

**THE INSURANCE COMPANY
AS A SUBROGATED
PLAINTIFF: MAXIMIZE YOUR
RECOVERY WHILE
MINIMIZING YOUR
EXTRACONTRACTUAL
EXPOSURE**

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THE INSURANCE COMPANY AS A SUBROGATED PLAINTIFF: MAXIMIZE YOUR RECOVERY WHILE MINIMIZING YOUR EXTRACONTRACTUAL EXPOSURE

I. INTRODUCTION TO RECOVERY.

A. Introduction.

Recovery operations play a vital role in the insurance industry. While collectible premium dollars are a primary part of the assumed estimate that an insured risk will occur, projected recoveries for the payable risk are also a part of the premium rating process. All lines of business are impacted by recovery operations, the most prolific of which applies to worker's compensation liens, first party property claims, auto physical damage claims, and surety bonds.

Subrogation is important for a number of reasons. One, subrogation apportions the risk of loss to the party who should bear the risk – i.e. the *responsible* party. Two, subrogation offsets the company's overall indemnity payout. Finally, subrogation is an essential claim service that is part of the added value proposition of products and services provided to your customer base. It's the last step in the claim handling process and one of the last opportunities you will have to make a positive impact on your insured.

That being said, because recovery operations are often part of the shared services within an organization, the manner in which subrogated claims are *handled* is often overlooked as an aside. There are, however, numerous pitfalls that can unnecessarily expose a company to claims of breach of the duty of good faith and fair dealing, and/or fines and penalties imposed following a negative market conduct exam. This article is intended to address the risks involved in handling subrogation claims, and a tried and true method of maximizing recovery potential while disposing of many of the uncertain risks inherent in the recovery process. Because recovery of worker's compensation benefits is largely governed by state statutory schemes, this article is for the most part, more applicable to the collection of first party property and auto physical damage (and/or UM/UIM) claims.

B. Subrogation Defined.

Let's start with a few basic concepts, the first being a working definition of subrogation.

Subrogation is defined as “[t]he substitution of one party for another whose debt the party pays, entitled the paying party to rights, remedies, or securities that would otherwise belong to the debtor.”¹ There are three basic forms of subrogation: One, conventional subrogation – which arises by way of contract. Two, equitable subrogation that arises by operation of law or equity; and three, statutory subrogation, such as liens imposed by the payment of workers compensation or hospital benefits.² The “subrogor” is the party for whom or to whom the benefits were paid.³ The “subrogee” is the party who paid the indebtedness.⁴ Without exception, the rights transferred by subrogation are transferred *only* to the extent of the payment made.⁵ Further, when the right of subrogation arises by contract (i.e. vis-à-vis a subrogation clause in the policy), the right of subrogation does not arise until the whole indebtedness is paid – in other words, when the insured is “made whole.”⁶ Only when the (1) policy contains a reimbursement (or priority) clause; or (2) by separate contract or agreement, can the right of priority in recovery be changed.⁷

¹ *Black's Law Dictionary*, 9th Edition (2004).

² *Fortis Benefits v. Cantu*, 234 S.W.3d 642 (Tex. 2007)

³ *Black's Law Dictionary*, 9th Edition (2004).

⁴ *Id.*

⁵ See e.g. *Labiche v. Legal Security Life Ins. Co.*, 31 F.3d 350 (5th Cir. 1994). Notwithstanding this principle, insurers *are* entitled prejudgment interest on the amounts paid. *American National Fire Ins. Co. v. Tabacalera Contreras Cigar Co.*, 325 F.3d 924 (7th Cir. 2003).

⁶ *New Orleans Assets, LLC v. Woodward*, 363 F.3d 372 (5th Cir. 2004); *Allstate Ins. Co. v. Hugh Cole Builder, Inc.*, 772 So.2d 1145 (Ala. 2000).

