PRORATION AGREEMENTS - ANALYSIS AND RECOMMENDATIONS

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The issue of proration of the proceeds of subrogation arises because the standard fire insurance policy typically contains no language that explains how the recovery from a responsible third-party is to be shared.

When an insured has a substantial deductible, suffers a coinsurance penalty, is underinsured or lacks insurance for damages recoverable against a tortfeasor, an issue of how proceeds are to be allocated between the company who reimbursed the insured and an insured who is not made whole exists. The policy itself provides for the right of subrogation. In enforcing this right under the policy, insureds are often asked to execute subrogation receipts. Typical language of a subrogation receipt is the following:

> In consideration of an to the extent of said payment, the undersigned hereby subrogates said insurance company to all of the rights, claims and interests which the undersigned may have against any person or corporation liable for the loss mentioned above, and authorized the said insurance company to sue, compromise or settle, in the insured's name or otherwise, all such claims, and to execute and sign releases and acquittances and endorse checks or drafts given in settlement of such claims in the name of the undersigned with the same force and effect as if the undersigned executed or endorsed them.

Garrity v. Rural Mutual Insurance Co., 253 N.W.2d 512, 515 (Wis. 1977); Peterson v. Ohio Farmers Insurance Co., 191 N.E.2d 157) 159 (Ohio 1963). Because the language in the subrogation receipt is silent as to the proration of recoveries, the courts have adopted a variety of rationales. The commentators have set forth the general principles.

Couch sets forth the following:

> In contrast with the situation in which the insurer has not discharged its obligation in full, the insurer may in a given case have made the full payment required of it by its contract of insurance but this amount is not adequate to indemnify the insured in full. In such an instance, it has been held, in absence of waiver to the contrary, that no right of subrogation against the insured exists upon the part of the insurer where the insured's actual loss

> exceeds the amount recovered from both the insurer and the wrongdoer, after deducting costs and expenses. In other words, the insurer has no right as against the insured where the compensation received by the insured is less than his loss.

16 Couch on Insurance 2d (rev'd.) §61:64 (1983) (footnote omitted). Windt sets out the rule this way:

> As a general rule, the insurer has not right to reimbursement until the insured's entire loss has been paid. This is true even if the insurer is liable for only a part of the loss and pays its entire obligation. An insurer cannot recoup any part of its loss while the insured is still less than whole.

A. Windt, Insurance Claims & Disputes, §10.06 at 410 (1982) (footnote omitted).

Although somewhat simplistic and really requiring a close case-by-case analysis, apportionment can be lumped into three general categories[1]:

(1) insurer: whole
(2) insured: whole
(3) proration

Pennsylvania Law

One of the earliest, if not the earliest, Pennsylvania decisions considering subrogation is Stoughton v. Manufacturers' Natural Gas Co., 165 Pa 428 (1895). Several insurers

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[1] These phrases were coined by Professor Robert Keeton in summarizing the various rules of division of insurance subrogation proceeds.

> 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. Proration. The recovery from the third person is to be prorated by insurer and the insured in with the percentage of the original loss for which the insurer paid under the policy. Insured: Whole. Out of the recovery from the third insured is to be reimbursed the loss not covered by insurance the insurer is entitled to a balance, up to sum sufficient to reimburse the insurer fully, the insured being entitled to anything beyond that.

paid to Stoughton an amount aggregating $4,527.36. Subsequently, Stoughton secured a verdict in the amount of $5,675.89 from a third-party tortfeasor. The insured had signed subrogation receipts transferring its claims to the companies. The insurers had actively participated in prosecuting the action against the third-party tortfeasor. In addition the policy also contained the standard subrogation clause.

The court determined that the verdict against the gas company in the amount of $5,575.89 represented the insured's total loss although the insured had averred his total loss to be $9,972.77. Therefore, where recovery is had against a third-party tortfeasor by way of verdict, that verdict establishes the insured's total loss. Thus, the insured is made whole and must reimburse the company. As the court stated in Stoughton:

> Subrogation is based upon equity, and no doubt the statute, in directing through its standard form of insurance policy the subrogation of the insurers to the rights of the insured against the party primarily responsible for the loss, meant that it should be administered on equitable principles. But the effect of the statute is to put such subrogation on the footing of a legal right, which must prevail unless a stronger equity be shown against it.

