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Insurance - Right Of Insurer To Subrogate To Collateral Contract Rights Of The Insured - In The Matter Of Future Manufacturing Cooperative, Inc.

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Insurance — Right Of Insurer To Subrogate To Collateral Contract Rights Of The Insured

In The Matter Of Future Manufacturing Cooperative, Inc.[1]

Future Manufacturing purchased certain refrigeration equipment from the Scatena York Company under a conditional sales contract which among other things provided that the vendee was to have the equipment insured against fire for the benefit of the vendor and that the vendee would remain liable for the purchase price should the property be destroyed before such price was fully paid. *Future* failed to have the equipment insured, but Scatena York, on its own initiative, procured the desired coverage. Subsequently the equipment was destroyed by fire while $17,654.88 of the purchase price remained unpaid. Scatena

[1] 165 F. Supp. 111 (D.C. N.D. Cal. S.D. 1958).

recovered $13,244.20 from the insurer and, in addition, realized $810.00 in salvage from the sale of the damaged equipment. Shortly thereafter, *Future* was adjudged bankrupt, and Scatena asserted a claim in the bankruptcy proceedings for $16,844.88, representing the unpaid portion of the purchase price less the salvage recovery. The referee allowed Scatena's claim to the extent of $3,600.88 (the value of the unpaid purchase price less the recovery under the insurance policy and the recovery by way of salvage). An additional amount equal to the value of the premiums paid for the insurance was also allowed Scatena. The referee found that the insurer could not assert a claim against the bankrupt by way of subrogation to the vendor's rights under the conditional sales contract, despite the fact that the insurance policy expressly granted the insurer the right to subrogate to any claims the vendor had against the vendee under the sales contract.[2] The District Court affirmed, giving the vendee the benefit of the vendor's insurance.

In discussing the possible remedies which could be afforded under the circumstances of the instant case, the court suggested three ways in which the rights of the interested parties might be resolved: (1) to allow the vendor to recover the full contract price and the insurance (which in effect would allow a double recovery); (2) to allow the insurance proceeds to affect the unpaid portion of the purchase price to the extent of such proceeds, thereby giving the vendee the benefit of the vendor's insurance; or (3) to allow the insurer to subrogate to the vendor's contract rights for the unpaid purchase price.[3]

The Court was of the opinion that the first approach would contravene public policy, by increasing the moral hazard of the insurer by making the property more valuable after its destruction than before, and in actually allowing a double recovery by the insured vendor. Courts, in general, are in accord with this view.[4] The Court of Appeals of

[2] The policy provision as to subrogation read:

"In the event of any payment under the policy the Company shall be subrogated to all the assured's rights of recovery therefor against any person or organization and the assured shall execute and deliver instruments and papers and do whatever else is necessary to secure such rights." *Ibid.*, 112.

[3] *Ibid.*, 113.

[4] Deming v. Merchants Cotton Press & Storage Co., 90 Tenn. 306, 17 S.W. 89 (1891); Indemnity Insurance Co. v. Otis Elevator Co., 315 Mich. 393, 24 N.W. 2d 104 (1946); Hartford Fire Insurance Co. v. Chicago Tunnel Terminal Co., 12 Ill. 2d 539, 139 N.E. 2d 770 (1956); Washington Fire Ins. Co. v. Kelly, 32 Md. 421, 442 (1870). For a general discussion of this problem see: 2 RICHARDS, INSURANCE (5th ed. 1952), 662.

Maryland, in *Washington Fire Insurance Co. v. Kelly*,[5] rejected the suggestion of a possible double recovery under similar circumstances, saying:

> ". . . the contract of insurance is strictly a contract of indemnity, and the mortgagee is *not* entitled to recover from the insurer the value of the property lost, and his whole debt besides, from the mortgagor."[6]

Since the courts are almost uniformly opposed to allowing a double recovery by the insured vendor, the basic problem in the instant case becomes one of determining whether to allow the vendee to benefit from the vendor's insurance, although he failed to fulfill his obligation under the contract of sale by not obtaining the insurance himself, or to allow the insurer to minimize his loss by subrogating him to the contract rights of the vendor. Before dealing directly with this problem, it is desirable to briefly inquire into the nature of the doctrine of subrogation and determine if and when it is applicable to collateral contract rights.

