

## **REINSURER CLAIMS TO SUBROGATION AND SALVAGE**

### **RECOVERIES IN A RECEIVERSHIP CONTEXT**

**By**

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#### **INTRODUCTION**

When a ceding insurer makes a subrogation or salvage recovery it is commonly credited to the reinsurers who helped pay the loss generating the recovery. From an accounting standpoint, this credit usually takes the form of a setoff or netting against reinsurance recoverables due from such reinsurers.

On occasion, there are insufficient reinsurance recoverables to set off fully the subrogation or salvage recovery. Ordinarily, this means that the cedent transfers funds representing an appropriate portion of such recovery to the reinsurer. When the cedent is insolvent, however, the receiver of the cedent may wish to use subrogation and salvage recoveries to fund losses of insureds and claimants, rather than to reimburse the reinsurers who helped pay the claim. This article explores the case law relating to a reinsurer's claim to subrogation and salvage recoveries in the receivership context.

#### **SUBROGATION AND SALVAGE**

Subrogation is an equitable doctrine designed to avoid unjust enrichment and to reimburse an innocent party who has incurred a financial loss. In an insurance context, an insurer which compensates an insured due to a loss caused by a third party is subrogated to the right of the insured to be compensated by that third party. Salvage is the equitable right of the insurer to the residual value of property for which the insurer has paid a total loss.<sup>[1]</sup>

Ceding insurers commonly share subrogation and salvage recoveries with the reinsurers with contributed to the loss payments which generated the subrogation and salvage recoveries. Reinsurance contracts commonly contain clauses which specifically allocate subrogation and salvage recoveries<sup>[2]</sup> or net them off in determining the "ultimate net loss"<sup>[3]</sup> payable by the reinsurer. Some reinsurance contracts specifically allow the

reinsurer to pursue subrogation and salvage recoveries if the cedent declines or otherwise fails to do so.<sup>[4]</sup> The presumption upon which such a practice appears to be based is that the reinsurer, by payment of its portion of the loss, has an equitable right to an appropriate portion of the subrogation or salvage recovery.

### **IMPACT OF RECEIVERSHIP ON SUBROGATION AND SALVAGE RECOVERIES**

The question of the reinsurer's right to subrogation and salvage recoveries is posed most clearly in the receivership context. Such recoveries may be a relatively low priority during the early days of the receivership as the receiver tries to determine the extent of the liabilities and marshals the larger assets. The reinsurer may not be aware of subrogation or salvage opportunities or have insufficient information to pursue them. Guaranty funds which pay losses and obtain subrogation or salvage recoveries may wish to use these recoveries to net down their losses and thus may resist turning over such recoveries to receivers.

Virtually every state has priority of distribution statutes which govern the order in which the debts of the estate are paid. Administrative expenses and the losses of insureds, claimants and guaranty funds are at the top of the list. The unsecured claims of other creditors usually fall within a "general creditor" category that is seldom reached in the asset distribution process. Absent an opportunity for setoff or recoupment,<sup>[5]</sup> the claim of a reinsurer for premiums and the claim of a cedent for reinsurance recoverables are general creditor claims.<sup>[6]</sup>

While receivers sometimes characterize a reinsurer's claim for subrogation or salvage recoveries as a contract debt within the general creditor category, reinsurers argue that the cedent holds the reinsurer's portion of such recoveries as a trustee. As a result, the argument goes, the reinsurer's portion of such recoveries is not an asset of the estate and must be paid to the reinsurer in the full amount, ahead of all other creditors.

This produces a very highly-charged debate since: (a) assets that might otherwise be available to pay insureds and claimants would be withdrawn from the estate; (b) the reinsurer would receive the full amount due rather than the pro-rated portion often paid to other creditors; and (c) priority of distribution statutes are designed to put reinsurers, absent setoff or recoupment, toward the end of the line as claimants against the estate. While the debate continues between receivers and reinsurers, there is case law which suggests a conclusion.

