

# Subrogation

I Development of Subrogation Concept.....	1
Subrogation is Substitution .....	1
Beginnings of Subrogation .....	2
Recoupment .....	2
Origination .....	3
Subrogation in America.....	4
UCC.....	5
Statute of Frauds and Insurance Contracts.....	5
Formal Engagement .....	5
How it Arises.....	6
Subrogation Components .....	6
Objective of Subrogation.....	6
Lower Loss Lowers Cost .....	7
Assessing Loss Potential.....	8
Great West Casualty Co. v. MSI Insurance Co. ....	9
Types of subrogation .....	11
Indemnity insurer's subrogation rights .....	11
Surety's subrogation rights .....	11
Security Interest .....	12
Subrogation rights against trustees.....	12
II Equitable Subrogation .....	13
Made Whole Doctrine.....	13
Superior Interest .....	14
Made Whole Doctrine in the States.....	15
When Subrogation Rights Arise.....	16
Other Considerations .....	16
ERISA Act.....	17
Private Sector.....	17
Equitable relief vs. legal relief.....	18
ERISA- Equitable Relief .....	19
Define "Equitable Relief".....	20
Recovery Approved .....	20
Equitable nature of relief sought.....	21
Healthcare Lien, Subrogation and Reimbursement.....	21
Equitable Subrogation v. Contractual Subrogation.....	22

# Subrogation

## I Development of Subrogation Concept

### Subrogation is Substitution

Generally defined, subrogation is the substitution of one party (the insurer) to another party's (the insured's) rights. The substitution occurs because the first party has made a payment for which another is responsible. In insurance, subrogation occurs when the insurer pays a claim while the insured possesses a right of action against a third party for causing a loss. The idea is that if a person pays a debt for which another person is liable, that payment should give the debt-paying person a right to collect the debt from the liable party.

A good example of subrogation is the automobile insurance collision policy. Mr. Smith is responsible for a collision with Mrs. Wilson. Mrs. Wilson may sue Mr. Smith for damages, or she may collect under her own auto collision insurance policy. If she decides to collect her own insurance, the insurer will be subrogated for Mrs. Wilson's in the right to sue Mr. Smith. The insurance company will "step in the shoes" of the insured so as to recover from an accountable third party, in tort or contract, for the payments made by the insurer to cover the losses of the insured. Typically, an automobile insurance policy provides that in the event of any payment under the policy, the company shall be subrogated to all the insured's rights of recovery. The insured is obligated to do nothing after loss to prejudice such rights.

Subrogation clauses are found in property and liability insurance contracts and are typical provisions in health plans. Subrogation clauses are also found in other types of casualty insurance. Subrogation does not apply to life insurance. Subrogation can be brought about by contract or by operation of law. Unless a contract specifically provides otherwise, equitable principles apply even when a subrogation is merely the usual equitable right that would have existed in any event in the absence of a contract.

Subrogation is the exercise, for one's own benefit, of rights or remedies possessed by another against third parties. As a corollary (i.e. a natural consequence of an established principle) of indemnity, subrogation allows proceeds of claim against third parties to be passed to insurers, to the extent of their insurance payments. At common law, an insurer's subrogation action must be conducted in the name of the insured. Subrogation seeks to protect the parent principle of indemnity, by ensuring that the insured does not get paid twice for the same loss.

In the context of insurance, the right of subrogation is based on two premises:

- 1.) an insured should not be allowed to recover twice for the same loss, which would be the result if the insured recovers both from their insurer and the tortfeasor, and
- 2.) a wrongdoer should reimburse an insurer for payments that the insurer has made to the insured. An insurance policy reaffirms the rights of parties relative to subrogation but, in the absence of an express provision to the contrary, does not alter fundamental principles pertaining to subrogation.

Note also that when an insurer receives more from a lawsuit it pursued by way of subrogation than it paid its insured, the difference generally goes to the insured. There is no subrogation in life insurance because life insurance is not a contract of indemnity. Mr. A is killed as a result of B's negligence. The survivors of A can pursue a wrongful death claim against B. The survivors of Mr. A can also collect life insurance proceeds (assuming one or more of them are listed as beneficiaries). The life insurer is not subrogated to the claim.

## **Beginnings of Subrogation**

Subrogation is an ancient concept; its roots are in Roman law. Under the reign of the Emperor Hadrian, Roman law began to shape the building blocks of subrogation. Suretyship was an accessory contract, and the surety was known as the *fidei-jussor*. Sureties had the *beneficium divisionis*, and enjoyed the *beneficium ordinis*, invented by Justinian, and the *beneficium cedendarum actionum*, or subrogation to the right of action of the creditor against the principal debtor, or *pro rata* against the co-sureties. It came to America through civil law, and it was from the civil law that the Courts of Chancery (equity) derived both the term and the doctrine of subrogation. As a result, subrogation is one of the oldest concepts known to the Anglo-American common law. It seems to have been formally established in common law in the *Magna Carta*. The right of subrogation was established in Article 9 of the *Magna Carta*, which provides:

Neither We nor Our bailiffs shall seize any land or rent for any debt so long as the debtor's chattels are sufficient to discharge the same; nor shall the debtor's sureties be distrained so long as the debtor is able to pay the debt. If the debtor fails to pay, not having the means to pay, then the sureties shall answer the debt, and, if they desire, they shall hold the debtor's lands and rents until they have received satisfaction of the debt which they have paid for him, unless the debtor can show that he has discharged his obligation to them.

Under the common law, subrogation has its foundation in the law of suretyship. The Statute of Frauds contains guidance on the duties expected of a surety. The statute of frauds refers to the requirement that certain kinds of contracts be memorialized in a signed writing.

## **Recoupment**

Shortly after insurance companies began paying claims, insurance executives began pondering ways to recoup some of the money that they had paid out to their insureds. Subrogation is firmly based in the concept of indemnity and a method where insurance can be made affordable. The gains achieved through subrogation are eventually passed on to the insurance buying public through lower insurance premiums.

In 18th century England, the founding father of insurance law, Lord Mansfield, recognized subrogation in court cases. The underlying doctrine was to prevent a windfall to an individual insured. The Courts did not think it fair that a person could recover both against the insurance company that insured the loss as well as recovering against the person who caused the loss. The courts and the insurance companies felt that to allow the insured to recover twice would be a "windfall" to the insured.

## Origination

There are actually two views as to how the doctrine of subrogation developed;

**Equity-** The first view is that it developed as part of the English legal system known as equity. The equity side of the courts strove to right "wrongs" and to follow the natural law. They attempted to be fair. The idea is that double indemnity offends natural justice.

**Common Law-** The other view is that the doctrine stems from the common law. Applying common law (law that is not written down as an ordinance or statute) courts implied that every insurance contract contained a term that gave the insurer the tacit permission of its policyholder to exercise any recovery rights that may exist against the party that caused the wrong even though that party is not a party to the contract. Hence the origins of the word subrogation, which means "substitution." In these cases it means the substitution of the insurer for the insured.

Lord Mansfield addressed the concept of subrogation in *Mason vs. Sainsbury* in 1782. He spoke in that case about the right of the insurer to step into the shoes of its insured and recover its losses. In *Mason vs. Sainsbury* rioters ransacked Mr. Mason's house and his insurance company paid the claim. The Riot Act of 1713 provided a means to recover damages against the local administrative district body. The insurance company pursued a recovery action against this administrative body in the name of its insured.