Generally it is recognized that subrogation is an *equitable* right taken from the civil law,[7] and is considered to be *legal* when it arises by operation of law,[8] as in most cases, or *conventional* when it arises by express provisions in a contract.[9] The basis of the doctrine seems to be analogous to the theory of suretyship. Thus, a tortfeasor is considered to be the party primarily liable, and the insurer secondly liable, producing the result that the insurer is entitled to proceed against the party primarily liable when he is caused to idemnify the insured.[10] Likewise, in the vendor-vendee situation, such as is present in the instant case, the debtor vendee is considered to be primarily liable while the insurer is only secondarily liable, since in effect he is merely insuring the vendor's security

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[5] 32 Md. 421 (1870).

[6] *Ibid.*, 442. It is noted that the *Washington* case involved a mortgage situation rather than a conditional sale.

[7] 29 AM. JUR. 1000, Insurance, § 1335; Comment, *Subrogation of the Insurer to Collateral Rights of the Insured*, 28 Col. L. Rev. 202 (1958); King, *Subrogation under Contracts Insuring Property*, 30 Texas L. Rev. 62, 71-85 (1951).

[8] The word "legal" is not used in contradistinction to "equitable".

[9] Mullen, *The Equitable Doctrine of Subrogation*, 3 Md. L. Rev. 201 (1939). In addition it is noted that in Maryland 8 MD. CODE (1957), Art. 101, § 58, grants an employer the right of subrogation where the employee recovers from him for an injury sustained because of the acts of a third person, and by 1 MD. CODE (1957) Art. 8, § 3, the right of subrogation is given to a surety in a bond or other obligation.

[10] *Supra*, n. 7; VANCE, INSURANCE (3rd ed. 1951), 787-8, § 134; Leavitt v. Canadian Pac. Ry. Co., 90 Me. 153, 160; 37 A. 886 (1897).

for the debt.[11] Essentially subrogation is an equitable right which places the burden of loss upon the person primarily responsible for it and the insurer's right of subrogation arises out of the nature of the contract — as a contract of indemnity.[12]

In mortgage cases, where the mortgagee obtains insurance for his own benefit, the insurer has been allowed to subrogate to the mortgagee's right to recover payment of the debt from the mortgagor.[13] The reasoning behind the rule seems to be that the mortgagor takes the risk of loss, and consequently, the insurer is actually insuring the property which represents the security for the debt. In such cases the theory of suretyship applies. Conversely, where the mortgagee and the mortgagor are both insured under the same policy, there can be no right of subrogation, unless the policy is somehow voided as to the mortgagor.[14]

Similarly, where a shipper procures insurance on his goods which are then entrusted to a common carrier, the shipper's insurer is allowed to subrogate to the shipper's rights on the coverage contract.[15] The reasoning in such cases appears to be based on the fact that almost absolute liability is imposed upon the carrier by law. Since the carrier is legally responsible for the goods, and can escape liability only by proving an act of God or similar occur-

[11] Interstate Ice & Power Co. v. United States Fire Ins. Co., 243 N.Y. 95, 152 N.E. 476 (1926); McCoy v. Continental Ins. Co., 326 Mich. 261, 40 N.W. 2d 146 (1949).

[12] Nat. Garment Co. v. N.Y.C. & St. L. R. Co., 173 F. 2d 32 (8th Cir. 1949).

[13] First National Bank of Elk City v. Springfield Fire and Marine Inance Co., 104 Kan. 278, 178 P. 413 (1919); Tarrant Land Co. v. Palmetto Fire Ins. Co., 220 Ala. 428, 125 So. 807 (1930); Union Assurance Society v. Equitable Trust Co., 127 Tex. 618, 84 S.W. 2d 1151 (1936); Combs v. American Insurance Co., 286 Ky. 535, 177 S.W. 2d 881 (1944); Pacific National Fire Ins. Co. v. Watts, 266 Ala. 606, 97 So. 2d 797 (1957); Leyden v. Lawrence, 79 N.J. Eq. 113, 81 A. 121 (1911); Milwaukee Mechanics Ins. Co. v. Ramsey, 76 Or. 570, 149 P. 542 (1915). The only jurisdiction consistently in disagreement with the rule is Massachusetts, e.g. International Trust Co. v. Boardmon, 149 Mass. 158, 21 N.E. 239 (1881) which reasons that the mortgage contract is wholly collateral to the insurance and therefore not available to the insurer. In Maryland see Washington Fire Insurance Co. v. Kelly, 32 Md. 421 (1870); Grangers Mutual Fire Ins. Co. v. Farmers National Bank, 164 Md. 441, 165 A. 479 (1933); Mutual Fire Insurance Co. v. Dilworth, 167 Md. 232, 173 A. 22 (1934) and Frontier Mortgage Corp. v. Heft, 146 Md. 1, 13, 125 A. 809 (1924) where the court remarked:

> "The mortgagor derives no benefit from a policy covering the interest of the mortgagee alone, but is bound to pay the mortgage debt to the insurers when they become his substituted creditors."

