Subrogation of Personal Injury Claims: Toward Ending an Inequitable Practice

INTRODUCTION

Each year, thousands of Americans submit claims to their insurance companies to recover for injuries and illnesses sustained as a result of the negligence or recklessness of others.[1] Tragically, because of insurance limitations and frequently judgment-proof defendants, many of these people achieve little or no relief. Still others achieve some level of satisfaction only to watch as much of their award is consumed by the costs of protracted litigation. With this in mind, this comment addresses the validity and propriety of insurance policy provisions which subrogate[2] an insurer to the personal injury claims of its insured.[3]

I. PREFATORY EXAMPLE[4]

In March of 1988, Billy, an eighteen year old, was injured while riding as a passenger on a motorcycle. As a result, Billy was declared a permanently disabled adult. Fortunately, Billy was the beneficiary of a health and

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1. In 1995, for example, over three million people were injured and thirty-five thousand were killed on America's highways alone. Fifteen hundred of these deaths occurred in Illinois. American Automobile Manufacturers Association, AAMA Motor Vehicle Facts & Figures, 92-93 (1996).

2. Subrogation has been defined as:

> the substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies, or securities. Subrogation denotes the exchange of a third person who has paid a debt in the place of the creditor to whom he has paid it, so that he may exercise against the debtor all the rights which the creditor, if unpaid, might have done. . . . Black's Law Dictionary 1427 (6th ed. 1990) (citations omitted).

3. For an excellent article identifying various problems associated with the extension of subrogation to personal injury cases, and canvassing approaches by different jurisdictions to address such problems, *see* Roger M. Baron, *Subrogation: A Pandora's Box Awaiting Closure*, 41 S.D. L. Rev. 237 (1996).

4. The following prefatory example is based upon In re Estate of Scott, 567 N.E.2d 605 (Ill. App. Ct. 1991). The example illustrates a common situation in which medical payments made by the insurer of an injured, non-negligent insured give rise to a right of subrogation. Note that this case deals with a self-funded plan. Subrogation itself is more palatable in such situations because such plans are likely to include subrogation recoveries in premium computations, unlike in standard insurance situations. *See infra* note 24 and accompanying text.

disability group plan provided by his father's employer, Sundstrand-Sauer. Altogether, Sundstrand paid approximately $200,000 for Billy's injuries pursuant to the plan, which contained a typical subrogation provision entitling the insurer to be reimbursed out of any subsequent action taken by Billy arising out of the accident in question.[5] This amount did not come close to making the disabled young man whole, so his estate brought an action against the motorist who had struck the motorcycle upon which Billy was riding. That suit ended in a settlement for $121,000, the policy limit of the negligent motorist. After paying litigation costs and attorney's fees, Billy's estate was left with only $89,000 from the settlement.

Shortly thereafter, Sundstrand brought an action seeking to recover this $89,000 pursuant to the subrogation provision in the plan, in spite of the fact that Billy's actual damages were between three and five million dollars, and the fact that the previously paid $200,000 was thus clearly inadequate. Should Sundstrand be able to recover the $82,000?[6] Another way of asking the question is, "Who should bear the risk of non-recovery?" Should concepts of public policy militate against allowing an insurer to recover its payments *and* retain any premiums the insured had paid, while the insured is not made whole? These are the fundamental questions which shall be addressed in this article.

First, this article discusses the history of subrogation and its extention, in most jurisdictions, to personal injury claims. It will then describe the harshness that often results when subrogation is so applied, as well as the

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5. The provisions read:

Subrogation, Assignment and Lien. On payments of benefits hereunder as a result of Injury or Illness, the Fund shall be subrogated, to the extent of benefits made or to be made under This Plan, to all the rights of a Covered Individual against any person, firm or organization arising out of such Injury or Illness and the Covered Individual shall execute and deliver instruments and documents and do whatever is necessary to secure such rights to the Fund. The Covered Individual shall do nothing to prejudice such rights. Each Covered Employee hereby assigns to the Trustees of the Fund out of any amounts received or to be received by the Covered Individual as a result of Injury or Illness for which the Covered Individual has a claim against any person, firm or organization to the extent of benefits made or to be made under This Plan. In addition, the Covered Individual hereby grants a lien to the Trustees of the Fund out of any amounts received or to be received by the Covered Individual as a result of Injury or Illness for which the Covered Individual has a claim against any person, firm or organization to the extent of benefits made or to be made under This Plan. *Id.* at 606.

6. The *Scott* court held in the affirmative, ordering all $82,000 be reimbursed to Sundstrand. *Id.* Benefits from the suit against the negligent motorist therefore inured only to Sundstrand and, of course, Billy's attorneys. Despite the inequity of the holding, the court is right but for the wrong reason. *See Id.* at 851 (Reinhard, J., concurring) (noting ERISA preemption of common law principles in employer funded insurance setting and citing *FMC Corp. v. Holliday*, 498 U.S. 52 (1990)).

various approaches that different jurisdictions have adopted to ameliorate such harshness. Special attention will be paid to the approach Illinois courts have taken to protect insureds in such situations, which is essentially limited to an inconsistent application of the "common fund doctrine."[7] Finally, it is proposed that the Illinois General Assembly or Supreme Court reject subrogation in the personal injury context, or limit the applicability of subrogation so that an insurer may only be reimbursed with any excess recovery remaining after the insured is made whole, or at the very least require that insurers provide and make insureds aware of alternative policies, albeit at higher premium prices, which do not contain subrogation clauses.

II. SUBROGATION GENERALLY

The doctrine of subrogation stems from equity, and allows a secondarily liable party who has paid a principal's debt to take advantage of any remedy which the creditor originally held against the principal debtor in order to reimburse such party.[8] Thus, in the insurance context, subrogation puts the insurer in the shoes of the insured, to the extent that the insurer has made payments, to pursue any parties that should in fact have been liable to the insured regarding the loss paid by the insurer.[9] Subrogation allows anyone who pays for another's wrong to look to such other for reimbursement, unless the payor is a mere volunteer.[10] While it has been said that subrogation creates a new right in the subrogee's favor, "the original right [of the subrogor] measures the extent of the new right."[11] Generally, the applicability of the doctrine is said to rely upon "principles of natural justice" and "dictates of equity and good conscience", rather than upon a contract.[12] Since the law of insurance has grown out of the general doctrine of suretyship, it may be helpful to think of a subrogee as a surety, who, after paying a principal's debt, assumes the role of creditor and may seek to force subsequent payment by the principal.[13]

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7. This doctrine concerns who shall be responsible for attorney's fees and costs incurred in subsequent actions against the true tortfeasor. *See infra* part III.