⁷ See e.g. *Progressive West Ins. Co. v. The Superior Court of Yolo County*, 135 Ca.App.4th, (Cal.App. 2005); In *Re: Katrina Canal Breaches Consolidated Litigation*, 601 F.Supp.2d 809 (E.D. La. 2009). A *reimbursement* clause (as opposed to a conventional subrogation provision) looks something like this:

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II. BEST PRACTICES IN RECOVERY OPERATIONS

A. Introduction.

Recovery operations are complicated on a good day and on a bad, completely detached from the typical day to day “claim” operations within a company. Often times there is little to no communication between the subrogation claim handler and the adjuster assigned to investigate the claim, and sometimes the claim is closed and paid before recovery specialists become involved. One thing that must be remembered from the outset, however, is that recovery specialists are not “adjusters,” in the typical sense of the word. An adjuster is “[o]ne who is appointed to ascertain, arrange or settle a matter; esp., an independent agent or employee of an insurance company who investigates claimed losses and negotiates and settles claims against the insurer.”⁸ Adjusters are required to be *licensed* in many states. Recovery specialists, on the other hand, do not investigate or negotiate a claim. Neither do they settle or make payment for an insured risk under an applicable policy of insurance. Recovery specialists, then, are not required to be licensed, and may operate without restriction in all jurisdictions. Still, the licensing

issue aside, there is some overlap between claim handling and recovery operations – namely, that both activities to create potential extra contractual exposure to insurers. Thus, defining best practices in recovery operations is of pivotal concern.

B. The Made Whole Rule.

First up on the list of problems encountered when navigating recovery claims is the “made whole rule.” Typically, the question is posed in terms of whether or not the subrogation claim has “value,” – in other words, “should I shut my subrogation claim down because the uninsured losses exceed the recovery potential.” And, this is a valid question. After all, maximizing recovery is a top priority in recovery operations. However, the better question posed is whether by law, you *can* move forward to pursue recovery and if not, what are your options.

Under the “made whole” doctrine, “[a]n insurer is not entitled to subrogation if the insured's loss is in excess of the amounts recovered from the insurer and the third party causing the loss.”⁹ While most Courts recognize an exception to the made whole rule in cases involves conventional subrogation, absent a specific policy provision or separate agreement to the contrary, virtually every jurisdiction addressing the issue applies the made whole rule to subrogated claims. In the *Foris Benefits* case, the Supreme Court of Texas held:

Our Ortiz decision addressed the "made whole" doctrine in the context of equitable subrogation, but it did not discuss how the doctrine applies, if at all, to contractual subrogation. Other courts, however, have discussed whether the doctrine applies in the face of a contract that grants the insurer greater subrogation rights. For example, in *Oss v. United Services Automobile Ass'n*, 12 the Fifth Circuit, applying Texas law in a

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- A. If we make a payment under this policy and the person to or for whom payment is made recovers damages from another, that person shall:
 - 1. Hold in trust for us the proceeds of the recovery; and,
 - 2. Reimburse us to the extent of our payment.

Labiche v. Legal Security Life Ins. Co., 31 F.3d 350 (5th Cir. 1994). The agreements are enforced and *do not* embody the made whole doctrine. Likewise, conditions that actually provide the insurer with a right of priority are enforced. *See e.g. S.R. Int'l. Business Ins. v. Alliance Ins. Co.*, 343 Fed.Appx. 629 (2nd Cir. 2009).

⁸*Id.*

⁹*Ortiz v. Great Southern Fire & Cas. Ins. Co.*, 587 S.W.2d 342 (Tex. 1980).

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diversity case, was confronted with facts similar to those in this case. The insured was not made whole by the settlement following a car wreck, yet insurer USAA sought enforcement of its contractual subrogation rights under the policy. Like Fortis, USAA urged the Fifth Circuit to reject the "made whole" doctrine by distinguishing Ortiz as involving equitable rather than contractual subrogation. The Fifth Circuit, relying on the El Paso Court of Appeals' decision in Means v. United Fidelity Life Insurance Co., refused because it believed that, in Texas, "the same principles govern both equitable and contractual subrogation."¹⁰

Still, at least two other jurisdictions prohibit *pro tanto*¹¹ subrogation unless the insured has been made *completely* whole – meaning that the carrier must pay the insured's cost of recovering its uninsured losses *before* the right of subrogation vests.¹² In those jurisdictions, Court disallow the splitting of causes of action between the carrier and the insured, assigning the right to one party or the other, depending upon whether full payment has been made.