[14] Savings Bank of Ansonia v. Schancupp, 108 Conn. 588, 144 A. 36 (1928); Aetna Life Ins. Co. v. National Union Fire Ins. Co., 98 Neb. 446, 153 N.W. 553 (1915).

[15] Wager v. Providence Ins. Co., 150 U. S. 99 (1893); National Garment Co. v. New York, C. & St. L. R. Co., 173 F. 2d 32 (8th Cir. 1949); Adams v. Hartford Fire Ins. Co., 193 Iowa 1027, 188 N.W. 823, 24 A.L.R. 189 (1922).

rence, he is, in effect, an insurer of the goods and is the primary obligor, and again the theory of suretyship will apply. It is general practice today for carriers to provide in their bills of lading that any insurance on the goods will inure to their benefit. Such a provision has been held to vitiate the right of the insurer to subrogate to the insured shipper's right against the carrier.[16] On the other hand, the insurance companies have adopted a policy provision which acts to avoid the contract insurance where the insured agrees that the benefits received through the insurance are to inure to the carrier's benefit. This type of policy provision has also been sustained by the courts, on the theory that the parties are free to contract as they desire.[17]

The greatest divergence of opinion is found in the cases involving contracts for the sale of realty or personalty, such as the one currently under discussion. Some jurisdictions have maintained that the situation is closely analogous to the mortgage situation mentioned above, and have applied the same rules.[18] In *Home Insurance Co. v. Bishop*,[19] the Maine court found that an insurer is entitled to subrogate the rights of a conditional vendor against the vendee for the balance due on the purchase price, where the vendee intentionally destroyed the goods. Likewise, where the insurance originally covering both vendor and vendee is cancelled as to the vendee for failure to pay premiums or for similar reasons, the insurer is subrogated;[20] however, this rule only applies where the policy contains a loss-payable clause,[21] thereby making the right of subrogation contractual or *conventional* and not a legal application of the equitable doctrine.

The general view in cases of this nature seems to be that expressed in *Leavitt v. Canadian Pac. Ry. Co.*,[22] where the court said:

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[16] Jackson Co. v. Boylston Mutual Ins. Co., 139 Mass. 508, 2 N.E. 103 (1885): Hartford Fire Ins. Co. v. Payne, 199 Iowa 1008, 203 N.W. 4, 39 A.L.R. 1116 (1925); Carstairs v. Mechanics Ins. Co., 18 F. 473 (D.C. Md. 1883).

[17] Insurance Co. of N.A. v. Easton, 73 Tex. 167, 11 S.W. 180 (1889): Hartford Fire Ins. Co. v. Payne, 199 Iowa 1008, 203 N.W. 4, 39 A.L.R. 116 (1925).

[18] Home Insurance Co. v. Bishop, 140 Me. 72, 34 A. 2d 22 (1943); Interstate Ice & Power Corp. v. United States Fire Ins. Co., 243 N.Y. 95, 152 N.E. 476 (1926); Leavitt v. Canadian Pac. Ry. Co., 90 Me. 153, 37 A. 886 (1897).

[19] *Ibid.*

[20] Cadillac Auto Co. v. Fisher, 54 R.I. 264, 172 A. 393 (1934).

[21] Fields v. Western Millers, 290 N.Y. 209, 48 N.E. 2d 489 (1943). The court pointed out that the insurer collected the premiums for a risk and could not in good conscience keep its premiums and be made whole too.

[22] *Supra*, n. 18.

> ". . . an insurer who has paid a loss for which another is responsible, either by statute or at common law, is subrogated to any claim that the insured had against the person whose tortious act caused the injury; or who, for any other reason, is liable to the owner therefor."[23]

In each of the above cases the conclusions seem to be justified that the vendee, by his acts (while either amounted to malfeasance or non-malfeasance), should not be entitled to any equitable relief and what equities are present favor the insurer.