8. WILLIAM R. VANCE & BUIST M. ANDERSON, VANCE ON INSURANCE, § 134 (3d ed. 1951).

9. GEORGE J. COUCH & RONALD A. ANDERSON, 16 COUCH CYCLOPEDIA OF INSURANCE LAW, §61:1 (Mark S. Rhodes ed., rev. 2d ed. 1983) (hereinafter 16 COUCH CYCLOPEDIA).

10. Garrity v. Rural Mut. Ins. Co., 253 N.W.2d 512, 514 (Wis. 1976).

11. *Id.* (quoting 4 WILLISTON ON CONTRACTS, § 1265, at 844 (3d ed. 1967)).

12. 16 COUCH CYCLOPEDIA, *supra* note 9, § 61:20, at 96.

13. VANCE ON INSURANCE, *supra* note 8, § 134, at 787-88. Note that a "surety's right of subrogation does not arise ordinarily until the debtor is paid in full. A partial payment of the debt, even though it may be the full amount for which surety has bound himself, will not entitle him to subrogation to the creditor's rights and securities." *Garrity*, 253 N.W.2d at 514

A. SHOULD SUBROGATION APPLY IN PERSONAL INJURY CASES?

The right to subrogation has been held to arise from the common law, a contract, or by virtue of statute.[14] Thus, commentators speak of a difference between legal or equitable subrogation on the one hand, and conventional or contractual subrogation on the other.[15] Increasingly, insurers have relied upon the latter, both to protect their rights under existing law and to expand the law of subrogation to include application in new areas.[16] One area in which insurance companies have sought to expand the application of subrogation is that of "med-pay" policy provisions for personal injuries suffered by the insured. Under the common law, the doctrine was held not to allow subrogation of personal injury claims,[17] so most jurisdictions initially refused to so extend the doctrine. More recently, however, insurance companies have been quite successful in their efforts to expand subrogation into the personal injury arena.[18] Should this be allowed?

Several states answer this question in the negative. In doing so, courts, particularly in earlier cases, have relied upon the common law prohibitions against splitting a cause of action,[19] and against assigning personal injury

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(citing 4 WILLISTON ON CONTRACTS §1269 (3d ed. 1967)). This analysis would seem to suggest that an insured must be made whole before any excess money need be reimbursed to the insurer. For an example, albeit a muddled one, of an Illinois court acknowledging this principle and reaching such a result, *see* Hardware Dealers Mut. Fire Ins. Co. v. Ross, 262 N.E.2d 618 (Ill. App. Ct. 1970); *but cf. Scott*, 567 N.E.2d at 607 (distinguishing *Ross* on other grounds and reaching a contrary result without discussing the surety analysis).

14. Dworak v. Tempel, 161 N.E.2d 258 (Ill. 1959).

15. 16 COUCH CYCLOPEDIA, *supra* note 9, § 61:2-3, at 75-76. The distinction is only rarely significant, such as where an express contract grants broader rights than the common law of the state would otherwise provide. *Id.* While statutes may give rise to rights for subrogation, the more common situation as far as this article is concerned is the limitation or elimination of otherwise valid subrogation rights by statutes. *See, e.g.*, Va. Code Ann. § 38.1-381.2 (1970)

> No policy or contract of bodily injury or property damage liability insurance that contains any representation by an insurer to pay all reasonable medical expenses incurred for bodily injury caused by accident to the insured or any relative or other person coming within the provisions of the policy, shall be issued or delivered by any insurer licensed in this Commonwealth upon any motor vehicle then principally garaged or principally used in this Commonwealth, if the insurer retains the right of subrogation to recover amounts paid on behalf of an injured person under the provision of the policy from any third party. *Id.*

16. Roger M. Baron, *Subrogation on Medical Expense Claims: The "Double Recovery" Myth and the Feasibility of Anti-Subrogation Laws*, 96 DICK. L. REV. 581, 583 (1992).

17. *See* VANCE ON INSURANCE, *see supra* note 8, §134, at 796-97.

18. Baron, *supra* note 16, at 583.

19. *See, e.g.*, Lowder v. Oklahoma Farm Bureau Mut. Ins. Co., 436 P.2d 654 (Okla. 1967).

claims.[20] The latter prohibition is frequently cited by courts refusing to extend subrogation. Reasons for the prohibition against assignment of personal injury claims were cited by the Connecticut Supreme Court in *Berlinski v. Ovellette*[21]. These included: (1) to discourage "unscrupulous interlopers" from purchasing pain and suffering claims and pursuing remedies pursuant thereto, in a champertous fashion; (2) out of recognition that personal injuries are by their nature too personal to be assigned; (3) out of recognition that tortfeasors should not be held liable to persons that they did not harm; (4) to reduce "excessive litigation"; and (5) out of recognition that subrogation arrangements may prejudice the ability of the insured to receive full compensation for his or her injuries.[22] The court went on to state that for these reasons a cause of action for personal injury cannot be assigned absent a statute to the contrary.[23]

On the other hand, some states have rejected the common law prohibition on various grounds. For example, the Supreme Court of Rhode Island, after pointing out the need for widely available hospitalization insurance, rejected the prohibition against assignment of personal injury claims, as far as subrogation is concerned, out of a hope of reducing insurance premium rates.[24] Other courts have gotten around the problem by similarly holding that the subrogation setting provides an exception to the assignment prohibition,[25] or by conveniently holding that subrogation is not an assignment at all, but merely a device giving rise to some lesser right of reimbursement, or an equitable lien.[26]

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20. *See, e.g.*, Travelers Indem. Co. v. Chumbley, 394 S.W.2d 418 (Mo. App. Ct. 1965).