Living with the "made whole" rule as a carrier is somewhat difficult – at least from a recovery perspective. From the standpoint of the claim department, the insurer is only required to pay what is owed when it is owed under the terms of the policy. On the other hand, the amount of uninsured losses may correspond hand in hand with amount paid – or

not, under the policy. To complicate matters further, insureds may inflate the amount or value of uninsured losses either because it feels that the damage claim was unfairly valued or simple greed. Money is money, after all. An additional layer of complexity is involved as well, when the carrier pursues subrogation in violation of the rule – creating unnecessary extra contractual exposure to the company. The argument running in these cases is that the insured is putting its own financial interest ahead of the insured's in either pursuing recovery before the insured is made whole, or setting its claims with the tortfeasor while the insured's claims remain outstanding.¹³

There is, however, a simple legal tool that operates to determine the right of priority in subrogation cases, while maximizing the full recovery potential of the case at a minimal expense to the insured. That tool is a joint allocation agreement. Among the many virtues of these agreements is significantly reduced exposure to extracontractual claims. We will discuss the use of these agreements more fully below. For the time being, however, let it be said that an allocation agreement is not only a fair means to diffuse disparity between you and your insured in the recovery process, it is a fair compromise to the impediments and exposures created by the "made whole" rule.

C. The Anti-Subrogation Rule.

Another risk of exposure exists when an insurer violate the "anti-subrogation" rule. Under the "anti-subrogation" rule, "[a]n insurer has no right of subrogation against its own insured for a claim arising from the very risk for which the insured was covered."¹⁴ In *Reliance Insurance Company in Liquidation v. Chitwood*¹⁵ the Court explained the anti-subrogation rule thus way:

¹⁰*Fortis Benefits v. Cantu*, 234 S.W.3d at 646.

¹¹Literally, "to that extent." *Black's Law Dictionary*, 9th Ed. (2004).

¹²See e.g. *Wimberly v. Am. Cas. Ins. Co. of Reading, PA*, 571 S.W.2d 200 (Tenn. 1979); *Drinkwater v. Am. Family Mut. Ins. Co.*, 714 N.W.2d 568 (Wis. 2006).

¹³See e.g. *Alfano v. State Farm Fire & Cas. Co.*, 2009 U.S. LEXIS 84927 (Pa. App. 2009).

¹⁴See *Pa. Gen. Ins. Co. v. Austin Powder Co.*, 68 N.Y.2d 465, 468, 502 N.E.2d 982, 510 N.Y.S.2d 67, 68 (1986); *Walker v. Vanderpool*, 225 Va. 266, 302 S.E.2d 669, 672 (Va. 1983)

¹⁵433 F.3d 660, 662-663 (8th Cir. 2006).

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Missouri law recognizes the anti-subrogation rule, which is that where an insurance company attempts to recover, as a subrogee, from a coinsured generally covered under the policy, whose negligent act occasioned the loss, the action must fail in the absence of design or fraud on the part of the coinsured. The Missouri courts have held that allowing an insurer to sue for recovery against one of its own insured would violate the basic principles of subrogation and equity, as well as violate sound public policy. The anti-subrogation rule prevents an insurer from passing its loss to the insured, thereby avoiding coverage for the very risk for which it accepted premiums, and it prevents insurers from having a conflict of interest that might deprive an insured of a vigorous defense.

Other Courts have defined the purpose of the anti subrogation rule as thus:

This rule serves two purposes: (1) it prevents the insurer from passing the loss back to its insured, an act that would avoid the coverage that the insured had purchased; and (2) it guards against conflicts of interest that might affect the insurer's incentive to provide a vigorous defense for its insured.¹⁶

The rule applies even in cases involving indemnity contracts between co insureds.¹⁷ The

essential criteria that triggers the rule is that the suit for damages must be the *same risk* initially insured by the carrier in the first instance. If the same risk is not insured, the carrier is typically free to pursue another party insured. This typically occurs when the party is insured under a completely separate policy.¹⁸

The anti-subrogation rule most commonly arises in cases involving property damage claims between landlords and tenants, cases involving property damage to condominium unit owners insured under a condominium association policy, cases involving auto physical damage caused by an employee of an insured employer, and construction (third party) liability cases.

