Griffin Const. Co.*, 280 S.W.2d 178, 181 (Ky. 1955).

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which is founded on contract, and "legal" subrogation, which is founded on equitable principles, and therefore is often called "equitable subrogation."[24] There is no real difference between the two unless it can be argued that the insurer paid as a volunteer. If the insurer pays without being required by law or contract to do so, that insurer can only bring a conventional subrogation claim.[25]

Hartford did not argue below that National acted as a volunteer in this matter. Therefore, there was no reason for the Court below to consider the distinction between the two types of subrogation claims. It had only to apply the general rule: An insurer who makes payment on behalf of its insured succeeds to "any right of action which the insured may have against a third person whose negligence or tortious action caused the loss."[26]

According to the District Court's opinion "any right of action" now means "any right of action except against a primary carrier if the insured has had the foresight to purchase excess insurance." Neither Kentucky law nor public policy favors such an exception to the general rule. Furthermore, as the District Court seems to acknowledge, the weight of authority from other jurisdictions contradicts the holding below.

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[24] *Dodson v. Key*, 508 S.W.2d 586 (Ky. 1974).
[25] *Id.*
[26] *Ohio Casualty v. Vermeer*, *supra*, 298 F.Supp. 2d at 579.

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The District Court created such an exception to the general rule for two reasons:

(1) A case from the Court of Appeals of Kentucky, *American Continental Insurance v. Weber & Rose*[27] refused to allow an excess insurer to be equitably subrogated to the rights of its insured to bring a malpractice action against defense counsel hired by the primary carrier.

(2) Public policy reasons required the Court to predict that the Supreme Court of Kentucky would ignore the weight of authority and declare that where an excess carrier indemnified the insured against an excess verdict, no actual harm was suffered. Therefore, the insured had no rights against the primary carrier to which the excess carrier could subrogate.

National submits that the District Court's reliance on *American Continental* was misplaced. And its prediction regarding Kentucky law bore little relation to Kentucky's public policy in insurance cases, which would lead it to join the majority of jurisdictions allowing the kind of claim National brings here.

B. The District Court misunderstood—and in fact mistakenly quoted—*American Continental*

In *American Continental* a law firm defended an insured in a case resulting in an excess verdict. Fearing that the excess carrier that had to satisfy that verdict

[27] 997 S.W. 2d 12 (Ky.App. 1998)

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might sue the firm for malpractice, the law firm sought a declaration that an excess carrier had no such right. The carrier asserted that it could bring such a claim under the doctrine of equitable subrogation, and cited cases from other jurisdictions that had allowed that. The Court of Appeals of Kentucky, however, found that the excess carrier could not sue the firm for malpractice. To allow such a claim would "undermine this jurisdiction's adherence to a view promoting the preservation of traditional attorney-client relationships."[28]

Thus, the Court of Appeals did not reject the excess carrier's claim because it chose to proceed under the doctrine of equitable subrogation; it did so because Kentucky jealously defends the relationship between attorney and client. The Court feared that allowing one excess carrier to bring such a claim would permit other excess carriers in the future to interfere with the relationship between defense counsel and the insured.

The *American Continental* Court was not asked to rule on the issue in this case, which is whether the excess carrier can sue the primary carrier for its conduct that causes an excess verdict. Kentucky's decision on that issue would not be driven by the nature of the attorney-client relationship. In fact, the District Court could only apply *American Continental* principles to this case by combining two unrelated phrases from that case into one quoted sentence.

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[28] *American Continental*, *supra*, 997 S.W.2d at 14.

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In its Opinion and Order the District Court wrote of the *American Continental* opinion: "Though it (the Court of Appeals) acknowledged 'that some courts permit excess insurers to proceed against primary insurers for negligence and bad faith,' the Kentucky Court of Appeals was 'not persuaded that Kentucky should adopt such a course.'"[29] The *American Continental* opinion actually stated:

> In light of the fact that **some courts permit excess insurers to proceed against primary insurers for negligence and bad faith**, ACIC urges us to follow the lead of Texas courts which permits excess insurers to also maintain malpractice actions against attorneys employed by primary insurers on behalf of insureds ACIC argues that doing otherwise discourages an insured from demanding competent counsel, while simultaneously both imposing a burden on the primary insurer and relieving the insured's counsel of liability for legal malpractice. However, while it is true that Texas permits an excess insurer to bring a malpractice action against an insured's attorney based upon subrogation theories (cite omitted), **we are not persuaded that Kentucky should adopt such a course.** [30]

The language that the District Court quoted is emphasized in bold. The two concepts that the District Court turned into one sentence were 85 words apart in the *American Continental*. But the District Court conflated them, so it appeared that the Kentucky court was not persuaded to allow excess carriers to sue primaries for negligence or bad faith. The *American Continental* Court simply made no such statement, and the inference that the Court even considered the excess v. primary issue can only be based on an incorrect reading of that case.