### **SUBROGATION AND SALVAGE RECOVERIES HELD IN TRUST**

There appears to be no shortage of cases holding that an appropriate portion of subrogation and salvage recoveries by insured or an insurer are held in trust for the other. One such case is *National Garment Co. v. New York, C. & St.L.R. Co.*, 173 F.2d 32 (8<sup>th</sup> Cir. 1949). In this case, clothes were damaged in shipment in an amount in excess

of the insurance coverage. The insured brought suit against the shipper which objected that the insured's claim had been extinguished by the insurance recovery and that the insured was not the real party in interest. The court ruled for the insured stating:

In this situation there are two real parties in interest - the insurer to the extent of its payment and the insured to the extent of the difference between the payment received from the insurer and the whole loss. . . . Where the action is by the insured for the whole loss, . . . the recovery is impressed with a trust for the insurer to the amount to which it is entitled by subrogation.<sup>[7]</sup>

*Braniff Airways, Inc. v. Falkingham*, 20 F.D.R 141 (D.Minn. 1957) was a suit by an insured against the party who allegedly caused a loss. The defendant sought to join the plaintiff's insurers as necessary defendants. The court ruled that they were not necessary defendants stating:

The instant case as presently aligned cannot possibly embarrass [the defendant] financially. Eventually there can be but one recovery. A judgment in favor of plaintiff, who is the party in legal interest, would insulate [the defendant] against another suit by plaintiff's insurer. In any event, the recovery may be impressed with a trust in favor of the party claiming the right to recovery.<sup>[8]</sup>

Similarly, the defendant in a subrogation action by an insured sought to join the insurers or dismiss the action in *Regent Cooperative Equity Exchange v. Johnson Fuel Liners, Inc.*, 122 N.W.2d 151 (N.D. 1963). Again, the court ruled that this was not necessary since the rule of law "has in effect made the insured a trustee for the insurer to the extent of the insurer's interest . . . ."<sup>[9]</sup>

*North River Ins. Co. v. McKenzie*, 74 So. 2d 599 (Ala. 1954) was a suit by an insurer against its insured. The insured had been paid for its loss, recovered from the party responsible for the loss and declined to reimburse its insurer. The court ruled that the subrogation recoveries were held in trust for the insurer to the extent of its payment.

*Krause v. State Farm Automobile Ins. Co.*, 169 N.W. 2d 601 (Neb. 1969) involved a subrogation action by the insured and the proper allocation of the costs of the subrogation recovery between the insured and the insurer. During the course of its opinion, the court observed:

[T]he insured is compelled to hold the amount of the subrogation claim for the benefit of his [insurance] carrier and to account to [it] for the amount [recovered in] the action against the tort-feasor. Translated into orthodox legal language, this is simply a declaration impressing a trust upon the fund coming into the hands of the insured and requiring him, following a fiduciary's duty, to account for the proportionate amount of the proceeds corresponding with the subrogation right.<sup>[10]</sup>

Citing numerous cases and an ALR annotation, the *Krause* court concluded: “In these cases the insured becomes a trustee and holds the amount of recovery, equal to the indemnity for the use and benefit of the insurer.”<sup>[11]</sup>

As the above cases demonstrate, it is clear that an appropriate portion of a subrogation recovery is held in trust by: (a) an insured for its insurer; and (b) by an insurer for its insured. The issue at the reinsurance level is whether a similar trust relationship exists between the cedent and the reinsurer.