With respect to condominium claims, virtually every state in the country is subject to some type of Condo-Association act, preventing insurers from recovering against unit owners for property damage payable under a policy of insurance issued to the condominium or homeowners' association.¹⁹ For example, the Connecticut Common Interest Ownership Act²⁰ provides:

- (a) Commencing not later than the time of the first conveyance of a unit to a person other than a declarant, the association shall maintain, to the extent reasonably available: (1) Property insurance on the common elements and, in a planned community, also on property that must become

692 (2001); *Jones Lang Wootton USA v. LeBoeuf, Lamb, Greene & MacRae*, 243 A.D.2d 168, 674 N.Y.S.2d 280, 289 (N.Y. App. Div. 1998).

¹⁸See e.g. *Kirtos v. Nationwide Ins. Co.*, 2008 Ohio 870 (Oh. App. 2008); *White v. Allstate Ins. Co.*, 1996 U.S. App. LEXIS 27462 (9th Cir. 1996).

¹⁹See e.g. C.R.S. 38-33.3-313 (2009)(Colorado's Condominium Ownership Act and Common Interest Ownership Act) provides that on any policy issued to a condominium association, "[t]he insurer waives its rights to subrogation under the policy against any unit owner or member of his household."

²⁰Conn. Gen. Stat. §47-255 (2010).

¹⁶*Boulder Plaza Residential, LLC v. Summit Flooring*, 198 P.3d 1213 (Co. App. 2008).

¹⁷*Tokio Marine and Fire Ins. Co. v. Rosner*, 206 Fed. Appx. 90 (2nd Cir. 2006); *ELRAC, Inc. v. Ward*, 96 N.Y.2d 58, 76-77, 748 N.E.2d 1, 9, 724 N.Y.S.2d

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common elements, insuring against all risks of direct physical loss commonly insured against or, in the case of a conversion building, against fire and extended coverage perils. The total amount of insurance after application of any deductibles shall be not less than eighty per cent of the actual cash value of the insured property at the time the insurance is purchased and at each renewal date, exclusive of land, excavations, foundations and other items normally excluded from property policies; (2) flood insurance in the event the condominium is located in a flood hazard area, as defined and determined by the National Flood Insurance Act, as amended, USC 42 Section 4101, P.L. 93-234, and the unit owners by vote direct; and (3) liability insurance, including medical payments insurance, in an amount determined by the executive board but not less than any amount specified in the declaration, covering all occurrences commonly insured against for death, bodily injury and property damage arising out of or in connection with the use, ownership or maintenance of the common elements and, in cooperatives, also of all units.

* * *

(d) Insurance policies carried pursuant to subsections (a) and (b) of this section shall provide that: (1) Each unit owner is an insured person under the policy with respect to liability arising out of his interest in the common elements or membership in the association; (2) the insurer waives its right to

subrogation under the policy against any unit owner or member of his household; (3) no act or omission by any unit owner, unless acting within the scope of his authority on behalf of the association, will void the policy or be a condition to recovery under the policy; and (4) if, at the time of a loss under the policy, there is other insurance in the name of a unit owner covering the same risk covered by the policy, the association's policy provides primary insurance.

Thus, in the context of community residential developments, the anti-subrogation rule is *statutory*, meaning that violation of the rule (i.e. pursuit of recovery against a unit owner for property damage to another unit or the common area) definitely exposes an insurer to common law or statutory bad faith claims.

Property damage claims between landlords and tenants is less complex, although the anti-subrogation rule is still difficult to circumvent. In these cases, some Courts allow recovery up to the co-insured tortfeasor's limit of liability under its own liability policy (i.e. the \$50,000.00 fire damage limit of liability). Other Courts look carefully at the language of the policy under which the responsible party claims to be additionally insured, applying it according to the claim made. Still, all bets are off in other Courts, and subrogation is prohibited across the board in cases involving parties co-insured under the same policy for the same risk insured.²¹ Thus, to avoid extra contractual exposure to your company, suits involving claims against another party insured should be carefully investigated before the decision is made to move forward. Only after it is determined that the loss insured was not the

²¹See e.g. *Dominion Insurance Company, Ltd. v. State of New York*, 305 A.D.2d 760 (N.Y. App. 2003).