165 Pa. 433. Thus, in large measure, the court does adopt the principles applicable to conventional contractual subrogation.

The importance of the insurance contract between the parties is further borne out by the case of Illinois Automobile Insurance Exchange v. Braun, 280 Pa 550 (1924). The insured's vehicle was destroyed in a collision with a train. After a lawsuit between the insurer and insured, the insurer paid the insured. The policy under which payment was made contained the standard subrogation provision. Prior to trial, and without notice to the insurer, the insured

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Keeton, Insurance Law, 160-62 (1971)

settled its claim against the third-party tortfeasor. The insureds recognized the insurer's right to subrogation by way of correspondence from their counsel.

Reviewing the law that an insured cannot recover from its insurer if prior to payment by the insurer it destroys the insurer's subrogation rights, the court noted that the insured should be in no better position when the claim against the third-party tortfeasor is settled without the knowledge or consent of the insurer. More importantly, however, the court in answering the question of what amount the insurer was entitled to recover stated:

> The court below held it [insurer] was entitled to receive the entire amount it had paid to appellants without deduction of any kind. We think this was correct. Appellants argue that the only sum which appellee is entitled to recover from them is such amount as has been received by them from the insurer and the wrongdoer in excess of the amount of their loss after allowing them the expenses of litigation.... and they set up that their loss was greater than the sum received by them from both sources. While it is true the amount claimed from the railroad company was greater than the total they received from both, they did not test out what their full loss was by pressing the suit against the railroad company to verdict and therefore cannot avail themselves of the principle they seek to invoke. The clause in the policy expressly provides that the insurer is to be subrogated to the amount of its payment under the policy; this provision fixes the sum to which it is entitled even though the insured had suffered a loss over and above that which was covered by the insurance.

280 Pa. at 557-58.

This decision is also of importance because of the emphasis it placed upon the policy's subrogation provision. However, it must also be recognized that in the event the company does not exercise its subrogation right either by joining in the suit against the third-party tortfeasor or by assisting and participating in such a suit, the right to subrogation fixed by the policy is not enforceable. Aetna Insurance co. v. Confer, 158 Pa. 598 (1893).

The Pennsylvania Superior Court has also emphasized and relied upon the policy language, and the language of the subrogation receipt, in enforcing the insurer's priority in

recovering from a third-party tortfeasor, Manley v. Montgomery Bus Co., 82 Pal Super. 530 (1924), the insured executed a subrogation receipt pursuant to the terms of the policy. This receipt assigned to the insurer call claims which the insured had against those responsible for his loss. In enforcing the insurer's priority right of recovery, the court stated:

> It will thus be seen that the equitable right of subrogation arising from the payment by the insurer became a right at law which might be asserted in a court of law. The insurer in such a case is no longer required to establish the equity out of which subrogation might arise, but is put in the place of the party injured to the extent of the indemnity paid by the former. A contract of insurance is a contract of indemnity and from its nature, the insurer, after paying to the insured the amount of a loss on a Policy, is entitled to be subrogated in a like amount of the insured's right of action against the wrongdoer.

82 Pa. Super. at 532-33. It should be noted, however, that the insured settled his action against the third-party tortfeasor without the knowledge or participation of the insurer. It is in this situation that court found the superior equities to lie with the insurer. Md. at 534.

Following these decisions, it was not until Roberts v. Fireman's Insurance Co. of Newark, 376 Pa. 91 (1954), that the Pennsylvania courts once gains were called upon to review subrogation in the context of a property insurance policy. In Roberts, the insureds settled their claim against the third-party tortfeasors. However, this action was undertaken after the insurer had denied any liability to the insured based upon certain policy provisions. In this suit by the insureds to recover under the policy, their insurer set up as a defense the insured's discharge of the insurer's subrogation claim. Applying the well-settled rule that payment is a prerequisite to the enforcement of the right of subrogation, the court refused to permit the insured to set up as a defense the insured's settlement with the tortfeasors. The court also ruled that the insurer had waived its subrogation rights, if, indeed, any had existed due to its initial repudiation of the claim.