### **SUBROGATION AND SALVAGE RECOVERIES HELD IN TRUST FOR REINSURER**

One of the older cases on point is *Universal Ins. Co. v. Old Time Molasses Co.*, 46 F.2d 925 (5<sup>th</sup> Cir. 1931). The reinsurer paid half of a cargo loss and attempted to intervene in the insured’s action against the shipper. The shipper alleged that the reinsurer was a stranger to the relationship between the shipper and the insured and that the reinsurer had no action against it (the shipper). The court first acknowledged the equitable right of subrogation by an insurer against a party which causes a loss. The court went on to hold:

The equitable considerations which give rise to a right of subrogation in favor of an insurer who pays the loss insured against apply in favor of a reinsurer who complies with his obligation to his reassured, whether that obligation is for the whole or part of the amount of the loss incurred by the latter in favor of his assured. (Citation omitted.) In the circumstances disclosed the original insurer could not plausibly have contended that it was equitably entitled to recover for itself the entire amount paid under its policy, the [reinsurer] having furnished one-half of that amount.<sup>[12]</sup>

*Automobile Ins. Co. of Hartford v. St. Paul Fire & Marine Ins. Co.*, 89 F.2d 163 (2<sup>nd</sup> Cir. 1937) is a bit factually obscure. It involves a claim by a reinsurer against the cedent for a salvage recovery and a counterclaim by the agent for a cedent for the expenses involved in the recovery. The lower court granted both the claim and counterclaim and the reinsurer appealed the judgment on the counterclaim. The Second Circuit affirmed.

A primary insurer brought an action against an agent for reimbursement for losses on an improperly issued policy in *Glacier General Assurance Co. v. G. Gordon Symons Co. Ltd.*, 631 F.2d 131 (9<sup>th</sup> Cir. 1980). The agent’s defenses included the argument that Glacier’s damages should be calculated net of reinsurance. The court held that “the underlying relationship between Glacier and its reinsurers is one of partial subrogation and Glacier may collect from the defendants . . . for the entire loss.”<sup>[13]</sup> It further held that the reinsurers were not a necessary party to the litigation: “Disposition of this action in the absence of the reinsurers will not impair or impede their ability to protect their interests because Glacier’s recovery is impressed with a trust for the reinsurers in the amounts they are entitled to receive by principles of subrogation.”<sup>[14]</sup>

One of the cases most commonly cited by reinsurers attempting to collect subrogation or salvage recoveries from receivers is *Pink v. American Surety Co. of N.Y.*, 28 N.E. 2d 842 (N.Y. 1940). In this case, an insolvent cedent attempted to set off salvage recoveries due to the reinsurer against sums due from the reinsurer to the cedent on a separate transaction. The reinsurance contract in question gave the reinsurer a right to a proportionate share of salvage recoveries. The court did not allow the insolvent cedent to set off the salvage, stating:

The salvage was received for a specific purpose by the terms of the contracts, to reimburse both the reinsured and reinsurer proportionately for their losses. Out of its receipt, no relation of debtor and creditor was created. In relation to any salvage collected to recoup losses on a specific risk under the reinsurance contracts the reinsured was a trustee for the reinsurer as to moneys in its hands belonging to the latter or to be applied to the specific purpose (citations omitted) and an action at law might be maintained to recover the proportion to which the [reinsurer] was entitled.<sup>[15]</sup>

*In Re Preferred Accident Ins. Co. of N.Y.*, 147 N.E.2d 476 (N.Y. 1957) involved a receiver who wished to impose a trust on salvage recoveries. In a very brief opinion, the Court of Appeals affirmed the opinion of the lower court that a cedent which obtained salvage recoveries must turn over an appropriate share to the insolvent reinsurer, notwithstanding setoff and recoupment provisions in the reinsurance contract.

While the volume of case law is thin,<sup>[16]</sup> relevant case law supports the application of the primary rule concerning subrogation and salvage to reinsurance. Just as insurers hold an appropriate portion of subrogation recoveries in trust for their insureds, such insurers hold an appropriate portion of their subrogation recoveries in trust for their reinsurers.

## **CONCLUSION**

Subrogation and salvage are equitable doctrines designed to avoid unjust enrichment and assure that the party at fault ultimately pays the loss. Should more than one party have equitable rights to a subrogation or salvage recovery, the law imposes a constructive trust on the recovery to assure that these parties receive their appropriate portions. There is a great deal of case law supporting this doctrine between insurers and insureds, and a small but consistent group of cases supporting the application of the doctrine between cedents and reinsurers. In addition, cedents and reinsurers commonly insert provisions concerning the allocation of subrogation and salvage recoveries in their reinsurance contracts.