However, this doctrine has been applied in less compelling circumstances. In *Interstate Ice & Power Corp. v. United States Fire Ins. Co.*,[24] the Court of Appeals of New York held that the insurer was entitled to subrogate to the insured vendor's rights where the goods were destroyed during a period of negotiation between vendor and vendee — after the latter had been in default and the former had caused the goods to be attached and seized by the sheriff. Likewise, in *McCoy v. Continental Ins. Co.*,[25] the Michigan Court allowed the insurer to subrogate to the insured vendor's rights where the insurer was caused to indemnify the vendor for loss by fire, but in this instance the policy contained a subrogation clause and in addition had been procured by the vendor on his own initiative.

The Court in the instant case, recognizing the holdings of the above cases, said:

> ". . . an insurer upon indemnifying an insured mortgagee for the loss of his interest in destroyed mortgaged property is entitled to be subrogated to the mortgagee's right to enforce payment of the mortgagor's debt."[26]

However, the Court refused to apply this principle of the mortgage cases as it did not feel the analogy compelling, but rather gave the benefit of the vendor's insurance to the vendee. In so doing, the Court, after voicing its opinion that authority in support of either view was almost equal, said:

> "But when an insured vendor has been indemnified by his insurer for the loss of property subject to a

[23] *Ibid.*, 888.
[24] *Supra*, n. 18.
[25] 326 Mich. 261, 40 N.W. 2d 146 (1949).
[26] In re Future Manufacturing Cooperative, 165 F. Supp. 111, 113 (D.C. N.D. Cal. S.D. 1958).

> sales contract, the tendency has been to give the vendee the benefit of the vendor's insurance rather than to subrogate the insurer to the vendor's right to recover the purchase price from the vendee."[27]

This theory, which has been accepted by a number of jurisdictions is based upon the idea that the vendee is the equitable owner of the property he buys from the time the contract of sale is made and, as a result, is entitled to any benefit that may inure to the estate in the interim,[28] and that the vendor retains an insurable interest in the property in the form of a lien upon the property[29] until he is fully paid. Thus, if the property is destroyed between the time of the contract and the payment of the purchase price, the vendee is considered to be entitled to the benefit from the vendor's insurance which itself is looked upon as a benefit accruing to the insured property.

In *Gilbert & Ives v. Port,*[30] the court said:

> "The vendee, because he is the equitable owner, and, as such, is compelled to sustain the loss, occurring after the sale and before the conveyance, is entitled to any benefit that may accrue to the estate."[31]

Following this theory, the courts have given the vendee the benefit of the vendor's insurance; where the vendor, before being paid by the vendee, reconveyed the property to another, and the other in turn conveyed the property to a fourth person who had it insured;[32] where the vendee actually contracted to bear the loss of damage due to fire and to purchase insurance on the property, but failed to do so;[33] where the vendor had purchased insurance on his own and in his own name;[34] where the insurer required the vendor to assign to it the vendor's rights to the purchase price;[35] and where the sales contract actually con-

[27] *Ibid.*, 114.

[28] Kaufman v. All Persons, 16 Cal. App. 388, 117 P. 586 (1911); Gilbert and Ives v. Port, 28 Ohio St. 276 (1876); Skinner & Sons' Co. v. Houghton, 92 Md. 68, 85, 48 A. 85 (1900).

[29] White v. Gilman et al, 138 Cal. 375, 71 P. 436 (1903); Skinner & Sons' Co. v. Houghton, 92 Md. 68, 85, 48 A. 85 (1900); McRae v. McRae, 78 Md. 70, 27 A. 1038 (1893).

[30] *Supra*, n. 28.

[31] *Ibid.*, 293.

[32] White v. Gilman et al, 138 Cal. 375, 71 P. 436 (1903).

[33] Automatic Sprinkler Corp. v. Robinson-Slagle L. Co., 147 So. 542 (La. 1933).

[34] Brakhage v. Tracey, 13 S.D. 343, 83 N.W. 363 (1900); Marion v. Walcott, 68 N.J. Eq. 20, 50 A. 242 (1904); In the Matter of Future Mfg. Coop., Inc., 165 F. Supp. 111 (1958).