The Roberts decision stands for the proposition enumerated above and none other. However, dicta in the Roberts decision could be read to imply a different result. In Roberts, the court stated:

> Moreover, subrogation is to be accorded upon equitable principles even though the right thereto, as authorized by statute in respect of policies of insurance ... is contractually declared. ...."Subrogation rests upon purely equitable grounds and it will not be enforced against superior equities.... As we have thus recognized, the right of subrogation exists wholly apart from contractual provision and, from the facts hereinbefore related, it amply appears that the jury was well justified in finding the equities to be with the insured.

376 Pa. at 107-08. More importantly, however, the court distinguishes those decisions where the insured extinguishes the insurer's subrogation rights before the insurer is given an opportunity to compensate the insured for his loss, Highlands v. Cumberland Valley Farmers' Mutual Fire Insurance Co., 203 Pa. 134 (1902) from those situations where the insurer has paid the insured and is "entitled to be subrogated to the insured's rights against the one inflicting the damage." Id. at 109 (citing Illinois Automobile Insurance Exchange, supra.) Thus, Roberts does not stand for the proposition that the insured is to be made whole before the insurer may participate in the recovery.

The only "modern" case discussing an insurer's right to the proceeds obtained from a third-party tortfeasor is found in Associated Hospital Service of Philadelphia v. Pustilnik, 396 A.2d 1332 (1979). Associated Hospital Service paid medical bills on behalf of Pustilnik. The amount of these bills was disputed based upon the method used by Blue Cross to adjust its accounts with various hospitals. The amount of bills ranged from $18,960.18 to $30,200.87.

During the trial, but before the verdict was returned, Pustilnik settled with the third-party tortfeasor for $235,000. The subscription agreement which Blue Cross had with Pustilnik included a provision granting Blue Cross the right to subrogation. 396 A2.2d at 1335.

Pustilnik refused to reimburse Blue Cross for the amount of its payment. After the trial, the trial court determined that Blue Cross was entitled to $18,960.18, but then further reduced Blue Cross' recovery by one-half on the ground that Pustilnik had not been fully compensated for his injuries. The Supreme Court reversed this ruling citing Illinois Automobile Insurance Exchange v. Braun, supra, where the Supreme Court held that the settlement of the claim with the third-party tortfeasor fixes the amount of the claim as the insured waives his right to a judicial determination of his losses. However, it is the court's reasoning for this result that had been subject to criticism. The court's reasoning is as follows:

> Sound policy requires this result. It is of course possible that in some cases a subrogor will be well advised to settle for substantially less than his claim because of the tenuous proof establishing the alleged tortfeasor's liability. This possibility, however, does not imply that the subrogor should be permitted to assert against the subrogee that after all, his claim against the tortfeasor really was worth more than he had settled for which is what the trial court permitted to happen here. Such a procedure would encourage unethical practice, if not _____ testimony: a representation in the court where the suit against the tortfeasor was tried that the case for liability was strong, to obtain a high settlement, followed by a representation in the court where the subrogation claim was tried that the case for liability was weak. Liability should be determined, whenever possible in one proceeding. When a subrogor settles, he waives his right to a judicial determination of his losses, and conclusively established the settlement amount as full compensation for his damage.

396 A.2d at 1338.

Initially it should be noted that the Pennsylvania Supreme Court overruled Pustilnik on the ground that Blue Cross had not proven the amount of its claim. Hence, the case was resubmitted to the trial court to permit Blue Cross to put forth its proof as to actual payment. The case was not disapproved by the Supreme Court on any other grounds. Associated Hospital Service of Philadelphia v. Pustilnik, 439 A.2d 1149 (Pa. 1981). The reasoning in Pustilnik has been severely criticized by Windt, § 1006 at 411-12. Nonetheless, the result in Pustilnik is

supported by the policy language and previous Pennsylvania precedents. As noted, Pennsylvania adheres to the concept that a settlement or verdict fixes a loss. Therefore, there can never truly be a situation where the insured's loss exceeds the total compensation from the tortfeasor and insurer. In fact, exactly the opposite is true. Since the verdict or settlement represents the total damages, the insurer should always be accorded its full right to subrogation.