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[29] R 19-3, Memorandum and Opinion; JA____

[30] *American Continental*, *supra*, 997 S.W.2d at 13.

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C. Kentucky public policy regarding insurance case would lead it allow an excess carrier to bring a subrogation action against a primary carrier.

The District Court also concluded, after a lengthy analysis, that public policy dictates against allowing excess carriers to bring an action against a primary carrier whose conduct causes an excess verdict against an insured. It reasoned that even if the primary carrier's conduct is negligent or in bad faith, its conduct harms no real victim—the insured is not harmed, because it had excess insurance, and the excess carrier is not harmed because it took a premium to indemnify the insured against an excess verdict.

Such reasoning would upset the entire business of insurance as it is conducted in Kentucky, and indeed throughout most of the county. Consider such logic applied to a more typical kind of excess insurance—underinsured motorist coverage. This arrangement allows automobile drivers to buy insurance that protects them and their families against the risk of being injured by another driver who has inadequate coverage. Insurers who offer this coverage must indemnify their own insured for damages the insured suffers exceeding the tortfeasor's policy limits.

Under the District Court's reasoning, the insurer should not have a subrogation claim because the underinsured motorist caused no real harm, and left no real victim. The injured person suffers no harm because he had underinsured

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motorist coverage. And by paying the injured person, the underinsured carrier has done nothing more than it accepted a premium to do.

Nevertheless, Kentucky does permit underinsured carriers to subrogate to the insured's rights against that tortfeasor, and seek reimbursement from the tortfeasor.[31] In fact, if the insured settles a claim against the tortfeasor without notice to his underinsured carrier, thereby damaging the carrier's subrogation rights, the insured may lose the right to recover underinsured motorist benefits.[32]

Kentucky courts have universally rejected the District Court's logic that whether Sufix suffered any harm from the excess verdict in this case depends upon whether it had insurance to cover that harm. "The general rule recognized in other jurisdictions is that damages recoverable for a wrong are not diminished by the fact that the injured party has been wholly or partially indemnified for his loss by insurance (to whose procurement the wrongdoer did not contribute)."[33] The Kentucky Court adopted this general rule as "sound, particularly since there is no logical or legal reason why a wrongdoer should receive the benefit of insurance obtained by the injured party for his own protection. It is a collateral contractual arrangement which has no bearing upon the liability of the wrongdoer."[34]

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[31] Kentucky Revised Statue (KRS) 304.39-320.
[32] *Coots v. Allstate Ins. Co.*, 853 S.W.2d 895 (Ky. 1993).
[33] *Taylor v. Jennison*, 335 S.W.2d 902, 903 (Ky. 1960).
[34] *Id.*

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Sufix's excess policy with National was just such a collateral source, and the fact that Sufix had the foresight to purchase such a policy does not relieve Hartford from its conduct that led to the excess verdict. That would make Hartford the beneficiary of the contract between Sufix and National when it did not contribute to the purchase of that policy. "Subrogation is designed to prevent unjust enrichment by requiring one who benefits from the payment of the debt of another to ultimately pay it themselves."[35]

Kentucky also has a strong interest in and public policy favoring the availability of affordable insurance. Its legislature has enacted an entire chapter of the insurance code[36] creating a Department of Insurance whose duties include monitoring the existence of a competitive insurance market,[37] and the rates that insurers charge.[38] Making sure that insurers have full rights to recoup payments they make on behalf of insureds fosters this policy.

Finally, Kentucky has a strong interest and public policy favoring the prompt and equitable settlement of insurance claims.[39] National could have delayed payment of the excess verdict in this case while litigating the issue of whether National caused that verdict. Instead, once the Court of Appeals affirmed

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[35] *Schwartz v. Hasty*, 175 S.W.3d 621, 626 (Ky.App. 2005)(disc. rev. denied).
[36] KRS Chapter 304.13
[37] KRS 304.13-041
[38] KRS 304.13-051
[39] *See*, KRS 304.12-230

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the trial court's judgment, National promptly paid the claim. That more quickly compensated the injured person and relieved its insured from the excess verdict, leaving the insurance companies to litigate the ultimate responsibility for that verdict. Kentucky's public policy favors such a procedure.