To this day many jurisdictions that have inherited the tradition of English Common Law still employ statutes that require police or other executive agents to deliver an oral warning, much like the Riot Act, before an unlawful public assembly may be forcibly dispersed. The reader will also note that 'riot' is a common exclusion in property/casualty contracts. Because the authorities were required to read the proclamation that referred to the Riot Act before they could enforce it, the expression "to read the Riot Act" entered into common language as a phrase meaning "to reprimand severely," with the added sense of a stern warning. The phrase remains in everyday use in English.

*Mason vs. Sainsbury* was predated by the case of *Randall vs. Cochran* 1748 where the insurer for an English ship taken by the Spanish was permitted to bring suit in the name of its insured against the administrators of a public prize fund that was compiled by the British government from the sale of captured Spanish ships. The Lord Chancellor declared:

"...the plaintiffs had the plainest equity that could be. The person originally sustaining the loss was the owner; but after satisfaction made to him, the insurer...the assured stands as trustee for the insurer, in proportion for what he paid..."

One hundred years later came the case of *Castellan vs. Preston*, which is probably the leading case in England establishing the principal of Subrogation. In that case a house that the owner had agreed to sell was damaged by fire before it was sold. His insurers indemnified him for the value of the repairs. The buyer for the house paid full price for the house in its damaged condition. Subsequently, the insurers learn that their insured had received full price for the house without deduction for the insurance proceeds that it paid to its insured - the seller of the property. Lord Justice Rhet set forth the principal that has been followed in England and United States up until present time:

"... The contract of insurance contained in a marine or fire policy is a contract of indemnity and of indemnity only, ... the insured shall be fully indemnified, but shall never be more than

fully indemnified. This is the fundamental principle of insurance, if ever a proposition is brought forward which is at variance with it, that proposition must certainly be wrong. "

## **Subrogation in America**

It is difficult to pinpoint one early case in the United States that can be said to mark the beginning of the court's recognition of the doctrine of subrogation. Essentially subrogation as a doctrine was transferred from England over to this country as part of Anglo Saxon law and equity. It has always been accepted here. Cases in the late 19th-century contain descriptions of subrogation and represent a clear understanding and acceptance of the concept.

In 1888 the United States Supreme Court was asked to consider the subrogation claim of Aetna Life Insurance Company against the township of Middleport, Illinois (Aetna Life Ins. Co. vs. Middleport, 124 U.S. 534 (1888)). The town had issued bearer bonds to the Chicago, Danville & Vincennes Railroad Company to convince the railroad to construct a railroad through the township. Aetna purchased the bonds from the railroad. The railroad built the line but then went out of business and Aetna tried to collect on the bonds claiming that the railroad had acted and the line was a benefit for the town and that by virtue of equitable subrogation Aetna stood in the place of the railroad. The court in its decision pointed out that equitable subrogation is a well recognized doctrine but that in this particular case, the court felt that Aetna had acted as a pure volunteer and that, therefore, the doctrine of equitable subrogation was not applicable.

A case decided on February 10, 1890 in Arkansas makes reference to an academic treatise on the subject, namely, Sheld on Subrogation and recites that:

"The right of the insurance company that has paid a loss to recover of the wrong-doer, after payment of the loss does not depend upon contract, agreement, stipulation, or privity. The right of subrogation is sometimes spoken of as an 'equitable assignment,' but that is only a convenient figure of speech. From the time of the insurance the insurer has a pecuniary interest in the thing insured, and he becomes entitled to a legal remedy whenever he suffers a loss by reason of that interest, and it appears that the loss has been occasioned by the wrongful act of another. Of course, he has no right of action until he has paid the loss to the insured, because until that time he has suffered no damage."

American courts from colonial times have favorably recognized the principle of subrogation as it was stated as recently as 1999 in a case involving Lloyds;

"Subrogation has been equated to and interchanged with the word substitution and the basic idea is that of substituting the insurance carrier for the insured in the insured's action against a third party. Subrogation is an equitable doctrine and is applicable whenever a debt or obligation is paid from the funds of one person although primarily payable from the funds of another." (*Prime Hospitality Corp. et al v. Underwriters at Lloyd's et al*, Civil No 1997-91 United States District Court for the District of the Virgin Islands, 1999 U.S. Dist)

There are some writers and jurists who believe that subrogation is not an appropriate remedy because there is no actual proof that subrogation recoveries are passed on to the insurance buying public. These critics of subrogation view subrogation as nothing more than a windfall for the insurance industry. From time to time a state has legislation pending that would eliminate the insurance company's right to subrogation. Ironically the basis of this legislation is that a claimant should be allowed to recover both against a

wrongdoer and his insurance company. Over two centuries of thoughtful consideration and reasoned opinions should not be thrown aside in an unthinking reaction to "consumerism."

## **UCC**

In the U.S., contracts for the sale of goods where the price equals \$5,000 or more fall under the statute of frauds in the Uniform Commercial Code (some jurisdictions retain a \$500 or more threshold as of this writing). The section is titled 'Promise to Answer for the Debt of Another.' This is often called the "Suretyship Section," and this provision applies typically to contracts wherein a promise is made to a creditor to pay the debts or obligations of a third person, the debtor. Thus, if a father tells a merchant to extend credit to his son, and says "If he doesn't pay, I will," the promise must be in writing to be enforceable. The factual situation can be reduced to the simple "If X doesn't pay, I will." The promise is said to be "collateral," in that the promisor is not the one who is primarily liable. He does not promise to pay in any event; his promise is to pay only upon the default of the one primarily obligated.

It is sometimes difficult to ascertain whether a promise is "collateral" ("I'll pay if X doesn't"), or whether the promisor undertakes to become primarily liable, or, as the courts say, makes an "original" promise ("I'll pay"). For example, a father tells a merchant to deliver certain items to his son, and says "I will pay for them." The Statute of Frauds does not apply, and the promise may be oral. Here, the father is not promising to answer for the debt of another; he is making the debt his own. It is to the father and to the father alone, that the merchant extends credit and looks for payment.

## **Statute of Frauds and Insurance Contracts**

Most states require that contracts of life, accident, and health insurance are in writing. Yet, the general rule is that oral contracts of insurance are enforceable as long as they can be performed within one year. In order to provide immediate temporary insurance until a written binder can be issued, oral contracts are often used in cases of fire, casualty, and marine insurance. There is always a danger of fraud or collusion so the time period during which oral binders are in effect is kept to a minimum.

The parties only discuss the bare essentials of the insurance contract when an oral agreement is formed. Terms of the contract usually consist of evidence of an understanding that the standard form of policy was meant to fill in the missing terms. When the agent represents more than one insurer writing the particular type of coverage that the agent agreed to, there must be some objective evidence other than the unwritten decision of the agent as to which insurer the agent has selected to write the policy. The mention of the insurer to the insured or written field notes of the agent have been held as sufficient for this purpose.