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same loss for which the responsible party bears liability should the case move forward.²²

D. Proration of Deductibles and Attorneys' Fees:

The issue of prorating deductibles and attorneys' fees incorporates both the principals associated with the "made whole" rule together with the "common fund" doctrine. Together, these rules ensure that the costs and equities of recovery suits are balanced between the insured and the insurer.

Under the common fund doctrine:

[A] private plaintiff, or plaintiff's attorney, whose efforts create, discover, increase, or preserve a fund to which others also have a claim, is entitled to recover from the fund the costs of his litigation, including attorneys' fees. The common fund doctrine is equitable in nature, intended to avoid unjust enrichment at the expense of the successful litigant. The doctrine operates to charge an award against the fund itself, rather than to impose personal liability against a party or beneficiary.²³

Leaving aside the few jurisdictions that do not permit the splitting of causes of action, (i.e. the causes of action belong wholly to the insured until a full recovery is made), or that simply disallow recovery until the insured has been made whole for costs associated with the recovery of uninsured losses, most jurisdictions apply the common fund doctrine to distribute the attorneys' fees and expenses incurred when one party labors to recover money for the benefit of both. This applies to both worker's compensation recovery (which is statutory in some jurisdictions), as well as recovery for

benefits paid under first and third party liability policies.

The proration of deductibles and attorneys' fees in the context of recovering auto physical damage and UM/UIM claims is also statutorily regulated in many jurisdictions. A table of the regulations applicable to auto subrogated demands is attached as an addendum to this article. Most states allow proration of costs and fees, although some states qualify the carrier's right to prorate upon the use of "outside" (as opposed to staff) counsel. It is likely that these regulations were passed to incent carriers to pursue recovery (which necessarily lowers premiums), as well as the class action exposure facing carriers who process a high volume of auto claims yearly.

Most of the regulatory schemes contain a variation of the following provision:

Insurers shall include the first party claimant's deductible, if any, in subrogated demands. Subrogation recoveries shall be shared on a proportionate basis with the first party claimant, unless the deductible amount has been otherwise recovered. No deduction for expenses can be made from the deductible recovery unless an outside attorney is retained to collect such recovery. The deduction may then be for only a pro rata share of the allocated loss adjustment.²⁴

What this means in practical terms is this: If you pay a claim for \$47,500.00 (\$50,000.00 limits subject to a \$2,500.00 deductible), and expend \$6,600.00 recovering \$20,000.00 from the responsible party (\$6,600.00 representing the typical 33% contingency fee to which counsel would be entitled), the insured would be entitled to .01% of the total recovery, (or \$200.00) and the insurer would be entitled to 99% (or \$19,800.00) of the recovery. From that, the insured would be taxed with .01% of the costs

²²*McKinley v. XL Specialty Ins. Co.*, 131 Cal.App.4th 1572 (Cal. App. 2005).

²³*Bogart v. King Pharmaceuticals*, 493 F.3d 323 (3rd Cir. 2007); *Insurance Co. of North America v. Norton*, 716 F.2d 112 (7th Cir. 1983).

²⁴ C.A.R. 054 00 CARR 043 (2009).

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(or \$66.00) to the insurer's 99% (\$6,534.00) responsibility.

Under these statutory schemes, literally hundreds of thousands of claims can be recovered each year, quickly and efficiently.²⁵ So, where's the extrac contractual exposure? Noncompliance. This is as much of a management issue as it is a legal conundrum. Not only does the failure to comply with these regulations present liability exposure to insurers, but fines and penalties may be assessed in the event of a negative market conduct exam.

E. Recovery of Punitive Damages, Treble Damages and Other Damages Predicated Upon Consumer Protection Claims.

A touchy subject among subrogation professionals is the addition of claims of punitive damages and liability under applicable state consumer protection laws, which can often yield double or even triple damages for a prevailing party. While subrogation lawyers (who typically work on contingency) include the claims to increase the overall value of the case, the practice can have a significant impact on your company.