21. 325 A.2d 239 (Conn. 1973).

22. *Id.* at 242.

23. *Id.* at 241 (citing 6 AM. JUR. 2d 220, *Assignments*, § 37).

24. Hospital Service Corp. v. Pennsylvania Ins. Co., 227 A.2d 105, 110 (R.I. 1967). *But see* PATTERSON, ESSENTIALS OF INSURANCE LAW, 151-52 (2d ed. 1957) (stating "subrogation is a windfall to the insurer. It plays no part in the rate schedules (or only a minor one).").

25. *See, e.g.*, Jacobson v. State Farm Mut. Auto. Ins. Co., 491 P.2d 168 (N.M. 1971).

26. *See, e.g.*, Damhesel v. Hardware Dealers Mut. Fire Ins. Co., 209 N.E.2d 876 (Ill. App. Ct. 1965) (holding that subrogated rights were not assigned). This conclusion was necessary for the court to enforce the subrogation provision since Illinois still recognizes that personal injury claims cannot be assigned. *See, e.g.*, Putnam v. Continental Air Transp. Co., 297 F.2d 501 (7th Cir. 1971); *see also* Town & Country Bank v. Country Mut. Ins. Co., 459 N.E.2d 639 (Ill. App. Ct. 1984). Other states have expressly rejected attempts to characterize the subrogation of an insured's rights as anything other than an assignment, holding that an assignment of a personal injury claim, by any other name, smells as bad. *See, e.g.*, Allstate Ins. Co. v. Druke, 576 P.2d 489, 492 (Ariz. 1978) (rejecting the argument that a mere reimbursement right was created and stating that "[w]hatever the form, whatever the label, whatever the theory, the result is the same."); *see also* Berlinski v. Ovellette, 325 A.2d 239, 242 (Conn. 1973) (the court rejected an argument that right of reimbursement stemmed from

In recent years, new criticisms have emerged. These criticisms have been based not upon alleged violations of common law precepts, but upon the faulty reasoning upon which the doctrine of subrogation is based, and the harsh consequences it often effectuates.[27] Subrogation is said to be founded upon the idea that it is proper to prevent an insured from achieving a double recovery for his or her loss, one recovery being from the insured, the other from the tortfeasor.[28] Arguably, this seems fair, but only in an ideal situation. For example, if an insurer makes a $10,000 payment to its insured, an automobile accident victim, and this fully compensates the victim, and the insurer subsequently brings an action against the tortfeasor pursuant to the insurer's subrogation rights and in fact secures a judgment or settlement for $10,000, then all ends well. The insurer and the insured are both made whole and the tortfeasor is out $10,000, the amount of loss caused by that person.

The problem arises, however, where an insured's losses far exceed the amounts that can be recovered from a tortfeasor plus what can be claimed under medical payments provisions of the injured person's own insurance policy.[29] This is so because the insured's policy usually contains limits and thus does not provide full indemnity,[30] or because the tortfeasor has limited assets, insurance, or is otherwise judgment proof,[31] or both. In such situations, it has been held that "it violates public policy to allow an insurer to collect a premium for certain coverage and then allow the insurer to subrogate its interest and deny the insured its benefits."[32]

Thus, courts have held that even when there is a recovery beyond the total loss, subrogation is not proper. This makes sense if one considers the nature of insurance premiums. Insurance companies, based upon actuarial statistics, essentially distribute the losses incurred by a few persons evenly to a large number of persons who face similar risks. This is done by creating a fund through the collection of premiums from each member of this large group of insureds. These premiums themselves are calculated based

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a "trust agreement" rather than a prohibited assignment).

27. *See, e.g.*, Baron, *supra* note 3, at 238-39. Baron actually calls into question any situation in which an insurer is subrogated to the rights of its insured to proceed against the party who caused the loss, whether such rights arise out of property damage or personal injury loss. This article is sympathetic but deals solely with the personal injury context.

28. *Id. See also* 16 COUCH CYCLOPEDIA, *supra* note 9, § 61:18.

29. *See, e.g., Scott, supra* note 4 and accompanying text.

30. Allstate Ins. Co. v. Druke, 576 P.2d 489, 491 (Ariz. 1978).

31. Maxwell v. Allstate Ins. Co., 728 P.2d 812, 815 (Nev. 1986).

32. *Id.* at 815. The court went on to cite Allstate Ins. Co. v. Reitler, 628 P.2d 667, 670 (Mont. 1981) in stating that "precluding the subrogation of the insurer does not result in a double recovery for the insured because the insured is merely receiving the benefits for which he has already paid." *See generally* Baron, *supra* note 16.

upon the losses actually incurred, adjusted, of course, to allow the company to pay its costs and make a profit. What is important to note is that the premiums are based upon losses alone, and do not take subrogation recoveries into account.[33] Thus, an insured is arguably paying for absolute indemnity, regardless of subsequent recoveries, but is receiving a limited, conditional indemnity, which is worth significantly less. Further, where the insured is made whole through suit against or settlement with the tortfeasor, that insured ends up in a worse position than an uninsured who is fully compensated by the tortfeasor, since the insured has had to pay premiums.[34]

An additional criticism was lodged by the Oklahoma Supreme Court in *Aetna Casualty and Surety Co. v. State Board for Property and Casualty Rates*,[35] where the court stated that subrogation was inapplicable in the personal injury context, because there "the exact loss is never totally capable of ascertainment," and thus "the reasons militating against double recovery do not obtain."[36] In other words, since the insured's loss is not measured by medical bills alone, but also includes pain and suffering and other intangibles,[37] then even where the sum of payments received from the insurer and funds obtained by way of settlement or judgment against the tortfeasor exceed the total demonstrable loss (i.e., medical specials), it cannot rightly be called a double recovery.

One final criticism concerns the role of the insured's attorney. The subrogation agreement may require an attorney to simultaneously represent both the client and the client's insurer while working for satisfaction against the tortfeasor. Since the insurer's interest as to the amount and structure of any recovery (settlement or judgment) will invariably differ in significant ways from the interests of the insured, the attorney may be subject to conflict of interest problems.[38]

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33. *See supra* note 24.