## **Formal Engagement**

Surety is a formal engagement where one party pledges or undertakes to become legally liable for a debt or performance of a service in the event of a default or failure to perform. The doctrine is, that a surety paying the debt for which he is bound, is not only entitled to all rights and remedies of the creditor against the principal for the whole

amount, but against the other sureties for their proportional part. This is clearly the rule where the principal obligation is the payment of money or performance of a civil duty. In old England, the sureties of a debtor to the king (as for duties, taxes, excise, etc.) have always, since the *Magna Carta* at least, had the right, upon paying the debt, to have the benefit of prerogative process, such as extent, or other crown process adapted to the case, to aid them in coercing payment from the principal, and compelling contribution from co-sureties. The concept of subrogation has since been incorporated into the laws of most states.

Subrogation is usually recognized in the context of insurance settings, but the right of subrogation can arise in other situations where one party pays a debt lawfully owed by another, including mortgage and real estate settings. The party whose debt has been paid (usually an insured), is known as the "subrogor", while the party who has paid the debt (usually the insurance company), is known as the "subrogee". The subrogee steps into the shoes of the subrogee and acquires all legal rights the subrogee has with regard to the subject of the claim. Subrogation has wide-reaching ramifications and benefits to society, the economy, and the system of civil jurisprudence.

### **How it Arises**

Modern subrogation arises in one of three ways. The first is known as *contractual subrogation* (also referred to as "conventional subrogation"). This type of subrogation is based on the contract between the parties, such as subrogation language contained in an insurance policy. The term "conventional" is defined as growing out of or established by *convention*; that is, an agreement or mutual engagement between two or more persons or entities. The second type of subrogation is known as *equitable subrogation* (also referred to as "legal subrogation"). Legal subrogation is a product of equity, and is not dependent on any contract, assignment, or privity. It arises by operation of law out of "fairness," where one person has been compelled to pay a debt which should have been paid by another. Legal subrogation is the doing of complete and perfect justice between the parties by securing the ultimate discharge of a debt by the person whom in good conscience and equity should pay it. Usually, when the term "subrogation" is used without any qualification, legal subrogation is meant.

### **Subrogation Components**

- Subrogee has paid obligation of the subrogor.
- The subrogee did not "volunteer" to pay the debt of the subrogor.
- The subrogee is secondarily, not primarily, liable for the obligation.
- The subrogor will not suffer injustice if subrogation is allowed (Doctrine of Equity).

The third type of subrogation is *statutory subrogation*. A right of subrogation and/or reimbursement can also be set forth in statutory law, giving an insurance carrier a right to recover certain benefits. It includes workers' compensation, hospital lien laws, Medicare, and many other areas.

### **Objective of Subrogation**

One of the chief purposes of subrogation is to place the loss ultimately on the person who caused it in the first place. Courts have stressed that one goal of subrogation is to

place the burden for a loss on the party ultimately liable or responsible for it and by whom it should have been discharged, and to relieve entirely the insurer or surety who indemnified the loss and who in equity was not primarily liable for the loss. An additional purpose which underlies the doctrine of subrogation is that it prevents the policyholder from receiving more than he or she bargained for from the contract of insurance. In essence, this prevents a "double recovery" by the insured. It has been suggested that if the insurer has only contracted to indemnify the insured for losses incurred, denying the insurer subrogation rights in effect rewrites the policy and allows the insured to retain benefits for which it had not contracted. Subrogation is a key mechanism by which insurance premiums are kept in check and held to a minimum.

### **Lower Loss Lowers Cost**

The law currently authorizes first-party insurers to acquire a subrogation interest in the insured's potential claim but generally limits that interest to the amount of benefits that the first-party insurer actually provides to the insured to cover economic loss and need that arises from adverse conditions resulting from the loss. That is, the first-party insurer can only recover through subrogation what it pays or promises to pay. Consistent with this reimbursement cap, the first-party insurer can acquire a contractual or equitable lien against the proceeds of any recovery its insured obtains by settlement or judgment in the tort system. Moreover, in the absence of a suit by the insured, subrogation allows the first-party insurer to assert a claim against the offending party to recover any amount it has paid out. First-party insurers treat the anticipated recovery from subrogation as a stream of income and use it to cover a portion of their costs of providing coverage; insurers will thus pass any increases in their income from subrogation through to their insureds in the form of lower premiums or outright rebates. For a description of how insurers pass-through expected subrogation recovery in the form of lower premiums, see generally Steven Shavell, *Economic Analysis of Accident Law*, 235-36 (1987) discussing how insurance subrogation lowers insurance costs. Because of competitive market forces (or, if that fails, because of government regulation), insurers will pass this expected recovery through to the insureds in the form of lower premiums. The available evidence suggests that the pass-through benefits of subrogation have a meaningful effect on rates)

Courts throughout the country agree that subrogation assists society by lowering insurance costs and preventing double recoveries (e.g., *Brooks v. A.M.F., Inc.*, 278 N.W.2d 310, 313 (Minn. 1979). As a recent example, the 8th Circuit Court of Appeals, considering a Missouri case, held that by denying health plans the right of subrogation, the cost of insurance for all plan members increases (*Administrative Committee of Wal-Mart Stores, Inc. v. Shank*, 2007 WL 2457664 (8th Cir., Aug. 31, 2007)). In addition, courts have recognized that subrogation and reimbursement is especially vital to the financial stability of small group and self-funded plans. For example, the Wisconsin Supreme Court in *Associated Hospital Serv., Inc. v. Milwaukee Auto. Mut. Ins. Co.*, 147 N.W.2d 225, 33 Wis.2d 170 (Wis. 1967), commented on the different insurance choices available to consumers in that state, writing:

Insurance companies writing medical and hospital expense coverage and medical payment coverage have made increased use of provisions in their policies which are aimed at avoiding duplication in coverage. These companies have written policies, with an appropriately reduced premium, which contain a subrogation provision. This contractual provision specifies that the insurance company has subrogation rights for

any recovery from a third-party or his insurer made by its insured who is injured by the negligence of a third-party and who incurs expenses which are paid by his own insurance company.

Following this reasoning, the subrogation clauses in insurance contracts allow greater choice and reduced premiums. Insurance is a plan of risk management or risk sharing. This risk sharing is normally done by an insurance company or health plan, although persons may choose to self-insure or spread the effects of a risk through group plans. Since the risk or loss covered by the insurance is in the future, the exact risk or loss is not known when the insurance contractor or policy is issued. Those sharing the risk, insurer and insured, view the risk as the probable amount of loss, and the amount of coverage and the premium for the insurance actually purchased are calculated on this unknown.

### **Assessing Loss Potential**

Correct measurement and assessment of the loss potential is the very foundation of any system of insurance. This assessment is accomplished only through the careful analysis or prior experience with loss, costs of administration of the insurance, the application of probability, or the mathematics of chance, as well as the likelihood that any loss will be recouped through the vehicle of subrogation. The insured decides, before he pays the premium, how much of the potential loss he wishes to bear, when he decides on the limits of coverage desired and whether he wishes to purchase a contract of insurance that provides for subrogation. Any negative financial implications of subrogation for the insured can be avoided by specifically requesting a policy without a subrogation or reimbursement clause. If subrogation recovery were not available for insurance companies (as is increasingly becoming the case in some states) the actual cost of insuring the past known risk would increase accordingly and the projected future costs would likewise have to be adjusted upward in the form of increased premiums. Subrogation costs not realized, or eliminated due to the erroneous application of equitable doctrines such as made whole or common fund, are reflected in and spread over future premiums among the issuing insurer and all of the insureds purchasing the same insurance. As a result, all who shared the risk during the time the claim was paid, and all who share the future risk, subsidize the reduction or elimination of subrogation recoveries or the payment to an insured that did not honor his or her subrogation agreement.