Therefore, while Pennsylvania law remains somewhat unsettled as to whether subrogation should be deemed equitable in nature even in light of contract terms, the effect of the judgment/settlement rule obviates any concern over the distinction. This conclusion, however, is based upon somewhat vintage precedent and it is impossible to predict how the Pennsylvania courts would rule if currently faced with additional issues.

It is important to understand that notwithstanding what rule is adopted in a particular jurisdiction, generally insurers and insureds are free to negotiate allocations of recovery. The significance of this is noted by Professor Keeton:

> In view of the fact that all but a very low percentage of the tort claims against third parties are settled, the frequency of agreement between the insurer and the insured for proration of settlement proceeds produces a substantial deviation from the principle that the insured should be fully indemnified first, even in jurisdictions where that might be the theoretical rule of allocation.

Keeton, supra, note 7, at 164.

New Jersey Law

Up until the recent New Jersey decision of Culver v. Insurance Company of North America, 221 N.J. Super. 493, 535 A.2d 15 rev. 559 A.2d 400 (1989), there has been limited legal authority relating to proration agreements. Culver provides some guidance on the present state of the law on allocation but, more importantly provides assistance in crafting enforceable proration agreements with insureds.

Mr. and Mrs. Culver suffered a fire at their home which caused $185,000 in damages. They were insured by INA to the extent of $82,373.12. Thus, they had an uninsured loss approximating $103,000.

INA took a total assignment of their rights against the potential third-party tortfeasors and commenced the subrogation. action. Initially, INA and the insured had agreed that INA would be reimbursed first to the extent of its payment. In return the insureds would receive a reduced attorneys' fee of 25% on any monies recovered in excess of the insurance payment. This agreement was later modified, and the parties agreed that INA would receive 70% of any recovery with the insureds recovering 20%. The insureds were led to believe by counsel for INA that it was unlikely that more than the $82,000 would be recovered, and the insureds were concerned that they would risk payment of litigation costs. Therefore, they agreed to the 80/20 split.

The subrogation action was commenced against General Electric and Better Living Department Stores, the manufacturer and installer of the gas stove which apparently malfunctioned at their home. Prior to trial, a settlement of $25,000 was reached with GE and these proceeds were apparently split according to the 80/20 agreement. The case against Better Living Department Stores was tried and the department store was found 100% liable. GE was exculpated. After the liability portion of the trial was concluded, Better Living Department Stores and INA, with the consent of the insureds, settled for $135,000.

Subsequently a hearing was held on the proration of recovery between INA and the insureds. At this hearing, the insured was asked if consent had been given to the settlement amount, and whether the apportionment agreement had been approved by the insureds. The answers to both of these questions were in the affirmative. The total settlement of $160,000 was

allocated by counsel for INA as follows: $92,000 to INA $23,583.33 to the insureds and $44,416.67 for attorneys fees and costs. When the insureds realized that INA would receive more than it had paid, the insureds refused to agree to the distribution.

INA sought confirmation of the distribution from the court which heard the subrogation action and the trial judge, apparently not distinguishing between the settlement with the tortfeasor and the subrogation agreement, affirmed the distribution offered by INA.

Rather than appealing the distribution order, the insureds filed a new complaint alleging that the subrogation agreement with INA was a breach of INA's fiduciary obligations and procured by misrepresentations of both fact and law made to the insureds. The insureds alleged that INA informed them that INA was entitled as a matter of law to payment of the first proceeds plus 12% interest and that recovery over that amount was not likely. The insureds alleged that it was for this reason they agreed to share the 20% believing that under any other circumstances, they would likely receive nothing. The trial court in this second action granted summary judgment to INA and the insureds appealed. On appeal, the Appellate Division ruled that if the insureds' story is credited, they are entitled to relief from the agreement under basic principles of subrogation law. The court held that unless the subrogation agreement otherwise provides, the subrogor and subrogee enjoy only those rights conferred by common law. Under common law, the insurer's right of subrogation does not arise until the insured has been made whole.