It is beyond dispute that under the facts pleaded in National's Complaint Sufix, had it not been insured against the excess verdict, would be able to file a bad-faith Complaint that would survive a motion to dismiss for failure to state a claim. National's Complaint alleges that Hartford did not comply with its contractual duty of good faith, including the duty to investigate the claims against its insured.[40] Other courts have held that the insurers have an affirmative duty to inquire whether their insured may have other policies applicable to a claim.[41] Hartford's failure to comply with this duty, as pleaded in the Complaint, may have injured both Sufix and National—had National been notified of this matter earlier, it would have been able to exercise its right to assume Sufix's defense, and might have been able to negotiate a settlement lower than the final verdict. Violation of the duty to investigate clearly gives rise to a bad-faith claim.

[40] Complaint, R1-5, ¶ 23.

[41] *Casualty Indemnity Exchange Ins. Co. v. Liberty National Fire Ins. Co.*, 902 F.Supp. 1235 (D.Mont. 1995); *American Star Ins. Co. v. Allstate Ins. Co*., 508 P.2d 244 (Or. 1973).

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National's Complaint also alleges that Hartford violated its duty to Sufix to settle claims against it within its policy limits.[42] Kentucky law imposes upon insurers a "general duty to protect its insured from liability in excess of the limit."[43] Had Sufix not had excess insurance, it would have had to satisfy the over $5,000,000 excess verdict from its own assets.

Thus, the only question before this Court is whether National is entitled to assert the rights that Sufix clearly had against Hartford. The District Court, predicting Kentucky law, said that National could not subrogate to Sufix's rights because Sufix, having excess insurance, suffered no harm. But Kentucky law has made it clear that National's payment under that excess policy is a collateral source that Hartford cannot rely upon to diminish the effect of its conduct.[44] To hold otherwise would permit Hartford's unjust enrichment, which is one of the wrongs subrogation law evolved to prevent.

The fact that Kentucky has never before applied subrogation principles to this kind of problem gives Hartford no support. "Subrogation is a highly favored doctrine in the law which is to be given a liberal application and which the courts are inclined to extend rather than to restrict." [45] The subrogation doctrine "is one of benevolence to prevent unjust enrichment and it attempts to do complete justice

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[42] R1-5, Complaint ¶ 23; JA____
[43] *Simpson v. Traveler's Ins. Co.*, 812 S.W.2d 510, 511 (Ky.App. 1991).
[44] *Schwartz v. Hasty*, *supra*.
[45] 73 Am Jur 2d, *Subrogation*, § 8 (2d Ed. 2001).

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between the parties. It is no fixed or inflexible rule and its object is to prevent injustice."[46] Because of this flexibility "the mere fact that the doctrine has not been previously invoked in a particular situation is not a prima facie bar to its applicability."[47] The District Court's inflexible approach reached a result that would permit Hartford's unjust enrichment.

D. The same public policy reasons underlying subrogation in Kentucky have led the majority of jurisdictions to allow excess carriers to sue primary carriers for their fault leading to excess verdicts.

Other American jurisdictions have considered the question at issue here, and "[u]nder the majority rule, a primary insurer owes a duty to an excess insurer via the primary insurer's duty to the insured, so that an aggrieved excess insurer may sue on an equitable subrogation theory."[48] The majority rule is founded on the same policies that underlie Kentucky's law of subrogation; giving an excess carrier the right via subrogation to bring a bad-faith claim against a primary carrier "encourages reasonable settlements, prevents primary insurers from obstructing settlement, prevents the unfair distribution of losses among primary and excess insurers, and reduces the cost of excess insurance."[49]

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[46] *Clarendon Nat. Ins. Co. v. Vetor*, 165 S.W.3d 484, 486 (Ky.App. 2005).
[47] 73 Am Jur 2d, *Subrogation*, §7 (2d Ed. 2001)
[48] 23 *Appleman on Insurance Law and Practice*, §145.5.
[49] *Id.* The same paragraph goes on to say that an excess insurer may need to get an assignment of the insured's rights against the primary carrier. In this case, however, the District Court acknowledged that National's policy with Sufix gave it a direct right of subrogation. R 19-9.

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The sheer number of such cases makes it impossible to discuss them exhaustively in this brief. The *Appleman* treatise referenced above cites many of them, and discussion of a few illustrative cases shows that *Appleman's* summarization of the policies behind the majority rule is accurate.