Here is a case that illustrates the concept of liability under the laws of workers' compensation. In it, the insurer has stood in the place of the insured. The concept of **subrogation** is important to this case. Subrogation is the right of the insurer to recover from a third party the amount paid to the insured under the policy. The insurer has no greater rights than those maintained by the insured. As a result, any defenses that are valid against the insured are germane when used against the insurer.

# Great West Casualty Co. v. MSI Insurance Co.

*Court of Appeals of Minnesota*

*482 N.W.2d 527 (1992)*

OPINION

PARKER, JUDGE.

On appeal from summary judgment in an insurance subrogation case, appellants claim the insured's failure to obtain workers' compensation insurance denied Great West Casualty Company any right of subrogation. We agree and reverse the trial court's grant of summary judgment for Great West.

FACTS

In February 1989 Jon Bergan was injured while driving his 1977 Kenworth semitractor north on County Road 14 in Mower County, Minnesota. On the date of the accident, Bergan owned the semi-tractor but was leasing it to Farmers Union Central Exchange, Inc., pursuant to a one-year independent contractor agreement. Farmers Union was given exclusive possession, control and use of Bergan's semi-tractor and assumed complete responsibility for its operation.

The agreement required Farmers Union to carry cargo and public liability insurance on the equipment, as required by the Interstate Commerce Commission. Farmers Union insured the semi-tractor by a policy with MSI Insurance Co., which provided liability and no-fault coverage pursuant to Minnesota law. The policy provided that Farmers Union would pay the first \$100,000 of any claim.

The agreement also required that Bergan carry a policy of workers' compensation that would provide coverage to himself. There is no dispute that Bergan failed to purchase the required workers' compensation insurance. He did, however, insure his tractor for "bobtailing," or non-trucking use, with Great West.

After the accident, Bergan submitted his no-fault claims to Great West, which paid him pursuant to its policy. Great West subsequently brought this lawsuit against MSI and Farmers Union for subrogation, claiming that, at the time of the accident, the tractor was being used in the business of Farmers Union, to whom the tractor was leased, and therefore an exclusion in Great West's policy applied. MSI and Farmers Union defended the suit by claiming that Bergan's failure to obtain workers' compensation coverage barred Great West from recovering.

ISSUE

Does an insured's breach of contract, which bars him from seeking indemnity, bar his subrogee derivatively?

DISCUSSION

Appellants claim that Bergan's failure to obtain workers' compensation insurance denied Great West a right of subrogation. We agree. Generally, an insurer can pursue any

rights which its insured has against the party causing the loss.... However, an insurer, as subrogee, has no greater rights than those possessed by its insured, the subrogor.... Therefore, as the subrogee of Bergan, Great West is entitled to no greater rights than Bergan and stands in his shoes.

The independent contractor agreement required that Bergan carry a policy of workers' compensation insurance to provide coverage for himself. This is consistent with Minnesota law providing that independent-contractor truck drivers will not be considered employees for the purposes of workers' compensation insurance.... Therefore, Farmers Union was not required to procure workers' compensation coverage.

Although Farmers Union had a mandatory obligation to provide no-fault benefits under I.C.C. regulations, this coverage would have been secondary to the workers' compensation benefits Bergan was required to obtain.... Because **workers' compensation** benefits are primary, MSI and Farmers Union would have had a defense against a claim for no-fault benefits against MSI (as carrier of liability insurance of Farmers Union) by Bergan, based on his breach of the contract.

The Minnesota Supreme Court has determined that a contractual agreement between two parties can extinguish a derivative subrogee's right to subrogation. *St. Paul Fire & Marine Ins. Co. v. Perl*, 415 N.W.2d 663, 665 (Minn. 1987); *see also Great N. Oil Co.*, 291 Minn. at 100, 189 N.W.2d at 407 (insured may defeat subrogation rights of its insurer by executing an exculpatory agreement with the party causing loss). In *Perl* an indemnification agreement entered into between an attorney and his law firm extinguished any subrogation rights of the firm's liability insurer against the attorney for claims paid as a result of the attorney's breach of fiduciary duty where the law firm had agreed to indemnify the attorney for such liability. Similarly, in this case Bergan's failure to purchase workers' compensation coverage, which would bar him from indemnification by Farmers Union's liability carrier (MSI), denies Great West recovery as his subrogee.

Because we have determined this case on the subrogation issue, we need not address whether Bergan was using his tractor in the business of Farmers Union at the time of the accident.

## DECISION

The trial court erred in failing to find that Bergan's breach of contract barred Great West from its subrogation claim. MSI and Farmers Union were entitled to summary judgment as a matter of law. The trial court's summary judgment in favor of Great West is reversed and remanded with instructions to the trial court to order entry of summary judgment on behalf of MSI and Farmers Union.

Ω

Although the basic concept is relatively straightforward, subrogation is considered to be a highly technical area of the law.

## Types of subrogation

The classes of subrogation rights are not fixed or closed. The various fields have the same conceptual underpinnings; there are subtle distinctions between them in relation to the application of the law of subrogation.

### Indemnity insurer's subrogation rights

With insurance subrogation, there are three parties involved: the insured; the insurer; and the tortfeasor (the party who is responsible for the damages). Under subrogation, the insurance company assumes the right to sue the tortfeasor for the amount of the damages reimbursed to the insured. An indemnity insurer has two distinct types of subrogation rights. The insurer is entitled to take over the remedies of the insured against another party in order to recover the sums paid out by the insurer to the insured and by which the insured would otherwise be overcompensated. Secondly, the insurer is entitled to recover from the insured up to the amount which the insurer has paid to the insured and by which the insured is overcompensated. The latter situation might arise if, for example, an insured claimed in full under the policy, but then started proceedings anyhow against the tortfeasor, and recovered substantial damages.

### Surety's subrogation rights

A surety who pays off the debts of another party is subrogated to the creditor's former claims and remedies against the debtor to recover the sum paid.

There are two important differences between surety and insurance;

1.) **Parties to the Agreement-** The surety bond contract involves three parties. That is, the principal, the surety, and the obligee. When dealing with fraud or misrepresentation (the perils that suretyship safeguards), this matters. If the principal tries to defraud the obligee, the surety's liability to the obligee remains. The reason the bond is required in the first place is to protect against fraud or dishonesty.

With an insurance contract, if the insured commits an illegal act as a means of collecting the insurance proceeds, the insurance contract generally becomes void and unenforceable. The only time fraud will void a surety arrangement is when a principal and obligee conspire to defraud the surety.

2.) **Relationship Between the Parties-** It is different between the surety and the principal. If an insured's negligent act results in a claim, the insurer must pay the claim. A child can start a fire while left unattended by parents or the insured causes injury to another because of a negligent act. The insured's act helps cause the loss yet the insurer must still pay the claim. The insurer has no recourse, nor can it make a claim for damages against the insured.

