

Know Your Rights: Contractual v. Equitable Subrogation

By: Richard J. Boyd

The goal of every subrogation professional is to maximize recoveries. To do this effectively, one must know the laws and principles that form the basis for all subrogation claims, and then use them to his advantage. This article will analyze the significant differences between equitable and contractual subrogation, and how they can play a crucial role in securing recoveries. This article will also discuss how insurance carriers can best protect their subrogation interests while ensuring that there is equity between the insurer and insured. From reading this article, the reader will develop new tools for maximizing recoveries and gain a better understanding of our subrogation world.

Equitable Subrogation

Subrogation is the principle by which an insurer, having paid its insured's loss, is placed in the position of its insured so it may recover from the third party legally responsible for the loss.¹ Subrogation is liberally applied for the protection of those who are its natural beneficiaries: insurers that have been compelled by contract to pay a loss caused by the negligence of another.²

Within this realm, there are two distinct means of recovery that the law recognizes: contractual and equitable subrogation. (Statutory subrogation is another means of recovery, but it will not be discussed in this article.) In the normal course of business, the subrogation professional does not have to worry about the differences between contractual and equitable subrogation. However, when the policyholder has uninsured losses that exceed the assets available from the liable third party, it is essential to have a solid understanding of these principles.

Equitable subrogation is based on principles of equity (fairness), which require a third party who has caused a property loss to ultimately pay for it. Equitable subrogation has its origins in common law (judicial opinions). In the situation where the policyholder argues that he has uninsured losses, the doctrine of equitable subrogation can work against the insurer. As courts have held:

If, however, the sources of recovery ultimately available are inadequate to fully compensate the insured for its losses, then the insurer – who has been paid by the insured to assume the risk of loss – has no right to share in the proceeds of the insured's recovery from the tortfeasor. Or, to state the rule another way, an insurer has no right of subrogation against its insured when the insured's actual loss exceeds the amount it has recovered from both the insurer and the wrong doer.³

So, when the amount of first-party coverage is inadequate to fully compensate an insured, and the tortfeasor has insufficient assets to make up the difference, the “made-whole”

¹ 16 Couch on Insurance, 2d edition, § 61:1.

² 16 Couch on Insurance, 2d edition, §61:11.

³ *Winkelman v. Excelsior Insurance Company*, 650 N.E. 2d 841, 626 N.Y.S. 2d 994 (1995).

doctrine prohibits a subrogating carrier from seeking recovery. This situation often arises in larger losses when the tortfeasor's available liability coverage is far less than adequate to compensate the insured for his uninsured losses. It is in this situation that the subrogating carrier is often left out in the cold, with no means of recovering significant dollars. Or so it may seem.

Contractual Subrogation

It is often the case that the insured involved in a larger loss has personal counsel who seeks to recover uninsured losses. The personal counsel will argue that the subrogating carrier has no right to recover from the tortfeasor's insurance because the insured has not been made whole. To often, the subrogating carrier agrees, the file is closed, and a significant opportunity to recover is lost.

Recovery through contractual subrogation may save the day. As stated previously, equitable subrogation is a judicially created doctrine of fairness, which arises from judicial opinions. Contractual subrogation, however, arises out of the insurance contract. This means that the parties to the insurance contract must look to the language of the policy to determine subrogation rights, and not to what a judge might think is fair. These contract-based subrogation rights are governed by the parties' express agreement as set forth in the insurance policy. Indeed, the terms agreed to by both parties contained within the policy are not invalidated by equitable subrogation considerations like the made-whole doctrine.⁴

As Professor George Couch, the preeminent scholar on insurance law, stated decades ago: "Where the right of an insurer to subrogation is expressly provided for in the policy, its right must be measured by, and depends solely on, the terms of such provisions."⁵

An overwhelming majority of courts throughout the country have also found that contractual subrogation rights trump equitable subrogation. As the Ohio Supreme Court has held:

We have long held that principles of equitable subrogation, including the made-whole doctrine, do not override clear and unambiguous contractual provisions. Our holding therefore does not constitute a change in our precedent but rather a reaffirmance of it.⁶

Likewise, the Hawaii Supreme Court found:

The right to conventional subrogation, as opposed to legal subrogation, does not depend on principles of equity. When subrogation claimed by an insurer is based on contract, the subrogation provisions of the policy constitute the sole measure of its rights.

Thus, while the made-whole doctrine may preclude a carrier from recovering in equitable subrogation, it does not apply in the contractual subrogation context. Instead, one must look solely to the applicable insurance policy to see what it says regarding subrogation rights. The language in the policy becomes controlling and dictates the parties' recovery rights.⁷

4 *Texas Health Insurance Risk Pool v. Sigmundik*, 315 S.W. 3d 12, 53 Tex. Sup. Ct. J. 770 (2010).

5 16 Couch on Insurance 3d, § 222:23, pp. 222-251 (emphasis added).

6 *Northern Buckeye Educational Counsel Group Health Benefits Plan v. Lawson*, 814 N.E. 2d 1210, 1215 (Ohio 2004).

7 *State Farm Fire & Casualty Company v. Pacific Rent All, Inc.*, 978 P. 2d 753, 767 FN 9 (Hawaii 1999).

Protecting the Subrogation Interest

When an insurance policy is clear that the subrogating carrier has first rights - or priority - to the tortfeasor's available assets, then that policy language is controlling. Courts throughout the country have provided us with guidance as to how a properly-worded policy should read in this regard. The following is such an example:

2. Subrogation – all other coverages

If any person or organization to or for whom the company makes payment under this policy has rights to recover damages from another, those rights are transferred to the company to the extent of such payment. That person or organization must do everything necessary to secure the company's rights and must do nothing after the loss to impair them. The company will be entitled to priority of recovery against any such third party (including interest) to the extent payment has been made by the company, plus attorney's fees, expenses or costs incurred by the company.