A receivership proceeding lends a heightened significance to any doctrine which reduces the assets of the estate to the benefit of a general creditor. However, case law on point does not support a different treatment in the receivership context. Indeed, the neutral application of a trust to subrogation and salvage recoveries can benefit receivers, and avoid setoff or recoupment, when the reinsurer is insolvent.<sup>[17]</sup>

## ENDNOTES

[1]. Stephen W. Schwab Debra J. Anderson, *et al* Onset of an Offset Revolution: The Application of Set-Offs In Insurance Insolvencies, Dickinson L. R. 449, 491 - 2 (1991) (hereinafter *Schwab and Anderson*).

[2]. The *Contract Wording Reference Book* published by the Brokers & Reinsurance Markets Association (hereinafter *Reference Book*) provides the following example of a subrogation clause for use in an excess of loss treaty when the loss adjustment expenses are prorated:

The Reinsurer shall be subrogated, as respects any loss for which the Reinsurer shall actually pay or become liable, but only to the extent of the amount of liability to the Reinsurer, to all the rights of the Company against any person or other entity who may be legally responsible in damages for said loss. The Company hereby agrees to enforce such rights, but in case the Company shall refuse or neglect to do so, the Reinsurer is hereby authorized and empowered to bring any appropriate action in the name of the Company or its policyholders, or otherwise to enforce such rights.

Any recoveries, salvages or reimbursements applying to risks covered under this Contract shall always be used to reimburse the excess carriers (from the last to first, beginning with the carrier of the last excess), according to their participation, before being used in any way to reimburse the Company for its primary loss.

In the event there are any salvages, recoveries or reimbursements recovered subsequent to a loss settlement, it is agreed that if the loss adjustment expense incurred in obtaining salvage or other recoveries is less than the amount recovered, such expense shall be borne by each party in the proportion that each party benefits from the recoveries, otherwise, the amount recovered shall first be applied to the reimbursement of the expense of recovery and the remaining expense shall be borne by the Company and the Reinsurer in proportion to the liability of each party for the loss before such recovery had been obtained.

[3]. The *Reference Book* provides the following example of an ultimate net loss clause for use when loss adjustment expense is part of ultimate net loss:

The term "Ultimate Net Loss" means the actual loss, including loss adjustment expense, paid or to be paid by the Company on its net retained liability after making deductions for all recoveries, salvages, subrogations and all claims on inuring reinsurance, whether collectible or not; provided, however, that in the event of the insolvency of the Company,

payment by the Reinsurer shall be made in accordance with the provisions of the Insolvency Article. Nothing herein shall be construed to mean that losses under this Contract are not recoverable until the Company's ultimate net loss has been ascertained.

[4]. See note 2, *supra*.

[5]. For extensive explorations of setoff in the receivership context, see *Schwab and Anderson* and T. Darrington Semple, Jr. and Robert M. Hall, *The Reinsurer's Liability in the Event of the Insolvency of a Ceding Property and Casualty Insurer*, 21 Tort & Ins. L. J. 407, 717 - 24 (1986).

[6]. See *Schwab and Anderson* at 508 - 511.

[7]. 173 F.2d 32 at 34 - 35.

[8]. 20 F.R.D. 141 at 144 - 5.

[9]. 122 N.W. 2d 151 at 154.

[10]. 169 N.W.2d 601 at 604.

[11]. *Id.*

[12]. 46 F.2d 925 at 927.

[13]. 631 F.2d 131 at 134.

[14]. *Id.*

[15]. 28 N.E.2d 842 at 844 - 845.

[16]. A case which raises but does not resolve the trust issue is *Munich American Reins. Co. v. Crawford*, 141 F.2d 585 (5<sup>th</sup> Cir. 1998).

[17]. See *In Re Preferred Accident Ins. Co. of N.Y.*, *supra*.