When a principal's negligence or fraud causes a claim to be paid by the surety to the obligee, the surety will then look to the principal for whatever satisfaction it can obtain. The surety will take over the position of the obligee in the legal right to seek redress from the principal. This is a distinction between suretyship and insurance. The surety

has the ability to seek reimbursement for losses from the principal; this is the party whose actions are warranted by the obligor, the surety.

Alamo Construction has contracted to build a new branch library for the Fort Bend County Library Board. Libraries are deemed vital to the operation and well-being of the county. They want it put up quickly and in a workmanlike manner. A surety bond is employed for the contract. The obligee is the Fort Bend Co. Library Board. The principal is Alamo Construction. If Alamo does not perform its obligation as spelled out in the construction contract, the surety bond requires the surety to pay the library board. There are two contracts involved in this sequence of events. A construction contract has the library board and Alamo as parties. A surety contract exists between the construction company, the board, and the bonding company.

For whatever reason, if Alamo Construction cannot complete the terms of the construction contract, the surety bond comes into play. When the breach of contract occurs, the library board looks to the surety for satisfaction of claims. The board does not have to engage in costly and time consuming litigation to solve its problem of getting a new library built. Money furnished by the surety allows a new contractor to be employed to finish the job. Certainty is substituted for uncertainty. This is the function of insurance. This allows the new branch library to be completed in a timely manner. The literary needs of the public are met. Help in construction of the library has been provided by the surety in the form of two essential services; It has furnished its financial strength and credit to that of the contractor's. The surety has also investigated the financial status and capability of the principal/contractor, Alamo Construction. Time and resources are saved for the library board, the obligee. They are in the business of lending literary tomes, not erecting edifices.

### **Security Interest**

In relation to a surety's subrogation rights, the surety will also have the benefit of any security interest in favor of the creditor for the original debt. Conceptually this is an important point, as the subrogee will take the subrogor's security rights by operation of law, even if the subrogee had been unaware of them. Accordingly, in this area of the law at least, it is conceptually improbable that the right of subrogation is based upon any implied term.

### **Subrogation rights against trustees**

A trustee of a trust who enters into transactions for the benefit of the beneficiaries of the trust is generally entitled to be indemnified by the beneficiaries for personal loss incurred, and has lien over the trust assets to secure compensation. If, for example, the trustee conducts business on behalf of the trust and fails to pay creditors, then the creditors are entitled to be subrogated to the personal and proprietary remedies of the trustee against the beneficiaries and the trust fund. Where under the terms of the trust instrument the trustees are permitted to trade in derivatives as part of the trust's investment strategy, then the derivatives document will also normally contain a subrogation clause to bolster the common law rights.

## II Equitable Subrogation

An insured suffers a property damage loss. The insured's own insurance pays the losses then he or she makes a claim against the insurance company of the person who caused the loss. The doctrine of equitable subrogation is applied liberally and is broad enough to include every instance in which one person, not acting voluntarily, has paid a debt for which another was primarily liable and which in equity and good conscience should have been discharged by the latter. This was stated in an appeals court case, *Matagorda County v. Texas Association of Counties Government Risk Management Pool*, 1998.

However, TAC argues that it is equitably subrogated to the rights of the underlying claimants to recover the amount paid in settlement of the claims against the County. The doctrine of equitable subrogation is given a liberal application and is broad enough to include every instance in which one person, not acting voluntarily, has paid a debt for which another was primarily liable and which in equity and good conscience should have been discharged by the latter.

Subrogation can be in conflict with the Made Whole Doctrine, the right of an injured party to recover full damages. This abrogation of the Made Whole doctrine puts the insurer in the position of having first claim to an at-fault party's assets, even if the assured is left destitute as a result. In other words, the law's intent to prevent dual recovery by the assured can lead to less-than-equitable recovery. The purpose of equitable subrogation is to allow the insurance company to recover the monies it has paid out, only after the insured injured person is fully compensated. The 'Made Whole' concept explains how this works.

### Made Whole Doctrine

The "made whole" doctrine (or "make whole" doctrine; the terms represent the same concept) is an equitable insurance law principle which holds that in the absence of contrary statutory law or valid contractual obligations to the contrary, the general rule under the doctrine of equitable subrogation is that where an insured is entitled to receive recovery for the same loss from more than one source, e.g., the insurer and the tortfeasor, it is only after the insured has been fully compensated for all of the loss that the insurer acquires a right to subrogation, or is entitled to enforce its subrogation rights. The rule applies as well to instances in which the insured has recovered from the third party and the insurer attempts to exercise its subrogation right by way of reimbursement against the insured's recovery. (Couch on Insurance § 223:134 (3d ed. 2000)).

Where the subrogating insurer and insured both have recovery claims and are competing for a limited amount of available money from a defendant, issues arise as to who is entitled to recovery, and/or how the recovery should be divided. These issues fall within the realm of the "make whole rule", which generally provides, that under certain circumstances (i.e. limited assets of a wrongdoing defendant, non participation of the subrogating insurer in recovery lawsuit), the insured is entitled to be "made whole" for uninsured damages from the wrongdoing defendant, before the subrogating carrier can

recover from the insured (via a lien or policy provisions) or from the defendant who caused the injury.

Although equitable subrogation rights are independent of and quite different from any contractual relationship or terms between two parties, courts have blurred the distinction between the two and hampered their ability to contract freely with regard to the rights between them in accordance with the law and their intent. A growing number of states have now begun to recognize the difference between the two, holding that parties can contract around the Made Whole Doctrine if that intent is clear from the contract. As a result, states are split as to whether, when, and how to apply the Made Whole Doctrine generally, and whether the equitable doctrine should be applied when contractual subrogation is involved. The Made Whole Doctrine's far-reaching tentacles affect virtually every line of subrogation and in a myriad of ways. Understanding a particular state's made whole laws is vital to a successful subrogation result.

### **Superior Interest**

The Made Whole Doctrine is a counterbalance to the concept of subrogation. No other fundamental equitable principle is as poorly understood as the inner workings and applicability of this defense to subrogation. When an insured is not fully reimbursed for all of its losses, there is a split of authority among the various states as to whether the insurer or the insured has a superior interest in the third-party recovery. Five outcomes are possible:

1. Insurer Whole Plus: The insurer is the sole beneficial owner of the claim against the third party and is entitled to the full amount recovered, whether or not it exceeds the amount paid by the insurer to the insured.
2. Insurer Whole: The insurer is to be reimbursed first out of the recovery from the third party and the insured is entitled to any remaining balance.
3. Proration: The recovery from the third person is to be prorated between the insurer and the insured in accordance with the percentage of the original loss for which the insurer paid the insured under the policy.
4. Insured Whole: Out of the recovery from the third party the insured is to be reimbursed first, for the loss not covered by insurance, and the insurer is entitled to any remaining balance, up to a sum sufficient to reimburse the insurer fully, the insured being entitled to anything beyond that amount.
5. Insured Whole Plus: The insured is the sole owner of the claim against the third party and is entitled to the full amount recovered, whether or not the total thus received from the third party and the insurer exceeds his loss.

In general, the courts have avoided rules one and five. Also, very few courts have applied the proration formula, leaving most states falling between rule numbers two and four. A few states have not directly addressed or applied the traditional made whole rule or applied it to all lines of insurance subrogation.