34. *Druke*, 576 P.2d at 492 (Ariz. 1978) (the court stated that allowing an insurer to subrogate itself to the personal injury claims of its insured after having charged the insured premiums denied the insured "of his thrift and foresight.").

35. 637 P.2d 1251, 1255 (Okla. 1981) (the criticism was lodged in dicta, as the outcome of the case was ultimately controlled by a statute expressly forbidding subrogation to rights of injured persons pursuant to automobile insurance policies).

36. *Id.*

37. *See Druke*, 576 P.2d at 492, where the court stated:

> [i]n addition to other 'out-of-pocket' losses, such as loss of income or earning power and the costs of asserting said claim such as court costs and attorney's fees, an accident victim often suffers non-economic losses such as physical pain and mental anguish which are often not monetarily indemnifiable and never insurable.

Id.

38. *See generally* Thomas S. Brown & M. Jane Goode, *Conflicts of Interest in Subrogation Actions*, 22 TORT & INS. L.J. 16 (1986) (an article that addresses conflicts for the benefit of the practitioner).

The current state of the law in Illinois is clear. In spite of the fact that Illinois maintains the common law prohibition against assigning personal injury claims, the subrogation situation is held not to give rise to an assignment.[39] An examination of the reasoning of several key decisions reveals that the logic supporting this proposition is faulty. "Subrogation presupposes an actual payment and satisfaction of the debt or claim to which the party is subrogated . . . [and] operates only to secure contribution and indemnity . . ."[40] This is often not the case. In an automobile accident, there is a significant chance that the tortfeasor will have policy limits on his liability insurance that are similar to the victim's, or that the tortfeasor is underinsured or uninsured. Unless the tortfeasor is independently wealthy, there will in such cases be no "actual payment and satisfaction of the debt", and subrogation works an injustice on the injured party.

B. HOW SHOULD RECOVERIES BE DISTRIBUTED?

Even if subrogation should apply within the personal injury context, there is still the question of how subsequent recoveries from tortfeasors should be distributed. As noted by a number of commentators, there are essentially five ways in which such recoveries may be apportioned: (1) by giving all of the recovery to the insurer regardless of whether this exceeds the amount of payments made by the insurer (this is the result of a true assignment of the insured's rights); (2) by giving the insurer first priority to be compensated, up to the amount of payments previously made by the insurer, and then giving any excess to the insured (insurer whole); (3) by giving the insured priority, and only reimbursing the insurer out of money remaining when the insured has been made whole (insured whole); (4) by refusing to apply subrogation and allowing the insured to keep the entire recovery, even where this recovery, when combined with payments already received from the insurer, is in excess of the insured's loss; and (5) by apportioning the recovery according to some proration, based upon the ratio of losses facing the insured and insurer, respectively, or some other formula.[41] The real

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39. *See supra* note 26 and accompanying text. Note that Illinois does allow the assignment of choses of action, even where they arise from claims of a personal nature. 735 ILCS 5/2-403 (1993).

40. *Damhesel*, 209 N.E.2d at 878; *see also* Remsen v. Midway Liquors, Inc., 174 N.E.2d 7, 12 (Ill. App. Ct. 1961).

41. *See* Elaine M. Rinaldi, *Apportionment of Recovery Between Insured and Insurer in a Subrogation Case*, 29 TORT & INS. L.J. 803, 805-06 (1994) (CITING ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW, § 3.10 (c)(2), at 160-62 (1971)). *See also* Baron, *Supra* note 3, at 247-55.

debate in the case law is between the "insurer whole" doctrine, number two above, and the "insured whole" doctrine, number three above.[42]

A majority of jurisdictions have adopted the "insured whole" doctrine.[43] The rationale behind this doctrine is that where either the insured or the insurer must bear a loss due to the fault of some third party, the insurer should bear the loss since it has been paid to assume such a risk.[44] Cases employing the "insured whole" doctrine frequently rely by way of analogy on the reasoning of the United States Supreme Court's decision in *American Surety Co. v. Westinghouse Electric Manufacturing Co.*[45] In *Westinghouse*, the principal was a contractor who, after completing his work pursuant to a government contract, received ninety percent of his pay, but subsequently failed to pay his suppliers and sub-contractors. These "creditors" made demands upon the contractor's surety, who consequently paid a sum into court to the extent of its legal obligation, but this sum was insufficient to fully pay all of the creditors owed. Later, the ten percent which had not been paid to the contractor became available for distribution, and the creditors and surety brought conflicting claims for such money, each claiming priority. The Court held that the creditors' rights to have their debts paid had priority over the surety's right to reimbursement. In so holding, the Court stated, "[a] surety who has undertaken to pay the creditors of the principal, though not beyond a stated limit, may not share in the assets of the principal by reason of such payment until the debts thus partially protected have been satisfied in full."[46] Judges and commentators alike have concluded that this reasoning applies in the insurance setting.[47]

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42. *See* Rinaldi, *supra* note 41, at 806 & n.15. The "insured whole" doctrine is the practical result in jurisdictions where the subrogation of personal injury claims, whether pursuant to legal or contractual subrogation, is prohibited. *See, e.g., Druke*, 576 P.2d 489.

43. Rinaldi, *supra* note 41, at 807. Note that Rinaldi lists Illinois among the jurisdictions that have adopted this doctrine, and cites *Ross*, 262 N.E.2d 618, for that proposition. While *Ross* supports this contention, later Illinois cases are inconsistent with that case. *See, e.g., Scott*, 567 N.E.2d 605 (*supra* notes 3-5 and accompanying text); *see also* Capitol Indem. Corp. v. Strike Zone, S.S.B. & B., 646 N.E.2d 310 (Ill. App. Ct. 1995) (the court, relying upon *Scott*, allowed subrogation where the insured had not been made whole).

44. Skauge v. Mountain States Tel. & Tel. Co., 565 P.2d 628, 632 (Mont. 1977); *see also* St. Paul Fire & Marine Ins. Co. v. W. P. Rose Supply Co., 198 S.E.2d 482, 484 (N.C. Ct. App. 1973); *Garrity*, 253 N.W.2d at 514.