[35] Godfrey v. Alcorn, 215 Ky. 465, 284 S.W. 1094 (1926)

tained a subrogation clause.[36] The doctrine has been applied where the vendor was required to obtain the insurance, but failed to do so.[37]

The fact that the vendee in the instant case failed to obtain insurance on the property, as he was contractually bound to do, made little difference, since it is well established that where the vendor obtains insurance, despite the vendee's contractual duty, it is unnecessary for the latter to perform his obligation, and he is, nonetheless, entitled to the benefit.[38]

This view clearly prevails in Maryland.[39] In *Skinner & Sons' Co. v. Houghton*,[40] the Court of Appeals held that the assignee of the vendee was entitled to the benefit of the insurance despite the fact that the vendors had obtained it prior to the contract of sale and had not surrendered title or possession at the time the property was destroyed by fire. In reaching its decision the Court said:

> "It is true that she [the vendor] had an insurable interest in the property until the purchase money was paid. . . . Under a contract of this kind, in equity, the vendee is in fact considered as the owner of the land, and although the vendor may still retain the title, he holds it as a *trustee* for the vendee, to whom all the beneficial interest has passed, with a *lien* on the estate [or property] as security for any unpaid portion of the purchase money. . . . Thus, if property is destroyed between the time of effecting the contract for the sale and delivery of the deed, the proceeds of an insurance policy upon such property belongs to the vendor between him and the (insurer), but the former is held to act as *trustee* for the vendee and must therefore account to his cestui trust in equity."[41]

[36] In the Matter of Future Mfg. Coop., Inc., 165 F. Supp. 111 (D.C. N.D. Cal., S.D. 1958).

[37] Sommers v. Dukes, 214 Md. 351, 135 A. 2d 419 (1957). This case seems to be more justifiable than some of the others as the seller was required to obtain the insurance for the buyer's protection.

[38] Automatic Sprinkler Corp. v. Robinson-Slagle L. Co., 147 So. 542, (La. 1933); Marion v. Walcott, 68 N.J. Eq. 20, 59 A. 242, 37 A.L.R. 1324 (1904); Russell v. Elliott, 45 S.D. 184, 186 N.W. 824, 22 A.L.R. 556 (1922); McGinley v. Forest, 107 Neb. 309, 186 N.W. 74, 22, A.L.R. 567 (1921).

[39] Skinner & Sons' Co. v. Houghton, 92 Md. 68, 48 A. 85 (1900); McRae v. McRae, 78 Md. 70, 27 A. 1038 (1893); Worthington v. Lee, 61 Md. 530 (1884); Brewer v. Herbert, 30 Md. 301 (1869); Sommers v. Dukes, 214 Md. 351, 135 A. 2d 419 (1957); Royal Insur. Co. v. Drury, 150 Md. 211, 221, 132 A. 635 (1926).

[40] *Ibid.*

[41] *Ibid.*, 85-86, 88.

In making a thorough examination of the problem, the court in the *Skinner* case adopted the view of *Hall v. Jones*[42] that, where the sale concerns real property, after a contract of sale is made the vendor's interest is not real estate but personal property,[43] the interest being in the security for the debt. The court further recognized the view of *Heller v. Marine Bank*[44] that an insurance policy is only a contract for personal indemnity, but that indemnity is against a possible loss on account of the interest of the insured in the thing mentioned in the policy and when the vendee fully pays the vendor that interest is at an end and likewise the indemnity no longer exists.

It would appear that the decisions which adopt this view, giving the vendee the benefit of the vendor's insurance, violate the concept of an insurance policy being a personal contract, but this violation is excusable on the theory that the vendee could have taken an assignment of the policy if he had so desired. Nonetheless, it is clear that where the risk of loss remains on the vendor under the contract of sale, the vendee obtains no benefit from the insurance because he can suffer no loss in the event of damage to or destruction of the property.[45] Thus the doctrine is limited to those situations where the risk of loss is upon the vendee. Furthermore, at least in Maryland, the doctrine will only apply where the vendor-vendee relationship exists and not in the analogous situation between mortgagor and mortgagee.[46]

In conclusion, it appears that the court in the instant case, in denying the insurer the right of subrogation and instead granting the vendee the benefit of the vendor's insurance, adopted the more equitable approach since the insurer did contract to indemnify the vendor and did, in fact, accept the risk of loss. Furthermore, the equities clearly favor the vendee as he was not responsible for the loss, and should not be called upon to suffer such loss when another actually obligated itself to take the risk of loss.

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[42] 21 Md. 439 (1863).

[43] *Ibid.*, 447, citing Smith & Gage, 41 Barbour 60 N.Y.S. Ct. (1863).

[44] 89 Md. 602, 43 A. 800 (1899).

[45] It follows as a natural result of the principle laid down in the cited cases that if the vendee is to gain the benefit of the vendor's insurance where the risk of loss is upon him, he should not be entitled to so benefit if the risk of loss remains on the vendor, as the vendee cannot be held to be the equitable owner.

[46] Mullan v. Beldin, 130 Md. 313. 322, 100 A. 384 (1917).