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FEBRUARY 11, 2009
(FILE NO. 2008-SC-0606-D)

Commonwealth of Kentucky

Court of Appeals

NO. 2007-CA-001165-MR

AUTO OWNERS INSURANCE
COMPANY APPELLANT

v.

APPEAL FROM JEFFERSON CIRCUIT COURT
HONORABLE MITCH PERRY, JUDGE
ACTION NO. 02-CI-005712

OMNI INDEMNITY COMPANY APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: COMBS, CHIEF JUDGE; KELLER JUDGE; HENRY,[1] SENIOR JUDGE.

HENRY, SENIOR JUDGE: The tort victim's underinsured motorist carrier, Auto Owners Insurance Co., appeals from an order of the Jefferson Circuit Court

[1] Senior Judge Michael L. Henry sitting as Special Judge by assignment of the Chief Justice pursuant to Section 110(5)(b) of the Kentucky Constitution and KRS 21.580.

determining that Auto Owners is not entitled to restitution from the tortfeasor's insurer, Omni Indemnity Company, for funds advanced to the tort victim pursuant to *Coots v. Allstate Insurance Company*, 853 S.W.2d 895 (Ky. 1993). Subsequent to the advancement, the tortfeasor filed bankruptcy and Auto Owners failed to file proof of its claim with the bankruptcy court, resulting in the tortfeasor's dismissal from the lawsuit with no finding of liability against him. For the reasons stated below, we affirm.

FACTUAL AND PROCEDURAL BACKGROUND

This case arises out of an automobile accident that occurred on September 27, 1999. The accident involved, among others, vehicles driven by Connie Herre and Troy Edlin. Edlin had an insurance policy with Omni Indemnity with policy limits of $25,000.00. Herre had a policy with Auto Owners which included underinsured motorist (UIM) coverage. It appears uncontested that Edlin was the tortfeasor, though there has been no adjudication of his liability as a matter of fact or law.

Omni Indemnity offered to settle Herre's personal injury claim against Edlin for the policy limits of $25,000.00. Rather than agreeing to the settlement, however, Auto Owners chose to preserve its subrogation rights against Edlin by substituting its funds in payment to Herre in accordance with *Coots v. Allstate*, *supra*.

On July 30, 2002, Herre filed a personal injury action against Edlin in Jefferson Circuit Court. On August 21, 2002, Herre filed an amended complaint to

add Auto Owners as a defendant in order to seek UIM benefits for any amounts awarded against Edlin in excess of $25,000.00. Based upon its preserved subrogation rights, Auto Owners subsequently filed a cross-claim against Edlin for any amounts which Herre may become entitled to recover against Auto Owners as a result of the accident. Auto Owners also filed a third- party complaint against Omni Indemnity for its substituted *Coots* payment and for Basic Reparation Benefits (BRB) amounts Auto Owners had previously paid to Herre.

On June 20, 2003, Edlin filed a Chapter 13 bankruptcy petition in the U.S. Bankruptcy Court for the Western District of Kentucky, thereby automatically staying the present action. The deadline for filing a proof of claim was November 17, 2003. It is uncontested that all parties to the present lawsuit were given notice of the filing. Though Herre and Auto Owners had notice of the bankruptcy proceeding, neither filed proof of claim forms, nor were any objections filed to the bankruptcy, nor were motions filed to lift the automatic stay.

At the conclusion of Edlin's bankruptcy proceeding, his restructuring plan provided for payments to unsecured creditors whose claims were duly proved and allowed. It made no provision, however, for payment of unproved claims and unallowed claims to unsecured creditors, including Herre and Auto Owners; thus, their claims against Edlin were effectively discharged.

On August 19, 2004, Edlin filed a motion to dismiss the claims against him in the present action upon the basis that Herre and Auto Owners had failed to file a timely proof of claim in the bankruptcy proceeding, and thus the

present claims were barred by Bankruptcy Code Sections 11 USC §§ 501 and 726. On February 14, 2006, the trial court entered an order granting Edlin's motion. The order further noted, however, that Edlin's dismissal from the proceeding did not bar Herre's claim for UIM benefits against Auto Owners.

On June 26, 2006, Edlin and Omni Indemnity filed a motion for clarification of the order seeking, in light of the order of dismissal, clarification of the status of Auto Owners' third-party claim against Omni Indemnity for the *Coots* substitution money.[2] The motion assumed the position that the claim could not survive the dismissal of Edlin from the action. Also during this time all claims were settled, including Herre's UIM claim against Auto Owners, except for the dispute between the two insurance companies over the *Coots* advance.