45. 296 U.S. 133 (1935). This case concerns a contractor's surety, which stands in an analogous position to the insurance company in an accident case, except that a surety has a contractual relationship with the principal, whereas there is no such relationship between an insurer and a third party tortfeasor.

46. *Id.* at 137.

47. *See, e.g.*, VANCE ON INSURANCE, *supra* note 8, § 134, at 790, where it is stated "the owner of the destroyed property is entitled to full indemnity and the doctrine of subrogation will not be applied in any case so as to deprive him of this right"; *see also Garrity*, 253 N.W.2d at 514 (quoting 4 Williston on Contracts, § 1269, 1273 (3d ed. 1967) and stating that

Other jurisdictions, however, have rejected this reasoning and have adopted the "insurer whole" doctrine, at least where specific contractual language calls for such a result. Perhaps the most frequently cited case in favor of the "insurer whole" doctrine is *Peterson v. Ohio Farmers Insurance Co.*[48] In that case, Peterson, the insured, suffered a $17,000 loss due to a fire at his farm which damaged certain buildings. He received $7,800 from his insurer. Peterson and the insurer then brought an action against the tortfeasor, which resulted in an $11,000 verdict. A dispute as to how to apportion this $11,000 gave rise to a second suit. The trial court awarded Peterson enough to cover his entire loss, and gave the excess to the insurer (the "insured whole" approach), but the appellate court reversed, reimbursing the insurer to the extent of the $7,800 payment, and giving Peterson only the remainder. The Ohio Supreme Court affirmed the appellate court, relying upon the language of the policy as well as the wording of a "subrogation receipt", signed by the insured at the time the $7800 payment was initially made, and stated that "[t]he assignee, being the owner of all the insured's right of recovery, must have priority in payment out of the funds recovered."[49]

It is important to note that in *Peterson*, as in other "insurer whole" cases, the key to whether or not that doctrine will be applied lies in the language of the particular subrogation provision in question. Thus, a different result may obtain where only legal subrogation is at issue. One commentator applauded this distinction, suggesting that the important "insured whole" cases had reached "untenable" results by improperly ignoring the nature of the subrogation contracts before them and making their decisions as though only legal subrogation was at issue.[50]

At least one Illinois court has agreed. In *Capitol Indemnity Corp. v. Strike Zone, S.S.B. & B.*,[51] the court held that where a subrogation agreement is valid and enforceable, then the terms of the agreement, not equities or common law precepts, control the result.[52] But other Illinois

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the "surety's right of subrogation does not arise ordinarily until the debt is paid in full.").

48. 191 N.E.2d 157 (Ohio 1963).

49. *Id.* at 159. Thus the court distinguished its earlier holding in Newcomb v. Cincinnati Ins. Co., 22 Ohio St. 382 (1872), which had stood for the "insured whole" principle. The *Peterson* court essentially limited the *Newcomb* holding to cases involving legal subrogation. *Peterson*, 191 N.E.2d at 159. In this day of modern insurance contracts, such cases will be few indeed.

50. Rinaldi, *supra* note 41, at 811.

51. 646 N.E.2d 310, 311-12 (Ill. App. Ct. 1995).

52. *Id.* This holding is curious in light of the fact that the opinion cited Village of Crainville v. Argonaut Ins. Co., 410 N.E.2d 5, 7 (Ill. 1980) for the proposition that "[w]here subrogation arises from contract, those rights will not be recognized where the debt on which the right of subrogation is based has not been paid." Perhaps the court read "debt" in this

cases addressing the question of who to "make whole" have divided.[53] The Illinois legislature, on the other hand, has adopted a clear public policy goal of assisting accident victims in their efforts to be made whole, as evidenced by laws mandating that every vehicle driven in the state carry liability insurance protection,[54] and by requiring all policies sold in the state to contain uninsured motorist provisions.[55] These statutes reveal a legislative recognition that in the event that a loss must be borne by some innocent party, it makes sense to place that loss with the party who can best afford it, particularly where that party was paid to assume the risk of just such a loss.

C. WHAT EFFECT SHOULD A CONTRACT HAVE?

Judicial decisions refusing to allow subrogation in the personal injury context, and decisions adopting the "insured whole" doctrine are based upon equity principles and notions of public policy. Also, any anti-subrogation legislation would have a similar public policy basis. One powerful argument against either is that parties should be able to contract freely, to bargain for specific provisions and to pay accordingly, without unnecessary meddling by the courts. Indeed, this is the main argument in support of the "insurer whole" doctrine.[56] Thus one Illinois court, refusing to adopt an "insured whole" position, stated that to do so would "upset the settled expectations of the parties as reflected in the policy of insurance by overlaying inapplicable equitable principles which contravene the contract terms and forge a new agreement between the parties."[57]

It is true that for a brief period in American jurisprudential history the right to contract was held to be a Constitutionally fundamental right worthy of substantive due process protections.[58] Since that time, however, the Supreme Court has reversed its position, so that the economic substantive due

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sentence to mean the limited debt owed by the insured under the policy in the first instance, instead of the whole debt owed by the tortfeasor.

53. *See supra* note 43 and accompanying text.

54. 625 ILL. COMP. STAT. ANN. 5/7-601 (a) (West 1993).

55. 215 ILL. COMP. STAT. ANN. 5/143 (a) (West 1993).

56. *See* notes 48-53 and accompanying text. As such, "insurer whole" is probably a misnomer, since the courts would likely construe insurance contracts literally whether the provisions granted the insured's rights priority, or the insurer's rights. "Insurer whole" will suffice, however, since insurance companies do the drafting of these agreements and it is quite unlikely that they will ever be written to benefit the insured to the detriment of the insurer.

57. Capitol Indem. Corp. v. Strike Zone S.S.B. & B. Corp., 646 N.E.2d 310, 312 (Ill. App. Ct. 1995).

58. *See, e.g.*, Lochner v. New York, 198 U.S. 45 (1905) (the Court recognized a Constitutionally protected right to contract while invalidating a law limiting the number of hours employees in a bakery could work).

process cases of the early part of this century are now vilified and rejected.[59] Thus, the right to contract is not inviolate, and must give way to concerns of public policy.