Make Whole can be further categorized as follows;

- Jurisdictions that hold the Made Whole Doctrine cannot be modified by contract.
- Jurisdictions that require that contractual modification of the Made Whole Doctrine be made by clear unequivocal, and/or specific language. Contractual subrogation flows from the terms of a contract.

- Jurisdictions that hold that general subrogation language gives insurers the right to the first monies recovered from a tort claim.

## **Made Whole Doctrine in the States**

As a representative state, California's Made Whole Doctrine and its applicability to subrogation generally is discussed here.

The Made Whole Doctrine has been viable in California since 1974. (*Travelers Indem. Co. v. Ingebretsen*, 113 Cal. Rptr. 679 (Cal. App. 1974)). In *Ingebretsen*, multiple insureds recovered insurance proceeds for damages caused to their property by the County of Los Angeles. Each policy contained a standard subrogation clause allowing the company to "require from the insured an assignment of all right of recovery against any part for loss to the extent that payment therefore is made by [the] company", as allowed by § 2071 of the California Insurance Code. (Cal. Ins. Code § 2071).

The insureds also executed a subrogation receipt or release, acknowledgment of satisfaction, agreement to immediate cancellation and assignment of subrogation document contemporaneously with receiving the insurance proceeds. After a dispute over third-party proceeds, the court concluded that where the subrogation provision and subrogation assignment convey "all right of recovery against any party for loss to the extent that payment therefore is made by this company," this entitles the insurer to first and total indemnification. The insurer's priority of right however was conditioned on it having cooperated and assisted in the recovery from the third party.

The insureds in *Ingebretsen* further contended that the insurers were not entitled to recovery because it was impossible to ascertain what portion of the judgment represented damages paid by the companies. According to the insureds, a portion of the judgment against the county was for noninsured losses, and consequently, the insurers should be denied recovery unless they could prove what portion of the judgment was attributable to covered losses. The court, again relying on the all right of recovery language contained in the subrogation clause, concluded that all claims of the insureds had been transferred to the insurers. Therefore, insurers were not required to prove what portion of the judgment was attributable to covered losses. The *Ingebretsen* rule applies only narrowly to the sort of facts contained in that case. In *Sapiano v. Williamsburg Nat'l Ins. Co* (28 Cal. App.4th 533 (1994)), the court concluded that in contrast to the policy and insurer in *Ingebretsen*, (1) the language of the subrogation clause in *Sapiano* contained general terms, and (2) the insurer did not cooperate or assist the insured in its efforts to recover from the tortfeasor. Court holds that, in absence of specific language to contrary, general provision that insurer was subrogated to rights of insured does not permit insurer to recover from third-party tortfeasor until insured has been made whole. The court also observed that where the insured does not assist in prosecution of the claim, insured may not be permitted to recover until insured has been made whole. As a result, the insured retained priority of right and was entitled to be made whole before the insurer could assert its right to subrogation. As in other states, California adheres to the view that the parties are free to agree that the made whole rule does not apply.

In several states, only one condition is imposed (*i.e.*, that the agreement be sufficiently specific). California imposes an additional requirement that the insurer cooperate and assist the insured in the recovery. California recognizes the potential harsh and one-

sided effect of expanding the principle of conventional subrogation. As applied in California, the Made Whole Doctrine generally precludes an insurer from recovering *any* funds from the tortfeasor unless and until the insured has been made whole for the loss (*Progressive West Ins. Co. v. Yolo County Superior Court*, Cal.Rptr.3d 434 (Cal. App. 2005)). However, the doctrine applies only when there is no agreement to the contrary (*Barnes*, supra; *Samura v. Kaiser Foundation Health Plan*, Cal. App.4th 1284 (Cal. App. 1993)). The applicability of the doctrine generally depends on whether the insured has been completely compensated for all elements of damages, not merely those for which the insurer has indemnified the insured.

## When Subrogation Rights Arise

Subrogation rights arise in the following ways:

- In *tort*. This usually arises where a third party negligently causes a loss indemnifiable by a policy. For example, a fire insurer, after paying a fire loss, discovers that the fire was caused by a negligent act of a neighbor of the insured. It sues the neighbor in the name of the insured for damages recognized by the law of tort.
- In *contract*. This arises where the insured (perhaps a landlord) has a contractual right (perhaps under a tenancy agreement) against another person (perhaps a tenant) for an insured loss. After indemnifying the insured for the loss, the insurer may exercise such right against that other person in the name of the insured.
- Under *statute*: If a person is injured at work, the employer's insurance carrier will have to pay a worker's compensation benefit to the employee in accordance with the provisions of the state's Workers' Compensation Law. The law grants subrogation rights to the indemnifying employer insurer. (See *Great West Casualty vs. MSI*)
- In *salvage*: The insurer may be said to have subrogation rights in what is left of the subject-matter of insurance (salvage), arising under the circumstances already discussed.

Subrogation can only apply if indemnity applies. Thus, if the life insured of a life policy is killed by the negligence of a motorist, the paying life insurer will not acquire subrogation rights, as this payment was not an indemnity.

## Other Considerations

There are other features to note:

(a) In the common law, subrogation rights are only acquired *after* an indemnity has been provided.

(b) Special considerations arise in respect to subrogation recoveries:

(i) The insurer cannot recover more under subrogation than was paid as an indemnity. By way of example, suppose there is an insured loss of an antique. The insurer pays, and some time later when the antique is found, its value is much higher. The insurer can only keep the amount paid; any balance belongs to the insured.

(ii) The above saying is not true in the event of subrogation arising after *abandonment* of the property to the insurer. There, all rights in the property belong to the insurer, of course including the right to "make a profit."

(iii) Sharing of Subrogation Proceeds;

Where the insurer has only provided a less-than indemnity on the basis of certain policy limitations, the insured may possibly be entitled to part of- sometimes even the whole of- the subrogation proceeds, depending on what limitations have been applied

in the process of claims adjustments. The following are illustrations of several manners in which the sharing of subrogation proceeds between the insured and the insurer can be done:

(1) *Excess*: Suppose the insured is responsible for a loss (excess) of \$10,000 before his or her liability insurer pays \$40,000, and \$20,000 is subsequently recovered from a negligent third party. The whole of \$20,000 will belong to the insurer. However, if the subrogation recovery is \$45,000 instead, the insured will be entitled to \$5,000 and the insurer \$40,000.

(2) *Limit of Liability*: Suppose an insured contractor has incurred liability to a road user in the amount of \$1.5 million, of which the insured has to pay \$0.5 million out of his own pocket because his policy is subject to a limit of liability of \$1 million. Any recovery from a joint tortfeasor will belong to the insured, except where it amounts to more than \$0.5 million in which case that part over and above the \$0.5 million threshold will belong to the insurer up to the amount of the insurance payment.

(3) *Average*: Suppose a fire insurer has paid 80% of a loss where there is a 20% underinsurance. The insured is entitled to 20% of subrogation proceeds as if he was a co-insurer for 20% of the risk.

## **ERISA Act**

The Employee Retirement Income Security Act of 1974 (ERISA) governs employee benefits of private sector employees. The law is not limited to pensions. It covers, health insurance plans, long term disability plans, sometimes severance plans, life insurance plans, defined contribution plans (401(k)) and various executive compensation plans. This means in excess of 100 million people in the US are subject to ERISA.