First, there are a number of jurisdictions that prohibit the assignment of causes of action that are deemed "personal" to the party who sustained the damage; legal malpractice claims, for instance. Second, while there is justification for asserting the claims to maximize recovery potential, what happens if you collect more than 100% of the loss paid? Virtually every jurisdiction that has addressed conventional and equitable subrogation limit the right to the amount paid.²⁶ Thus, the retention of money that simply doesn't belong to your company is a questionable claim practice. While this is may be a rare occurrence, there is also the bigger picture at stake.

²⁵An alternative possibility exists for those carriers who implement a qualified deductible waiver program, typically most helpful in UM/UIM or rear end physical damage claims. This allows the carrier to pursue 100% recovery without the added administrative expense associated with deductible returns.

²⁶See Footnote 5.

Pull back for a moment and look at your organization as a whole – a complete cohesively functioning unit. While there are always natural tensions (and even competition) between the interests of business units, the interest the claim department has in controlling indemnity payout is of prevailing concern. For instance, do you know how much money your company spends each year lobbying for tort reform – either individually or through trade organizations such as the ABA? Do you know how much they spend filing amicus briefs in cases of chief concern – cases involving excessive jury verdicts, excessive taxation of exemplary awards and so on and so forth? The answer in virtually every organization is "lots." So, that begs the question of whether the pursuit of such claims in subrogated suits runs completely contrary to company philosophy. Even the most golden insurer typically only recovers between 4-5% of total indemnity payout. Thus, the question of whether it is worth taking the risk of advocating for a damage award that your company may be fighting, and fighting hard, on both a legislative and judicial front.

The answer to this question is "maybe," and then, only in cases involving specific, carefully vetted facts, and/or in cases, as will be discussed more fully below, where you pursue recovery hand in hand with the insured, and the insured retains ownership of any amounts over and above your company's subrogated interest. Even then, however, the facts of each case should support such claims, for instance, aggregated (i.e. class action) product liability claims against manufacturers, or cases involving extremely egregious behavior, and not be added willy-nilly for the purpose of posturing or "puffing."

F. Coinciding Claim and Subrogation Investigations:

Many insurers have become increasingly sophisticated in managing their recovery operations. As a result, subrogation investigations often coincide with the underlying claim investigation. The dilemmas presented in this situation are obvious.

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First, at the most basic level -- evidence management. While subrogation professionals (lawyers and recovery specialists alike) may wish to conduct testing on materials recovered from a loss site, (and in some cases, destructive testing), testing may impede a claim investigation. Second, if there are not proper “chain of command” procedures in place, evidence can be lost or misplaced, resulting in “spoliation” issues that can expose the company to extracontractual liability (i.e. the insured may lose the ability to collect uninsured losses), or worse, valuable coverage defenses available to the claim department may be impeded. At a minimum, both the insured’s and the insurer’s causes of action can be impeded by inverse jury instructions.²⁷ Remember, there is no subrogation if there is no payment.

Additionally, there are issues related to the nature of the different disciplines involved. In subrogation, the goal is to determine causation and pursue responsible parties. In claim handling, the goal is to determine first and foremost whether the loss is a covered peril. And there two worlds collide. The problem is solved if the same experts are used. However, if the subrogation professional (or lawyer) hires an independent expert who fails to coordinate with the front line claim handler or the expert hired by the claim adjuster, you just may end up proving the insured’s claim (or their damages) before the claim is fully adjusted. Add potential Daubert problems on top of that (what if the expert reports conflict), and you have a big stew pot waiting to boil over. Did I mention that subrogation files are discoverable? So, if there is a pending “bad faith” claim between the insured and your company while your subrogation investigation is ongoing, make sure you coordinate with the people in the trenches. There are few other things that can tank a bad faith defense than when your recovery department (or your underwriters) come to a different conclusion than your claim department.

²⁷See. *Hughes v. Black & Decker, Inc.*, 2007 U.S. Dist. LEXIS 2372 (D.C. Minn. 2007); *South Georgia Productions, Inc. (and Travelers Indemnity Co. of Ill.) v. Pioneer Machinery, Inc.*, 2004 U.S. Dist. LEXIS 30707 (N.D. Ga. 2004).