As the Second Circuit Court of Appeals found, this provision expressly transferred to the subrogating carrier the insured's right of recovery from a third party to the extent of the payments made. It also expressly granted to the subrogating carrier priority of recovery of the amounts it paid.⁸

The Ohio Supreme Court found the following policy language to provide the subrogating carrier with priority of recovery as well:

In consideration of, and to the extent of said payment, the undersigned hereby subrogates said insurance company to all the rights, claims and interest which the undersigned may have against any person or corporation liable for the loss mentioned above.⁹

In both of these policies, it was made clear that the insured would assign *all* of its right of recovery, to the extent of the insurer's payment, to the subrogating carrier. In the former policy, it was made even clearer that the subrogating carrier was granted the right of first recovery – priority – of any amounts available from the tortfeasor. These policy provisions used clear language to express the intent of the parties that the subrogation carrier has first rights to any available proceeds of the tortfeasor, up to the amounts paid by the carrier. When it is made clear that the subrogating carrier has priority of recovery, most courts will enforce these rights and the made-whole doctrine will have absolutely no application.

A subrogation receipt can be signed by an insured following a loss which can preserve the right of priority recovery as well. Some policies do not contain any language regarding subrogation rights or the existing language may be unclear. In these instances, a subrogation receipt can be used to clearly set forth the recovery rights of the parties.

The following language should convey priority of payment to the insurer as well as assistance in the efficient resolution of the subrogation claim:

In consideration of, and to the extent of, the aforementioned payment, the undersigned hereby transfers to the insurance company all of the rights, claims and interests which the undersigned may have against any third party liable for the loss mentioned herein. The insurance company will be entitled

⁸ *SR International Business Insurance Company, Ltd. v. World Trade Center Properties, LLC*, (2008 WL 2358882)(affirmed in 343 Fed. Appx. 629, 2009 WL 2243837).

⁹ *Peterson v. Ohio Farmers Ins. Co.*, 175 Ohio St. 34, 191 N.E. 2d 157 (1963).

to priority of recovery against any such third party (including interest) to the extent payment has been made by the insurance company, plus attorney's fees, expenses or costs incurred by the company. The undersigned further authorizes the insurance company to sue, compromise and/or settle in the undersigned's name, to the extent of the aforementioned payment, and to execute and sign releases and endorse checks or drafts given in settlement of such claims, rights and interests in the name of the undersigned.

It is important for the insured to understand the ramifications of the language contained in the subrogation receipt as it can have a significant effect on the insured as discussed earlier in the article. Ideally, the insured should have the subrogation receipt reviewed by an attorney of the insured's choosing so as to ensure that there is full knowledge and awareness of its significance. Once signed, the subrogation receipt can serve as a clear indication of the insurer's right to priority of payment.

The Fairness Factor

There is often a debate as to whether it is fair for an insurance carrier to contract away an insured's ability to be made whole. A small minority of courts have found that it is not fair as the insurer was paid to accept the risk that it may go unpaid.¹⁰ This reasoning is flawed though as the insurance carrier only provides coverage in the amounts requested by the insured. As such, the insurer does not expect to go unpaid up to those amounts. It is ultimately the responsibility of the insured to purchase the requisite amount of insurance that will cover the value of her property. If the insured chooses to purchase a limited or insufficient amount of insurance, that is not the fault of the carrier and, therefore, should not provide a basis for application of the made whole doctrine.

The courts upholding the made whole doctrine in the contractual subrogation context also ignore the Constitution of the United States. Article I, Section 10, clearly provides that no state shall pass any bill or law that impairs the obligation of contracts. The courts noted above ignore the supreme law in this country by substituting their own concepts of fairness for the obligations created by freely negotiated contracts. If challenged, it is anticipated that these decisions would not remain binding.

The debate will continue regarding the fairness of contracting away subrogation rights. Fortunately for subrogation professionals, the strongest and most sensible arguments support their position. As the Pennsylvania Supreme Court aptly remarked nearly thirty (30) years ago:

The law demands of every man who bargains with another that he should do so only after due reflection of the possible consequences of his bargain and if he misjudges the consequences that could have been expected by a reasonably intelligent man, he cannot rely on the law to remedy his fecklessness. Absent some legally recognized infringement of the law of contract by one party, the law will not reform a written contract so as to make a contract for the parties that they did not make between themselves and certainly never to rescue a party who did not reasonably foresee the consequences of his bargain.¹¹

¹⁰ *Swanson v. Hartford Ins. Co. of the Midwest*, 309 Mont. 269, 46 P.3d 584 (2002); *Petta v. ABC Ins. Co.*, 278 Wis.2d 251, 692 N.W.2d 639 (2005).

¹¹ *New Charter Coal Co. v. McKee*, 411 Pa. 307, 312, 191 A.2d 830, 833 (1963)

Conclusion

When trying to maximize recoveries, the subrogation professional needs to be cognizant of the laws and principles that dictate in our field of expertise. By knowing that a properly worded insurance policy or subrogation receipt can grant priority of payment to the carrier, the subrogation professional is that much closer to maximizing his recoveries.

While most courts permit a subrogating carrier to have priority of recovery when it is clearly set forth in the policy, there may be situations where the insurer does not want to enforce this right. If the policy language is clear, it at least gives the subrogating carrier the right to make this decision and not the attorney for the policyholder or a sympathetic judge. When the value of a case is significant, an insurer should have the ability to recover the amounts it has bargained for. Contractual subrogation can provide that ability.

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About the Author

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