On June 10, 2007, the trial court entered an opinion and order determining, based upon *Nationwide Mutual Insurance Co. v. State Farm Automobile Insurance Co.*, 973 S.W.2d 56 (Ky. 1998), and *USAA Casualty Insurance Company v. Kramer*, 987 S.W.2d 779 (Ky. 1999), that Auto Owners was not entitled to recover the $25,000.00 it had advanced pursuant to *Coots* from Omni Indemnity. This appeal followed.

DISCUSSION

Before us, Auto Owners contends that the trial court erred in determining that it was not entitled to recover its *Coots* advance money from Omni Indemnity. More specifically, it alleges (1) that its substituted payment was not an

[2] Omni Indemnity conceded it would remain liable to Auto Owners for payback of the $10,000.00 in BRB benefits Auto Owners had paid to Herre.

"overpayment," and (2) that a tortfeasor's bankruptcy does not affect a UIM carrier's right to recover a substituted payment. We first consider the issues by way of a general discussion.

COOTS v. ALLSTATE

In *Coots*, the Supreme Court established a procedure whereby an injured party with UIM coverage could settle with a tortfeasor and the tortfeasor's liability carrier and still retain a claim against his or her UIM insurer. Under the *Coots* procedure, when the injured party, the tortfeasor and the tortfeasor's liability carrier tentatively agree to settle the injured party's claim against the tortfeasor for the policy limits, the injured party may preserve his or her UIM claim by giving notice to its UIM insurer of the parties' intent to settle and affording the UIM insurer the opportunity to preserve its subrogation rights against the tortfeasor by paying the injured party the policy limit amount. If the UIM insurer elects not to substitute its own funds by paying the liability insurer's policy limits to the injured party: (1) the UIM insurer forfeits its subrogation rights against the tortfeasor for any amount that it is later required to pay the injured party under its UIM coverage; (2) the tortfeasor's liability carrier pays the injured party the settlement amount; (3) the tortfeasor is released from all further liability to either the injured party or the injured party's UIM insurer; and (4) the injured party may proceed against his or her UIM insurer for any damages in excess of the liability insurer's policy limits. However, if the UIM insurer elects to preserve its subrogation rights against the tortfeasor and substitutes its own funds for the settlement amount by paying the

policy limit to the injured party, the UIM carrier: (1) has subrogation rights against the tortfeasor's liability carrier for the substituted amount paid to the injured party; and (2) retains its subrogation rights against the tortfeasor for any amount that it is required thereafter to pay the injured party under its UIM coverage. *True v. Raines*, 99 S.W.3d 439, 445 (Ky. 2003).

The 1998 General Assembly substantially codified the Coots procedure into Kentucky Revised Statutes (KRS) 304.39-320, the Underinsured Motorist Coverage statute. The amendments imposed specific statutory duties upon both the insured and the insurer to implement the *Coots* process. As concerns us, KRS 304.39-320(4) provides, in relevant part that "upon final resolution of the underinsured motorist claim, the underinsured motorist insurer is entitled to seek subrogation against the liability insurer to the extent of its limits of liability insurance, and the underinsured motorist for the amounts paid to the injured party."

NATIONWIDE AND *KRAMER*

In *Nationwide Mutual v. State Farm*, *supra*, UIM carrier Nationwide Mutual substituted $50,000.00 to the tort victim pursuant to *Coots*. However, when the case was submitted to the jury, it awarded only $26,683.00 in damages. Nationwide sought to recover $50,000.00, the entire amount of its substitution, from State Farm; however, the Supreme Court determined that it was entitled to recover only $26,683.00, representing its statutory entitlement to $10,000.00 for

basic reparations benefits paid to the tort victim[3] and $16,683.00 in substituted funds.

Similarly, in *USAA v. Kramer*, *supra*, UIM carrier USAA advanced $50,000.00 to purported tort victim Kramer, but at trial the jury determined the purported tortfeasor to be not at fault, resulting in a jury verdict of zero against the purported tortfeasor. The Supreme Court determined that USAA was not entitled to recoupment of any of the advanced funds from the liability carrier, State Farm.

Nationwide and *Kramer* make clear that if a case proceeds to trial and the verdict is less than the substituted funds, the UIM carrier will be limited to recovering the amount returned in the jury's verdict. It necessarily follows from the two cases that if by some other foreseeable and usual route (such as judgment on the pleadings, summary judgment, or directed verdict) the trial proceedings terminate in a judgment against the alleged tortfeasor for less than the substituted amount, the UIM carrier's entitlement to reimbursement will likewise be limited by the judgment amount.