The left hand should know what the right hand is doing – no exceptions.

G. Replenishment of Policy Limits – Yea or Nay?

One question that has floated around, at least informally, is whether a carrier is required to “replenish” policy limits upon a successful recovery. This is relevant in cases involving large uninsured losses – hypothetically, the replenished limits could then be paid to make the insured whole; and catastrophic loss where insufficient policy limits is also an issue. The five hurricanes that hit Florida in consecutive order in 2007-2008 are a prime example. The destruction of the World Trade Center on September 11th is another (both towers collapsed, raising the issue of whether there was one or two events).²⁸ While the issue has never been actually tried in a published decision that I could find (the issue was raised in the 9/11 bombing case), the answer, in this commentator’s opinion is “no.” Why? Because in virtually every state, premium rating plans must be filed by your underwriters. Why is this relevant? Because premium rating plans are a compilation of projected numbers, which include both potential indemnity payout for the particular line of business -- a risk that is spread among the many -- as well as projected subrogated recoveries, the gain of which is also spread amongst all insureds.²⁹ Recovery operations, in other words, are a part of the premium control plan and help keep rates reasonable. Thus, your company has already considered the possibility of recovery along with

²⁸*S.R. Int’l. Business Inc. Co. v. World Trade Center Properties, LLC*, 467 F.3d 107 (S.D. N.Y. 2006).

²⁹See e.g. 3 CCR 802-5 (2010). The Colorado Code of Regulations provides in pertinent part:

Loss Offsets: For all lines of business for which the ultimate loss payments are expected to be affected by the subsequent collection of salvage or subrogation amounts, or through the coordination of benefits, such anticipated reductions must be considered, either implicitly or explicitly, in the rate making process.

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the possibility of payout in calculating the base premium for the policy. In this way, the replenishment of policy limits following the recovery of sums paid for a portion of a loss, or one of many losses, would result in a “double recovery” to the insured in a world where the wealth has already been shared.

H. Consistency In Coverage Positions Between Claim and Recovery:

One final note on best practices involves internal consistency on coverage and claim-related issues – an important company dynamic within any insurance company – even between the business units where healthy tension and some natural *inconsistency* co-exists. However, consider for a moment the following dilemma: You are pursuing a property damage claim for product liability against a vendor, who is significantly underinsured. (The manufacturer cannot be sued directly because of the economic loss doctrine.) The vendor is additionally insured under the GL policy for the manufacturer, who is large and well insured, but the endorsement is qualified by a number of factual restrictions, some of which may apply. Do you (1) collude with the insured to plead the case within coverage under the manufacturer’s policy; and (2) argue an interpretation of the additional insured endorsement (i.e. ambiguity) that will impact the interpretation of the same or similar endorsements issued by your company? Think about that. Not only can pursuing alternative policy construction result in an opinion that potentially impacts the manner in which your own company’s defense and indemnify obligations lie, but having the same company argue contradictory opinions in different cases can damage your company’s credibility with the Courts. Thus, we recommend that the management teams between claim and recovery communicate regularly to insure that your company is maintaining consistent positions on important coverage issues and issues that may impact the company’s bottom line.

III. ALLOCATION AGREEMENTS:

Though certainly not an exhaustive list, we have identified at least six areas of risk

exposure in the recovery context: (1) violation of the made whole rule; (2) violation of the anti-subrogation rule; (3) evidence *mismanagement*; (4) violation of the state statutory scheme related to the reimbursement of auto deductibles; (5) failing to coordinate your investigation with the front line claim handler; and (6) generally putting your company’s financial risk ahead of the insured’s. (We do not believe that failing to coordinate your coverage positions puts you at *risk*, per se; it’s simply a best practices issue). On the other hand, we also have identified that recovery operations as a whole, are a valuable part of the claim services offered to insureds, presenting an *opportunity* for you to help build solid long-term relationships with your company’s client base and end the claim handling process on a positive note. So, how do we pull together the concepts of (1) defining the priority of recovery in a “made whole” world; (2) minimizing the risk of extrac contractual exposure; (3) maximizing recovery potential; and, (4) customer service? The answer, quite simply, is through the use of assignments, in the form of an allocation agreement.