That is the state of the law under the Illinois Constitution as well. As the Illinois Supreme Court said in *Memorial Gardens Association, Inc. v. Smith*:

> While rights of contract are favored and protected there is no principle of absolute freedom of contract. It is a qualified right and the State may, in its legitimate exercise of police power, pass laws which limit or affect the right of contract so long as those regulations are reasonably necessary to secure the health, safety, morals or general welfare of the community.[60]

Because of this, the "right of contract" argument does not effectively challenge the validity of anti-subrogation legislation passed pursuant to the legitimate police power objective of protecting the health of citizens.

That is not to suggest that only the legislature may define public policies which will void a contract. A court may of its own accord refuse to enforce contracts which violate public policy, as that term is defined by the common law of the jurisdiction.[61] For example, in Illinois a contract exempting persons from liability for negligent conduct may be held void where the transaction has a "semi-public" nature and there is a special social relationship involved.[62]

Another point to keep in mind concerning the weight that should be afforded these insurance agreements is the relative bargaining position of the parties to the contract. While insurance companies hire teams of lawyers to draft policies, the average policyholder is not sophisticated enough to define "subrogation", much less identify how a subrogation provision will affect some future recovery that the insured might otherwise be entitled to. While one might crassly respond that people should "read what they sign" and "hire a lawyer," it should be kept in mind that this is an unrealistic expectation under the circumstances, and at any rate the true disparity in bargaining position is something that should be considered since the insurer is asking for an equitable remedy.

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59. *See, e.g.*, Olsen v. Nebraska, 313 U.S. 236 (1941) (the Court upheld a state law fixing maximum employment agency fees).

60. 156 N.E.2d 587, 595 (Ill. 1959) (citing City of Chicago v. Chicago & N.W. Ry. Co., 122 N.E.2d 553 (Ill. 1954)).

61. *See* 17A AM. JUR. 2D *Contracts* § 257 (1991).

62. *See* Checkley v. Illinois Cent. R.R., 100 N.E. 942, 943 (Ill. 1913).

Particularly distressing in this regard is the reliance in some cases on "subrogation receipts,"[63] which are agreements signed by the insured after a loss has occurred and when a draft is cut by the insurer. It is clearly unconscionable to enforce a contract under such circumstances. The insured has recently suffered a loss, and probably incurred significant debts as a result. These debts, if unpaid, invariably lead to letters from hospitals, or perhaps the family physician, demanding payment, or later, angry letters from collection agencies that refuse to understand or sympathize with the insured's situation. It is troubling that in such circumstances insurers make it seem as though the payments which they are otherwise legally obligated to pay under the terms of the policy are conditional on the insured's signing an additional promise to subrogate. These agreements at best magnify the disparity of bargaining position, and at worst amount to contracts made under duress. Either way, they should not be enforced.

III. ATTORNEY'S FEES, COSTS, AND THE COMMON FUND DOCTRINE

In jurisdictions which allow insurers to subrogate themselves to the personal injury claims of their insureds, an additional question arises concerning who should pay the costs that arise in pursuing a settlement or judgment against the person who caused the loss. In the "insured whole" context, the question is merely whether reimbursment of such costs is a necessary component of making the insured whole. The Supreme Court of Michigan has held in the affirmative,[64] and this should not be a surprising result in jurisdictions which focus on making the insured whole and placing the risk of any loss on the insurer. On the other hand, the insurer may successfully argue that litigation costs were not the sort of risk it had agreed to accept. The question is raised here, but left unresolved for future study.[65]

In Illinois, however, the question of who pays such costs is addressed through the application of the common fund doctrine.[66] Generally speaking, the fund doctrine is an equitable doctrine which allows an individual who is responsible for generating or preserving a fund to be compensated for his services from those who benefit from such a fund.[67]

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63. *See, e.g., Peterson*, 191 N.E.2d at 159.

64. Washtenaw Mut. Fire Ins. Co. v. Budd, 175 N.W. 231, 233 (Mich. 1919).

65. Bear in mind that this is only important in those cases where recovery from a tortfeasor is enough to compensate the insured for personal injury damages but not enough to additionally cover attorney's fees and other costs.

66. For an article discussing in greater detail the treatment of the fund doctrine in Illinois, *see* Robert J. Thompson, *The Common Fund Doctrine: An Uncommonly Used Precept in Personal Injury Cases*, 84 ILL. B.J. 570 (1996).

67. *See* 7A C.J.S. *Attorney and Client* § 334 (1980).

The doctrine is ultimately based upon the notion that to allow individuals to benefit from such a fund without contributing to the costs of its creation would be to allow unjust enrichment.[68] Some decisions refer to the existence of a quasi-contract or fiduciary status between the benefactor and the beneficiaries.[69] For our purposes, the practical effect of the doctrine is to require an insurer to pay some part of the costs of pursuing the tortfeasor, since the insurer stands to gain thereby.[70]

The United States Supreme Court adopted the doctrine in *Trustees v. Greenough*,[71] where a man named Vose, a holder of bonds on the Florida Railroad Company, brought suit on behalf of himself and the other bondholders against the trustees of a fund which was pledged for the payment of interest on the bonds and for payments of the principal. He alleged that the trustees were wasting the fund. Terming Vose a "trustee in relation to the common interest,"[72] the Court held that Vose was entitled to recover his "reasonable costs, counsel fees, charges, and expenses incurred in the fair prosecution of the suit . . . ."[73]

Three years later, the Court extended the doctrine to allow attorneys themselves, as opposed to their clients, to bring an action to recover from the fund, in spite of the fact that such attorneys had already been fully paid under whatever contract they had with their clients.[74] The rationale for

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68. *Id.*; *See* Trustees v. Greenough, 105 U.S. 527 (1881); McGee v. Oldham, 642 N.E.2d 196, 198 (Ill. App. Ct. 1994).

69. *See Greenough*, 105 U.S. at 532 (the Court said that the benefactor "at least acted the part of a trustee . . .").