Central to the holdings in *Nationwide* and *Kramer* was a determination of who should bear the risk of a judgment less than the *Coots* substitution paid by the UIM carrier. In *Nationwide*, the Supreme Court, adopting the analysis of this Court in its decision in the case, discussed the issue as follows:

> [T]he system set up by the *Coots* decision accomplishes the remedial purposes of the MVRA in that the plaintiff can receive the amount of the tortfeasor's policy limits, either from the liability carrier or from the UIM carrier

[3] *See* KRS 304.39-020(2) and KRS 304.39-040(1).

without having to obtain a judgment. The tortfeasor has an incentive to settle, in that he may obtain a release from further liability, and the tortfeasor's liability carrier protects itself from a bad faith action by making the offer for policy limits. The plaintiff can then proceed against the UIM carrier and the UIM carrier can preserve its right of subrogation.

[I]t is the UIM carrier that should bear the risk of overpaying the plaintiff [because] doing so encourages the UIM carrier to make an informed decision as to whether its subrogation rights are valuable or simply illusory. Since UIM benefits are payable only when the tortfeasor's liability exceeds the tortfeasor's policy limits, the UIM carrier must determine the value of the plaintiff's claim and the value of the potential subrogation claim when the liability carrier has offered the policy limits. **The UIM carrier must determine, before it substitutes payment**, the strength of the plaintiff's claim, the extent of the plaintiff's damages and **the likelihood of being reimbursed by the tortfeasor for UIM benefits. It is appropriate that these matters be fully examined by the UIM carrier before it interferes with a settlement, and it should do so only when it finds those subrogation rights to be truly valuable.**

[A] substitution by the UIM [carrier] of the amount offered in settlement does not truly result in a settlement. The tortfeasor remains in a position of potential liability should the judgment exceed the amount of his policy limits. Further should the tortfeasor refuse to settle, instead going to trial, the jury could absolve him or her of liability or adjudge the liability to be less than the policy limits. Thus, **if the UIM carrier can substitute payment without any risk, then the tortfeasor may be in a better position if he does not make a settlement offer at all to the plaintiff. With the risk of a bad decision on the UIM carrier, the UIM carrier is forced to make an informed decision and a realistic assessment of the offer. Further, it promotes finality between the plaintiff and the tortfeasor when the UIM carrier decides that its subrogation right has no value.** Finally . . . placing the risk of loss on the UIM carrier

> also simplifie[s] the determination of UIM coverage. Once the issue of liability is decided, the only question remaining is the amount of damages. Hence the time and expense of the subsequent proceedings will also be reduced.
>
> **[It] is clear that . . . the UIM carrier must determine its own destiny: if it chooses to substitute payment based on the risk evaluation of the liability carrier, it is bound by that assessment when the time to assert its subrogation rights arrives.**

Nationwide at 57 – 58. (Emphases added).

"The bottom line is that the UIM [carrier] bears the risk when it chooses to thwart a proposed settlement between the plaintiff and the alleged tortfeasor by substituting payment of the settlement amount." *USAA Cas. Ins. Co. v. Kramer*, 987 S.W.2d 779, 783 (Ky. 1999).

We construe the foregoing pronouncements of the Supreme Court as squarely placing the risk of unsuccessful litigation against the tortfeasor on the UIM carrier at trial. As previously noted, in addition to a jury verdict, the rule would clearly be applicable to, for example, a judgment in favor of the tortfeasor by judgment upon the pleadings, summary judgment, or a directed verdict at trial.

We believe the rule is also applicable to a claim which has become barred by the bankruptcy of the alleged tortfeasor where the UIM carrier has failed to preserve its subrogation rights through lack of diligence. As part of its overall evaluation of the strength of its subrogation rights against the tortfeasor, the duty is placed upon the UIM carrier to evaluate the financial wherewithal of the tortfeasor. One of the policies underlying the *Nationwide* and *Kramer* decisions is the notion

that a UIM carrier should not thwart a settlement by substituting *Coots* funds to preserve subrogation against a tortfeasor who will be unable to satisfy the judgment against him in excess of his liability coverage. Such subrogation rights are aptly described in *Nationwide* as "illusory." *Id.* at 58. Little is to be gained by substituting *Coots* money to preserve subrogation against a tortfeasor on the brink of bankruptcy.

Moreover, if a UIM carrier does so, it stands to reason that it must bear the responsibility of protecting its interests to the extent possible under the Bankruptcy Code in the event of a bankruptcy filing by the tortfeasor, and if it fails to do so, it follows that it must bear the attendant consequences. Auto Owners failed to protect its subrogation rights against Edlin in the Chapter 13 filing with the attendant result that its claim became barred which, in turn, resulted in Edlin's dismissal from the action without there having been an adjudication of his liability (both as to fault and damages) in the case. In addition, Auto Owners settled Herre's UIM claim, thus effectively mooting a principal aim of the *Coots* process – the determination of the value of that claim by a jury.