### **Private Sector**

ERISA only applies to private sector workers. Employees of local, state and the federal government are exempt from its grasp. So too are employees of Church organizations, such as a Catholic Archdiocese, or sometimes a religious based hospital. Those who are self employed and have health insurance or disability insurance should be able to avoid ERISA too. In there are situations when ERISA applies- and times when it may not. Insurance professionals need to be aware of its reach. ERISA's comprehensive nature can and does impact the distribution of insurance claims. The law was originally drafted with pension plans in mind, but over time ERISA has come to govern much more. Part of the concept behind ERISA was to create a uniform law for employee benefits and pensions nationwide. This was thought to protect employees and to make it more reasonable for employers that operated in many states. Rather than needing to comply with 50 different state laws, employers would be governed by one Federal law. It contains one of the broadest preemption clauses ever enacted by Congress. The application of which has been repeatedly referred to by the Supreme Court, a "comprehensive and reticulated statute," the product of a decade of congressional study of the Nation's private employee benefit system," *Mertens v. Hewitt Associates*, 508 U.S. 248, 251, 113 S.Ct. 2063, 124 L.Ed.2d 161 (1993), effects almost all aspects of the employer-employee relationship in the private sector.

ERISA welfare benefits are those employee benefits, such as disability insurance, health insurance, life insurance etc., as opposed to pension benefits which are

governed under different provisions of ERISA. When Congress enacted ERISA in 1974, its focus was on abuse and mismanagement of pension funds

It is hereby declared to be the policy of this chapter to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts. *ERISA Sec. 2, 29 U.S.C. ' 1001(b)*

Since then, ERISA has been greatly expanded, both legislatively by the Consolidated Omnibus Budget Act of 1985 ("COBRA"); Health Insurance Portability and Accountability of 1996 ("HIPAA") - and by Supreme Court decision. In *Aetna Health, Inc. v. Davila*, 542 U.S. 200 (2004), the Supreme Court sided with the HMO industry, rather than patients and their doctors, by concluding that ERISA pre-empted state laws aimed at HMOs.

Congress enacted ERISA to "protect ... the interests of participants in employee benefit plans and their beneficiaries" by setting out substantive regulatory requirements for employee benefit plans and to "provide for appropriate remedies, sanctions, and ready access to the Federal courts." 29 U. S. C. '1001(b). The purpose of ERISA is to provide a uniform regulatory regime over employee benefit plans. To this end, ERISA includes expansive pre-emption provisions; see ERISA '514, 29 U. S. C. '1144, which are intended to ensure that employee benefit plan regulation would be "exclusively a federal concern." *Alessi v. Raybestos-Manhattan, Inc.*, 451 U. S. 504, 523 (1981).

*Aetna Health, Inc. v. Davila*, 542 U.S. 200, 208 (2004).

## **Equitable relief vs. legal relief**

**Legal remedies** are the means with which a court of law, usually in the exercise of civil law jurisdiction, enforces a right, imposes a penalty, or makes some other court order to impose its will. There are three crucial remedies in American law;

- 1.) The first is from the traditional law courts of England, and is seen in the form of a payment of money to the victim. This payment is commonly referred to as damages. Compensatory damages compensate an injured victim or plaintiff, and punitive damages punish a wrongdoer who because of fraud or intentional conduct deserves punishment. Punitive damages serve the function in civil law that fines do in criminal law.
- 2.) The second category of remedy comes from the Chancellor of England, commonly called the Chancery Court, or, more commonly, equity. The injunction or restraining order is a type of equitable remedy, as is specific performance, in which someone who enters into a contract is forced to perform whatever promise s/he has reneged upon. The equitable lien and constructive trust are two additional equity remedies.
- 3.) The third broad group of remedies is known as declaratory relief. With this remedial device, the court pronounces its decision about the status of a person or a law, perhaps even the parties' rights in a contract. A divorce or adoption decree is an example of a declaratory judgment.

**Equitable remedies** are judicial remedies developed and granted by courts of equity, as opposed to courts of common law. These courts are authorized to apply principles of equity (fairness), as opposed to law, to cases brought before it. The decisions of equity courts, then, are not precedent-setting. Equity courts "handled lawsuits and petitions requesting remedies other than damages, such as writs, injunctions, and specific performance." Most were eventually "merged with courts of law." U.S. bankruptcy courts are the one example of federal courts which operate as courts of equity. Some jurisdictions (Delaware, Mississippi, New Jersey, South Carolina, and Tennessee) preserve the distinctions between law and equity and between courts of law and courts of equity. For most purposes, legal and equitable remedies have been merged and a single court can issue either (or both) remedies. Equitable remedies are distinguished from "legal" remedies (which are available to a successful claimant as of right) by the discretion of the court to grant them. In common law jurisdictions, there are a variety of equitable remedies, but the principal remedies include;

- injunction
- specific performance
- rescission
- rectification
- equitable estoppel
- subrogation
- equitable lien
- constructive trust

### **ERISA- Equitable Relief**

ERISA plans and beneficiaries may only obtain equitable relief and never legal relief. Most claims for relief arise under section 502(a) (1) (B) of ERISA, or 29 USC 1132(a) (1) (B). Other relief, which is rare, falls under section 502(a) (3) or 29 USC 1132(a) (3).

ERISA fiduciaries have a duty to act prudently and with loyalty toward participants in the plan (29 U.S.C. § 1104(a) (1)(A)(B)). When fiduciaries (typically an insurer) breach that duty, Section 502(a) (3) entitles plan participants (employees) to sue them to redress the breach. The Supreme Court has described this section as a "catchall" clause that provides a "safety net" to redress injuries that ERISA does not remedy under other provisions. Section 502(a) (3), however, expressly limits recovery to "appropriate equitable relief." The U.S. Supreme Court, through a series of cases, had unequivocally concluded that this excludes "legal" relief.

In the case *Great-West Life & Annuity Ins. Co. v. Knudson*, 122 S. Ct. 708, 713 (2002), Janette Knudson was seriously injured in a car crash. Her health insurer provided by through her husband's employer paid \$411,157.11 in medical benefits. She sued Hyundai for defects in the car that harmed her. She settled her tort claim for \$650,000.00 of which \$13,828.00 was designated to reimburse the health insurer Great West. The insurer rejected that amount claiming that it was entitled to \$411,157.11 of the \$650,000.00 settlement, the full amount of medical bills paid. That settlement included \$256,745.30 to a Special Needs Trust to pay for Ms. Knudson's future medical care plus money to reimburse California Medicaid and to pay attorney's fees and costs. A series of litigation in both state and federal courts arose. The case made its way from the Ninth Circuit to the Supreme Court.

The question presented to the Supreme Court was whether §502(a)(3) of ERISA authorizes the action by Great West to enforce a reimbursement provision contained in the ERISA governed health insurance plan. Finding this claim to be premised upon a "contractual obligation," the Court concluded that the action was not equitable because suits for specific performance of a past-due financial obligation typically were not available in equity. The Court reasoned that the "restitution" claim did not seek to restore money in the "possession" of the defendant that is directly traceable to a property interest of the plaintiff, and as such amounted to a claim for restitution allowed at law but not at equity. The Supreme Court ruled that, as section 503 "by its terms, only allows for equitable relief," the provision excludes "the imposition of personal liability . . . for a contractual obligation to pay money."