The court stated that typically the common-law rule is modified by the insurance contract giving the insurer an assignment of the insured's rights against the third party. The court held that under equitable principles, the common-law rule survives the contract unless otherwise

provided. The court found this was especially so where the subrogation receipt or assignment assigns to the insurer the insured's entire claim.

Finding that the agreement with the insureds violated every concept of fair play, the court noted that INA's right was limited to the amount it had paid and additionally found that if the insureds' allegations were credited, the agreement was procured by misrepresentations by INA's attorneys. In concluding that the agreement should be set aside, the court stated:

> We think it clear then that the facts of record here support plaintiffs' claim for relief from the order enforcing their agreement with INA. At the least, if there are material facts which might yet be the subject of dispute, plaintiffs are entitled to the opportunity to provide their right to relief. (Emphasis added).

Unfortunately, the court does not distinguish this proration agreement from other more even-handed agreements. This raises many questions about the overall effect of the decision on such agreements generally. For example, although the language is not entirely clear, the court does state that the equitable principles of subrogation survive the contract of insurance (providing for total assignment of subrogation rights) "unless otherwise provided. " To the extent that an insurer and insured have entered into a fair proration agreement, it seems that this would fall into the "unless otherwise provided" circumstance.

Finally, the court here had no choice but to apply the insured whole doctrine when it decided that the 80/20 split between INA and its insured was inequitable, unconscionable, a breach of fiduciary obligation, and procured by misrepresentation. Nowhere in the opinion does the court state that insurers and insureds may not enter into proration agreements as a matter of law. What the opinion requires is that when such agreements are negotiated, that the insurer not breach its fiduciary obligation and that it not procure the agreement by misrepresentation.

Subsequently, the New Jersey Supreme Court reversed the appellate decision ruling in favor of the Culvers on the basis that the rules of res judicata had been misapplied.

The New Jersey Supreme Court recognized that subrogation rights may be created in one of three ways: (1) through an agreement between the insurer and the insured; (2) by statute, and (3) judicially, through equitable principles that compel the wrongdoer to undertake the obligation which it ought to pay. The Supreme Court stated that the appellate division improperly subordinated the contractual nature of the subrogation rights between the Culvers and INA (the insurance policy granted such subrogation rights to INA), to the equitable considerations stemming from the third method of creating subrogation rights, through equitable legal principles. The court stated that although the appellate division turned to equitable considerations, which normally would apply to the standard subrogation clause of an insurance contract without more, the appellate division failed to consider the relevance of the subrogation agreement between the Culvers and INA. The Supreme Court found that the New Jersey cases cited by the appellate division do not suggest that equitable considerations cannot be modified by contract.

In fact, the Supreme Court did not identify the "insured whole" rule as the only one that might be applicable in the absence of an agreement to the contrary.

> The rule adopted by the appellate division is just one of several rules that govern what happens if an insurer seeks recovery from a third-party tortfeasor where the insured's total loss has not been repaid in full.... The rule followed by the appellate division states that "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.... Other possible rules are: (2) 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 .... ; (3) the insurer is to be reimbursed first out of the remaining recovery from the third party, and the insured is entitled to any remaining balance .... : (4) 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 .... ; and (5) 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....

Slip Op. at 12, n.2.

The Supreme Court stated that the appellate division erred in ruling that the subrogation agreement was unenforceable as a matter of law, or that the insured was entitled to be made whole despite the subrogation agreement to the contrary. Therefore, while the court's basis "holding" rests upon the grounds res judicata, the court's discussion of the subrogation issues seems to leave little question that subrogation agreements may be enforced, and further, that the question of how a subrogation recovery is to be allocated between the insurer and insured is an open question under New Jersey law.

In light of differing interpretations of the right of first recovery in various jurisdictions, it is strongly urged that proration or apportionment agreements be entered into.

Recommendations

1. The agreement should be negotiated and entered into before payment is made to the insured, if possible.

2. The agreement should set forth specifically choice of counsel, legal fees and obligations for out-of-pocket costs.

3. The agreement should be fair and not one-sided and permit the insured the right to consult with his or her choice of counsel.

4. There should be a careful legal analysis by counsel as to the provable damages available against the tortfeasor as a result of the loss.

5. Even if a loss is total to insurance, an attempt should be made to fix actual cash value and replacement cost.

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