This quasi-contract approach poses possible conflict of interest problems for an attorney who cannot represent adverse interests. The Illinois Supreme Court has responded that as far as the creation of the fund is concerned, the client and the other beneficiaries are not adverse litigants in that they have the same common interest in creating the fund from which they will both benefit. Baier v. State Farm Ins. Co., 361 N.E.2d 1100, 1103 (Ill. 1977). This response seems to ignore the fact that it is not necessarily the amount, but the structure of the award that may be a point of contention between an insurer and its insured. For example, an insured will seek to gain a settlement which pays more for the consortium claims of a spouse, or more for pain and suffering, since such recoveries may not be subject to subrogation.

70. Typically, the insurance company would be required to pay a contingent fee based on the portion of the award that went to the insurer by way of subrogation. Thus, where the company had made $6000 in med-payments, after which the insured successfully brought suit against the tortfeasor without any assistance from the company, then the doctrine would allow the insured's attorney to deduct attorney fees from the $6000 portion of the recovery that would go to the company. Usually, this would be one-third, or in this case $2000. Other methods besides contingency arrangements have been utilized. *See* Monique Lapointe, Note, *Attorney's Fees in Common Fund Actions*, 59 FORDHAM L. REV. 843 (1991).

71. 105 U.S. 527.

72. *Id.* at 532.

73. *Id.* at 537-38.

74. Central R. & Banking Co. v. Pettus, 113 U.S. 116 (1885).

allowing attorneys to bring the action is quite different from that for allowing clients to do so, since an attorney who is paid by a client suffers no loss that equity would normally seek to compensate. At least one commentator has criticized the decision as creating an indefensible right of an attorney "to an extra award so that he might share in the wealth of strangers."[75]

Illinois cases have limited the applicability of the fund doctrine, at least in the personal injury context,[76] to cases involving insurance subrogation.[77] These cases require an "express agreement between the insured and insurer, subrogating the insurer to any claim the insured had against a third party . . ."[78] In order for a plaintiff to prove a case for the applicability of the fund doctrine, Illinois courts have required: (1) that the fund was created "as a result of legal services" performed by plaintiff's attorney; (2) that the insurer/subrogee "did not participate in the creation of the fund"; and (3) that the insurer/subrogee "benefitted from the fund."[79] The courts have also "recognized that the fund doctrine should be used with caution."[80] Further, the applicability of the doctrine is precluded where the services "have been knowingly rendered for an unwilling recipient."[81] These general rules form the basis of the law as applied throughout the state.

Much of the case law is dedicated to fleshing out this skeletal paradigm, but the courts have not consistently approached one area of inquiry in this regard: What sort of participation is needed on the part of the subrogee to preclude application of the doctrine, or asked another way, how does a subrogee establish that it is an unwilling recipient? The Illinois Supreme Court has so far declined invitation to provide definitive standards

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75. John P. Dawson, *Lawyers & Involuntary Clients: Attorney Fees from Funds*, 87 Harv. L. Rev. 1597, 1603 (1974).

76. The fund doctrine is applied in other contexts, for instance, class actions. *See* Ferdinand S. Tinio, Annotation, *Attorney's Fees in Class Actions*, 38 A.L.R.3d 1384 (1971).

77. *See* Boehm and Weinstein, Chtd. v. City of Chicago, 379 N.E.2d 4 (Ill. App. Ct. 1978). The court held that where a plaintiff's employer held a lien for plaintiff's medical expenses, and where this lien was ultimately paid out of the proceeds of a settlement of the plaintiff's action against a tortfeasor, the fund doctrine did not apply.

See also Maynard v. Parker, 369 N.E.2d 352 (Ill. App. Ct. 1977) (*aff'd* 387 N.E.2d 298 (Ill. 1979)), where the doctrine was not applied to a situation in which a hospital had a lien against a plaintiff's personal injury claim, and where the lien was satisfied out of funds derived from a settlement of that claim. *Id.* at 355.

78. Powell v. Inghram, 453 N.E.2d 1163, 66 (Ill. App. Ct. 1983).

79. McGee v. Oldham, 642 N.E.2d 196, 198; *accord* Perez v. Kujawa, 602 N.E.2d 38, 40 (Ill. App. Ct. 1992); Tenney v. American Family Mut. Ins. Co., 470 N.E.2d 6, 7 (Ill. App. Ct. 1984)(citing Smith v. Marzolf, 400 N.E.2d 949, 953 (Ill. App. Ct. 1980)).

80. *Tenney*, 470 N.E.2d at 8; *see also Powell*, 453 N.E.2d at 1166.

81. Pope v. Speiser, 130 N.E.2d 507 (Ill. 1955); *see also* Brase v. Loempker, 642 N.E.2d 202, 205 (Ill. App. Ct. 1994).

in this regard.[82] Instead, the courts have adopted a case-by-case approach.[83] The case that is invariably relied upon by insurance companies, however, is *Tenney v. American Family Mutual Automobile Insurance Co.*[84] The opinion in *Tenney* suggests that an insurer needs to do little beyond mailing a letter indicating that the insurer is an unwilling recipient of the attorney's services to avoid any responsibility for fees and other litigation costs incurred. This approach, however, allows an insurer to sit back and wait while the insured incurs significant expenses in pursuit of the tortfeasor, only to demand payment once satisfaction against the tortfeasor is achieved.

Other decisions have demanded more, however.[85] The case law is not at all consistent in this area, but those cases which have required more from the insurer have focused upon the timing of the letter in relation to the filing of the suit, and the language of the letter itself.[86] The timing of the letter is arguably important, because prompt notification to the insured's attorney that fees from the insurer will not be forthcoming, if received before the attorney has incurred large expenses, may materially affect litigation strategy. As to the language of the letter, however, this is mere form over substance, and results in insurers stumbling about, looking for the "magic words" that will preclude the doctrine.