Remember a basic concept of subrogation law, is that the rights and obligations of the parties *can be modified by contract*.³⁰ The same is true of post-loss agreements modifying the rights and obligations of the policy.

In *In Re: Katrina*, the Court held that an agreement to subrogate is treat in the same manner as an assignment.³¹ Absent an agreement to the contrary, principals of equitable (i.e. partial) subrogation applies, which incorporates the made whole rule.³² The same is true in most jurisdictions, where the assignment specifically addresses the priority issue.

In the context of subrogated claims, the standard ISO CGL policy generally provides:

If the insured has rights to recover all or a part of any

³⁰See e.g. *In Re: Katrina Canal Breaches Consolidated Litigation*, 601 F.Supp.2d 809 (E.D. La. 2009).

³¹L.R.S. §1827 (2009).

³²*In Re: Katrina*, 601 F.Supp. 2d at 265.

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payment we have made under this Coverage Part, those rights are transferred to us. The insured must do nothing after a loss to impair them. At our request, the Insured will bring “suit” or transfer those rights to use and help us enforce them.

Thus, the policy does not contain a right of reimbursement or priority of recovery. An allocation agreement executed post-loss, which contains *new consideration* (i.e. the advancement of recovery costs) can rectify this problem, while simultaneously controlling most of the areas where your company may be at risk for extrac contractual exposure.

In this regard, an allocation agreement acts as a *novation* (i.e. a “new agreement.”) There are no magic words that need to be used (save and except for the necessary assignment language), although our experience has taught us that there are several essential elements we recommend that you include: Those are:

- A brief recital of facts and loss;
- The policy information;
- A statement that policy terms remain unaltered except as provided in agreement;
- A statement as to amount of insured losses, if known, and *potentially* insured losses for the covered losses that may be paid by the insurer in the future;
- A statement as to the amount of *uninsured* losses sustained by the insured, if known, and potentially uninsured losses that may not be covered or paid by the insurer in the future;
- The consideration for the agreement (i.e. the advancement of all costs associated with prosecution of the suit and the insured has no obligation to reimburse costs and fees in the event the parties do not prevail in the recovery action);
- Identification of joint counsel and rights and responsibilities of counsel in relation to both parties;

- Assignment of all “non personal” (i.e. non-assignable) causes of action to carrier;
- Retention of all personal (i.e. bodily injury) claims by insured and all recovery realized as a result of such claims;
- Retention by insured, if your company agrees, of all sums awarded by way of judgment for punitive or exemplary damages, treble damages, or as a result of other consumer-protection type claims. In cases involving settlements, retention agreement should only be for net amounts in excess of covered losses and litigation expenses;
- Express waiver by insured of right of priority;
- Description of how suit will be prosecuted against responsible third parties (identification of party in control of litigation on particular claims);
- Advancement of interim costs by insurer (part of consideration);
- Agreement by insurer to hold funds in trust upon recovery and to allocate according to agreement;
- Allocation of interim costs upon final resolution (part of consideration being that insured bears no cost absent recovery);
- Allocation of net recovery;
- General boilerplate terms.
- General conditions, including duty to cooperate.

We have attached a copy of a sample allocation agreement (that can be used in the more straightforward cases). Other terms and conditions can be customized for the specific case, and include details related to the retention and storage of evidence, and agreements to determine ultimate allocation following the adjustment of the underlying claim (sometimes the total amount of insured and uninsured losses are not determined until much later). You can even provide for contingent allocation dependent upon the resolution of claim (or claim handling) disputes between the insured and your company, setting aside differences for the purpose of

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jointly prosecuting liability claims efficiently together.

Allocation agreements differ from subrogation receipts in one essential regard. Subrogation receipts do not operate to transfer any more rights than the carrier is entitled to under the policy for the premium that was paid, while post-loss allocation agreements operate (for new and separate consideration given) as an assignment of non-personal claims to the insurer. While the use of allocation agreements cannot totally eliminate potential extracontractual exposure, the risks can be substantially diminished. Coupled with the ability to both maximize the full recovery potential while addressing concerns imposed by the made-whole doctrine, allocation agreements are overall, a sound business practice.