In summary, though the cases are not directly on point, with the policy considerations underlying *Nationwide* and *Kramer* as our guide, we are persuaded that the risk of loss must fall upon Auto Owners under the facts presented here and that it is not entitled to reimbursement from Omni Indemnity for the *Coots* money previously advanced.

"OVERPAYMENT"

As noted above, *Nationwide* holds that "the UIM carrier [] should bear the risk of **overpaying** the plaintiff[.]" *Id.* at 57. Auto Owners argues that its $25,000.00 *Coots* substitution cannot be classified as an "overpayment" because there has never been a determination of Herre's actual damages by a jury. It contends that "the amounts paid to the injured Plaintiff were not 'overpayments'; they were simply amounts paid by agreement. The only way to determine whether those amounts constituted an 'overpayment' is to permit Auto Owners now to proceed with its subrogation claim against Omni, for recovery of its substituted payment." In other words, Auto Owners maintains that the *Nationwide* and *Kramer* rules cannot be properly applied until a jury determines Herre's damages following a presentation of the evidence at trial. Only then, they argue, can it be determined whether there was an overpayment.

The underpinning of this argument is, by and large, a matter of semantics. As previously noted, the litigation terminated with the functional equivalent of a zero verdict against Edlin. In this sense, it would be accurate to state that there was, indeed, an "overpayment." Thus, we are unpersuaded by this argument.

EFFECT OF TORTFEASOR'S BANKRUPTCY

Auto Owners argues that Edlin's bankruptcy has no effect on its right to seek recovery of its *Coots* advancement from Omni Indemnity.

In support of its argument, Auto Owners cites us to the previously noted clause of KRS 304.39-320(4), which provides, in relevant part that "upon

final resolution of the underinsured motorist claim, the underinsured motorist insurer is entitled to seek subrogation against the liability insurer to the extent of its limits of liability insurance, and the underinsured motorist for the amounts paid to the injured party."

We believe the statute is adverse to Auto Owners' position. The statute establishes the timeline for evaluating Auto Owners' subrogation rights as "upon final resolution of the underinsured motorist claim[.]" *Id*. In the normal course of events, that would occur following the return of a jury verdict ascertaining the tortfeasor's total liability in the cause. In the case at bar, however, the "final resolution" of the UIM claim came when Auto Owners settled Herre's UIM claim. At that juncture, any potential for a finding of liability against Edlin had been destroyed by his dismissal from the case. Moreover, the statute contains no provision for additional litigation, such as that proposed by Auto Owners, following the final resolution of the UIM claim.

Auto Owners further cites us to *7A Couch on Insurance* § 103:18, which discusses the effect of an insured's insolvency or bankruptcy. The treatise states therein:

> Where the **obligation** of the insurer is against liability, [] the insolvency or bankruptcy of the insured has no effect on the **obligation** of the insurer.
>
> . . . .
>
> Accordingly, the discharge in bankruptcy of the insured does not discharge the insurer's **obligation** under its policy.

It also cites us to *Padgett v. Long*, 453 S.W.2d 272 (Ky. 1970). In *Padgett*, Padgett was injured while constructing a barn for the Longs, who were insured by Ohio Casualty Company. Padgett sued the Longs, after which the Longs filed for bankruptcy. Padgett did not file a claim in the bankruptcy proceedings and his unliquidated claim against the Longs was discharged. The trial court dismissed Padgett's lawsuit on the basis that the discharge served as a complete defense against the claim. The former Court of Appeals reversed, holding that the proper procedure would have been for the trial court to have authorized the establishment and liquidation of the claim without permitting enforcement against the Longs, and with any judgment obtained collectible only against the insurance company.

We are not persuaded that the procedure approved in *Padgett* applies to the *Coots* process. By way of illustration, we believe *Padgett* and controlling cases cited therein would apply as follows to the facts of this case: with *Coots* not in play, if Herre had sued Edlin and Edlin thereafter filed for bankruptcy and, as a consequence, had Herre's claim been discharged, Omni Indemnity would nevertheless be bound by its liability carrier obligations. We believe that the foregoing authorities stand for no more than this rather unremarkable proposition.

However, *Coots* was in play, and we have discussed the attendant ramifications at length above. In addition, it must be borne in mind that Omni Indemnity is the **liability** carrier for Edlin. Its obligation under the liability policy

is a function of Edlin's liability. At the risk of repetition, the proceedings against Edlin terminated without a determination of liability against him. As such, "the insurer's obligation under its policy" was, in this sense, zero, and it is accordingly reasonable that Omni Indemnity would have no liability obligation under the facts at bar. Hence, our result is consistent with § 103:18 of *Couch on Insurance* and *Padgett*, and these authorities do not change our conclusions as previously set forth.

CONCLUSION

For the foregoing reasons the judgment of the Jefferson Circuit Court is affirmed.

ALL CONCUR.

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