At any rate, even where an insured can overcome the substantial obstacles described above in order to see the fund doctrine applied, the positive effect will in most cases be negligible.[87] Much of the benefit will be absorbed by the attorney.[88] Additionally, since the insurers are aware

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82. *See* Baier v. State Farm Ins. Co., 361 N.E.2d 1100, 1103 (Ill. 1977), where the Court rejected the invitation to set "appropriate guidelines" to govern fund doctrine cases as this would "require the decision of questions not presented on this record . . . which might arise upon remand . . . ." The defendant, who extended the invitation, pointed to State Farm Mut. Auto. Ins. Co. v. Geline, 179 N.W.2d 815 (Wis. 1970), where the Wisconsin Supreme Court had promulgated certain guidelines.

83. *See Brase*, 642 N.E.2d at 205; *cf. Perez*, 602 N.E.2d at 41 ("under the circumstances of this case, as in *Tenney*, it would be equitable to apply the fund doctrine").

84. 470 N.E.2d 6 (Ill. App. Ct. 1984).

85. *See, e.g., Powell*, 453 N.E.2d at 1166 (a letter was held insufficient evidence of unwilling recipiency).

86. *See Perez*, 602 N.E.2d at 41 (the doctrine was not applied where an insurer promptly and "unequivocally advised plaintiffs and their attorneys . . . of its intention to pursue its own subrogation lien . . . ."); *see also* Meyers v. Hablutzel, 603 N.E.2d 91, 94 (Ill. App. Ct. 1992) (stated that where the letter is sent prior to suit being filed, the doctrine will be precluded).

87. Baron, *supra* note 3, at 257 ("there is no consideration given to the windfall nature of the subrogated recovery to the insurer, nor to whether the insured is 'made whole' or fully compensated. It is minimal relief at best.").

88. *But see, generally,* Thompson, *supra* note 66. Thompson suggests that an attorney should use the fund doctrine to help clients achieve a better recovery. *Id.* at 573. In its pure

that the case law is inconsistent and often turns on subtle factual distinctions, it is in their interest to press the issue in every case, since many fees will not be worth litigating over. The result is an environment in which attorneys and insurers "split the difference," so that the insurer pays some lesser percentage for fees on its portion, further reducing the beneficial effect of the doctrine for the injured party.

IV. PROPOSALS

As has been said, Illinois allows the subrogation of personal injury claims. Because the law is quite developed on this point, it is probably too late in the day for the courts to hold otherwise. It is not too late, however, for the General Assembly to reevaluate the approach, and to legislatively adopt a prohibition, at least in the context of automobile insurance, against this sort of subrogation. Such legislation would be in keeping with the public policy goal of protecting the health of persons within the state by affording them opportunities to obtain relief when injured. This policy was manifested in the passing of the uninsured/underinsured laws,[89] laws which arguably burdened insurance companies, but were necessary for the greater public good. Similarly, the legislature should consider legislation prohibiting the sale or delivery in this state of any motor vehicle insurance policy which contains a provision purporting to subrogate the insurer to any personal injury claims its insured might possess.[90]

This would be a departure from Illinois law. A more conservative approach may be to require that the issuing or re-issuing of any policy for insurance in this state be accompanied by an offer to sell the insured, albeit at a somewhat higher price, insurance that does not contain provisions purporting to subrogate the insurer to the personal injury claims of the insured. Such

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application, this is the practical result. Instead of paying in attorney's fees one third the entire amount of the recovery before distribution to the insurer, the insured only pays one third of the portion the insured receives after such distribution. Again, consider the example where an insurance company pays $6000 in medical bills on behalf of its own insured. Assume the insured then hires an attorney, and recovers $12,000 from the tortfeasor. Under the fund doctrine, the company would be reimbursed its $6000 less one third for attorney fees (or $4000). The insured would receive the same amount. Without the common fund doctrine, the company would recover the full $6000. The insured would have to pay all of the fees (here $4000 or one third of $12,000) out of the insured's portion of the recovery. The insured would be left with only $2000. Often, however, attorneys do not require that their clients pay any fee on the portion of the recovery that goes to the insurer, whether or not the doctrine is applied. Thus the fund doctrine becomes a tool to enrich lawyers, but makes no practical difference to clients.

89. 215 ILL. COMP. STAT. ANN. 5/143 (a), (a-2) (West 1993).

90. *See* COUCH CYCLOPEDIA, *supra* note 15 for an example of a Virginia statute that accomplishes this task.

a law would require that the insured be informed generally of the nature of the provision, and have the opportunity to expressly reject such a subrogation-free policy. This would mirror the existing approach to the availability of underinsured coverage, which must be offered, and further must be specifically rejected by the insured or else automatically be provided in the policy.[91]

The Illinois Supreme Court, for its part, should recognize the strong public policy of ensuring that injured persons have every opportunity to be made whole. Considering the Illinois precedent allowing subrogation of personal injury claims, it is too late in the day to expect the Court to rule to the contrary. The Court should, however, realize the limitations of the fund doctrine toward making injured persons whole, and recognize the disparity in the case law regarding whether Illinois is an "insured whole" or "insurer whole" jurisdiction. The Court is in a position to resolve this dispute, and should take advantage of the next opportunity to reject decisions such as *Strike Zone*[92] and instead adopt the "insured whole" approach adopted by *Ross*.[93] The results would be more equitable for the people of this state.

CONCLUSION

The current state of subrogation law in Illinois works to disadvantage injured persons, like Billy's[94] damages may go uncompensated. In many cases, insurers who were paid to assume the risk of loss are themselves made whole by subrogation while their insureds are not made whole. This is inequitable since the insurer has agreed to assume the risk of nonrecovery, and has been paid for this. Finally, the inconsistent application of the fund doctrine does little to help injured persons, and, in fact, chiefly benefits attorneys. Action needs to be taken to reshape the law of this state to bring it into conformity with the public policy goals of making injured persons whole and empowering them to receive the benefits of their insurance bargains.

KEITH E. EDEUS, JR.

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91. 215 ILL. COMP. STAT. ANN. 5/143 (a), (a-2) (West 1993).
92. *Strike Zone*, 646 N.E.2d 310; *see supra* note 51 and accompanying text.
93. *Ross*, 262 N.E.2d 618; *see supra* note 43 and accompanying text.
94. *See supra* notes 3-