For example, in one case a Hartford Financial Services company (with which the Hartford defendant in this case is affiliated) made exactly the same claim that Hartford opposes here.[50] There Hartford Accident paid an excess settlement, and the court allowed it to recover from the primary carrier, which had made numerous errors in handling the claim. On appeal, the primary carrier raised the issue of whether Hartford Accident could state such a claim. Holding that it could, the court stated: "an insurer who has been compelled by his contract to pay to or in behalf of the insured claims for damages ought to be reimbursed by the party whose fault has caused such damages and the principle of subrogation ought to be liberally applied [to protect] its natural beneficiaries."[51]

And in *Employers National Insurance Corporation v. General Accident Insurance Company*,[52] the court analyzed the issue this way: "[I]f the insured, rather than the second-level carrier, had paid the excess, the insured would have an

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[50] *The Hartford Accident and Indemnity Co. v. Michigan Mutual Ins. Co*, 93 A.D.2d 337, 341, 462 N.Y.S.2d 175 (1983), aff'd 463 N.E.2d 608 (1984).
[51] *Id.*
[52] 857 F.Supp. 549 (S.D.Tex 1994)

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action for mismanagement of the claim."[53] Just as Sufix, had it paid the excess verdict in this case, would have had a claim against Hartford for mismanaging the claim against it. "Equity requires that the excess insurer be allowed to maintain the action that the insured could have brought itself against the primary carrier for the loss occasioned by the primary carrier's error." [54] Again the court relied on what by now should be a familiar concept: "Without this remedy, the primary insurer would have no incentive—other than spontaneous integrity—to work to settle within the limits of the primary policy when it is reasonably clear that the primary level will be consumed, as this case illustrates."[55]

The District Court disagreed with the logic in *Employers National*, questioning a hypothetical the court proposed in which a carrier with $1,000,000 limits which believes it has a five percent chance of winning a case might reject an offer to settle of $950,000, because it would be risking at most $50,000, even if the jury returned a $5,000,000 verdict. The District Court said this example failed to account for the practicalities of this insurance business: "An insurer who has estimated its success potential at trial to be a mere five percent is unlikely to

[53] *Id.*, 857 F.Supp. at 551.
[54] *Id.*
[55] *Id.*

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willingly incur the substantial transaction costs of litigation involved in defendant a lawsuit it is almost certain to lose.” [56]

But the District Court does not account for the fact that offers of settlement are made at different times in litigation. If the offer of settlement is made on the eve of trial, after the insurer has already incurred the bulk of litigation costs, its incentive will be to roll the dice at trial. The only way it can save money at this point is by getting a jury verdict well within the policy limits. And forget the fact that it believes it has only a five percent chance of doing so; it is not the insurance company that bears that risk—it is the insured, because as the *Employers Liability* court points out, the insurance company’s risk is limited to $50,000 in this scenario.

It is just this kind of calculation that produced the bad-faith doctrine. Courts provided a strong disincentive for insurers who choose to gamble with the insured’s assets.

If the District Court’s decision is allowed to stand, primary carriers who find themselves in the fortunate position of being in a case where an excess insurer is involved can once again roll the dice with someone else paying the costs of their losses. But as many courts have pointed out, while the excess carrier may bear the loss in any one instance, it is insureds who will bear that cost in the long run, as

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[56] R19-5, Memorandum and Opinion; JA____

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excess carriers adjust for this new level of risk by charging higher premiums. This contradicts both public policy and common sense. As Kentucky's highest court has said, "there is no logical or legal reason why a wrongdoer should receive the benefit of insurance obtained by the injured party for his own protection."[57] In other words, insurers who want to gamble should have to pay their own way at the tables.

VII. Conclusion

The District Court did not rule that National failed to plead sufficient facts to support its claim against Hartford; it simply held that Kentucky law would not recognize an excess carrier's claim against a primary carrier. It based this holding in part upon a misperception of the Court of Appeals of Kentucky's ruling in *American Continental*, which refused to allow an excess carrier to use the doctrine of equitable subrogation to sue counsel hired by the primary carrier to defend the insured. That Court's ruling was based on Kentucky's view of the attorney-client relationship, and not upon any hostility to the doctrine of subrogation.

In other instances Kentucky courts have applied the doctrine of subrogation flexibly to achieve justice. The principle of subrogation helps courts ensure that the party which causes a loss ultimately bears responsibility for that loss. Under the well-pleaded facts of this case, Hartford's conduct caused an excess verdict to

[57] *Taylor v. Jennison*, *supra*, 335 S.W.2d at 903 (Ky. 1960)

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Sufix, a loss against which the National indemnified Sufix. Both National's policy and the principles of subrogation require that it be permitted to seek reimbursement from Hartford.

These same principles foster the efficiency of insurance markets, and helps lower the cost of excess insurance. And applied by a majority of other jurisdictions, these tenets further the goal of promoting prompt and reasonable settlements. Those are all goals that Kentucky's courts strive to achieve, and the District Court's failure to recognize these goals and implement them in its prediction of Kentucky law was error.

Respectfully submitted,

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Certificate of Service

I hereby certify that a copy of the foregoing Proof Brief of Appellee was served by ordinary United States Mail upon:

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