### **Define "Equitable Relief"**

The ERISA statute does not define "equitable relief." However, in *Knudson*, the Supreme Court clarified that to determine if the requested relief is "equitable" under Section 502(a)(3), courts should look to standard texts on remedies and trusts as well as how such relief was characterized when the bench was divided between equity courts and law courts. The Court explained that to qualify as equitable under Section 502(a)(3), the relief must be the type "typically available in equity," (at 712 (quoting *Mertens*, 508 U.S. at 252)). Thus, the plaintiff must not only show that the relief would have been granted in equity in the days of the divided bench, the days in which some courts sat only in equity, but others in law, but that the relief was *typically*, as opposed to *occasionally*, available in equity.

Section 502(a)(3) of ERISA authorizes remedies "that were typically available in equity." In *Knudson*, the Court rejected the fiduciary's claim for restitution. The Court ruled that the restitution sought was not equitable because the funds were not actually in the beneficiary's possession. The liability sought was therefore personal and legal. By contrast, equitable restitution sought to impose a constructive trust or equitable lien on specific funds or property that were in the defendant's possession. This outcome was favorable for the insured.

### **Recovery Approved**

The case *Sereboff v. Mid Atlantic Medical Services, Inc.*, 547 U.S. 356 (2006), was a decision by the Supreme Court involving the ability of an ERISA fiduciary to recover medical costs from a beneficiary who was reimbursed for injuries by a third party. The Court ruled unanimously that ERISA permitted the fiduciary to recover costs from the settlement proceeds a beneficiary received in a personal injury lawsuit. This case marked a significant change from the holding in *Knudson*.

The Sereboffs were injured in a California car crash, and the plan paid the couple's medical expenses. They filed damage suits in state court against several third parties. Beginning soon after the suit was commenced, Mid Atlantic sent the Sereboffs and their attorney letters in which it asserted a lien on the anticipated proceeds from the suit for paid medical expenses eventually totaling \$74,869.37. The Sereboffs eventually settled their tort suit for \$750,000, but did not distribute anything to Mid Atlantic.

Mid Atlantic filed suit in the U.S. District Court in Maryland, claiming a right to collect from the Sereboffs under § 502(a)(3) of ERISA. Because the Sereboffs' attorney had already distributed the settlement proceeds to them, Mid Atlantic sought a temporary restraining order and preliminary injunction requiring the couple to retain and set aside at least \$74,869.37 from the proceeds. The District Court ruled for Mid Atlantic and ordered the Sereboffs to pay \$74,869.37, plus interest, with a deduction for Mid Atlantic's share of the attorney's fees and court costs that the Sereboffs had incurred in state court. The Fourth Circuit Appeals Court affirmed in relevant part.

The Supreme Court unanimously affirmed the Fourth Circuit. Under §502(a)(3) of ERISA, A fiduciary may bring a civil action "(A) to enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan." The Court believed the only question remaining in the case was whether the relief Mid Atlantic sought from the District Court was "equitable" under §502(a)(3)(B). The Court analyzed this issue by considering both the nature of the remedy Mid Atlantic sought, and the basis for its claim against the Sereboffs.

### **Equitable nature of relief sought**

The Court had previously construed section 502(a)(3)(B) of ERISA to only authorize remedies "that were typically available in equity." This was elaborated upon in the *Knudson* case, in which the Court rejected an ERISA fiduciary's claim for restitution. *Knudson* had involved similar facts, and the Court had ruled that the restitution sought was not equitable because the funds were not actually in the beneficiary's possession. The liability sought was therefore personal and legal. By contrast, equitable restitution sought to impose a constructive trust or equitable lien on specific funds or property that were in the defendant's possession.

The Court believed that Mid Atlantic's claim was one for equitable restitution, because the Sereboffs' possession of the settlement funds satisfied the requirement that was missing in *Knudson*. Mid Atlantic was not simply seeking to recover from the Sereboffs' assets generally, but rather to recover through a constructive trust or equitable lien on a specifically identified fund. That this action involved a breach of contract claim did not mean that the relief was not equitable, because that would make the ERISA provision that expressly provides for equitable relief to enforce plan terms "an empty promise."

### **Healthcare Lien, Subrogation and Reimbursement.**

An examination of the ERISA statute does not turn up the words, healthcare lien, subrogation or reimbursement in the statute. The law does not dictate what type of benefits must be provided in an employer provided benefit plan. ERISA's purported goal is to protect the interests of plan participants and their beneficiaries "by setting out substantive regulatory requirements for employee benefit plans and to provide for appropriate remedies, sanctions, and ready access to the Federal courts." (29 U.S.C. §1001(b)). ERISA professes to protect participants and beneficiaries, in part, by regulating how benefit claims are processed. The statute mandates the use of reasonable claims procedures and "full and fair" review of benefit claims; it requires reporting and disclosure of plan information (29 U.S.C. §1133(2) (2006); 29 C.F.R. §2560.503-1(b)(h) & §1021).

Section 1132(a)(3), an ERISA enforcement provision, is pertinent to subrogation and reimbursement and led to significant controversy as to whether ERISA plans can pursue subrogation and reimbursement claims. It permits a plan participant, beneficiary, or fiduciary to bring a civil action:

To enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan

A fiduciary can therefore bring suit under ERISA against a participant or beneficiary for appropriate equitable relief. The Supreme Court observed in the *Sereboff* case that the distinction between equitable relief and legal relief (equitable lien by agreement) is sometimes blurred.

## **Equitable Subrogation v. Contractual Subrogation**

Equitable subrogation arises by law while contractual subrogation flows from the terms of a contract. In general, equitable subrogation results when one party pays the debt of another or a party paying the obligations of a tortfeasor. Equitable subrogation thus lets the insurer "stand in the shoes" of its insured when pursuing claims against the wrongdoer. Theoretically, equitable subrogation prevents a party from receiving a windfall. Equitable subrogation prevents the insured from being unjustly enriched by recovering twice; once by having his or her medical bills paid by the insurer, and a second time, by recovering the cost of those bills from the negligent driver.

This interpretation is borne out by economic reality. But when the sharks from the plaintiff's bar start circling, equitable subrogation has its limits. The insured is typically protected by the "made whole rule," and the attorneys working on the insured's behalf are protected by the "common fund doctrine." In addition, the party seeking subrogation is also subject to typical equitable defenses such as "unclean hands."

Under the made whole rule the party seeking equitable recovery is precluded from doing so until the injured party is first fully compensated for his or her injuries. The made whole rule means that an insured who has settled with a third-party tortfeasor is liable to the insurer (subrogee) only for the excess received over the total amount of his or her loss. As noted in another section of this course, state courts generally treat the made whole doctrine as a default rule that is read into insurance contracts, except where it is explicitly excluded. (*Couch on Insurance* § 61:64 states that if an insurer pays less than the insured's total loss, the insurer cannot exercise a right of reimbursement or subrogation until the insured's entire loss has been compensated). Contractual subrogation can be viewed differently. Subrogation in this form's purpose is to obligate the insured to cause monies to flow from third party recoveries back to the health insurer. By contract, the health insurer modifies equitable defenses that could be asserted against under the doctrine of equitable subrogation.