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Making Less Out of More: Valuing Plaintiff's Recoverable Damages When Its Insurer Settles a Subrogation Claim With the Responsible Party for Less Than the Claim's Full Amount

By Darren S. Teshima

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I. Introduction

A company that is alleged to be responsible for a loss often finds itself defending against two suits: (i) a tort action filed by the injured party and (ii) a subrogation action brought by the injured party's insurer. This situation occurs when the injured party's insurer only partially compensates its policyholder for the loss. The injured party pursues its action for the uninsured amount, while its insurer seeks to recover the amount of the insurance benefits paid in subrogation.

While this situation requires the company to defend itself on two fronts, it also presents an opportunity. The company may be able to limit its exposure to less than the full amount of the injured party's loss. The company may settle the subrogation claim for *less than* the amount of the policy benefits paid to the injured party, yet still assert the *full* amount of the subrogation claim as an offset in the tort action. That is the holding of the California Court of Appeal in *De Anza Interiors, et al. v. Hsu*, *et al*., 2011 WL 6402146, No. CV-08-2550 (Cal. Ct. App. Dec. 21, 2011), the most recent decision on the subject.

II. Summary of *De Anza*

In *De Anza*, the plaintiffs' property was damaged in a fire that spread from the defendants' restaurant. De Anza's property insurer, State Farm Insurance Company, paid De Anza $475,000 under the terms of its insurance policy, which partially compensated De Anza for its loss. 2011 WL 6402146, at *1. De Anza sued the defendants, and State Farm then filed a separate subrogation action for the $475,000 in insurance benefits, which was consolidated with De Anza's suit. Prior to trial, State Farm settled its claim against defendants whereby the defendants' insurer paid State Farm $300,000--$175,000 less than the insurance benefits State Farm paid to De Anza—in exchange for a release and an assignment of State Farm's subrogation claim. *Id*. De Anza prosecuted the case to trial, and the jury found the defendants liable and awarded De Anza damages of $731,000. In a post-verdict motion, the defendants asserted State Farm's subrogation claim for $475,000 as an offset against the $730,000 damage award. The trial court granted the defendants' motion. *Id*.

On appeal, De Anza asserted the following main arguments: (1) the collateral source rule prohibited the offset; and (2) defendants' offset should be limited to $300,000, the amount of money defendants paid to settle State Farm's subrogation action. As discussed further below, the California Court of Appeal rejected these arguments, holding that the collateral source rule did not bar the offset, and that the defendants, as assignees of State Farm's subrogation claim, were entitled to offset the entire amount of that claim. *Id*. at *6, *19.[1]

III. Analysis

A. Overview of Subrogation

In the insurance context, subrogation is the claim of an insurer that pays a policyholder's covered loss to be put in the position of the policyholder and recover the amount paid from the party responsible for the loss. *E.g*., *Garbell v. Conejo Hardwoods, Inc*., 193 Cal. App. 4th 1563, 1568 (Cal. Ct. App. 2011); *Plut v. Fireman's Fund Ins. Co.*, 85 Cal. App. 4th 98, 104 (Cal. Ct. App. 2000). Subrogation is an equitable doctrine meant to ensure that the party responsible for causing the loss pays for it. An insurer is said to "stand in the shoes" of the policyholder because the insurer's subrogation claim is purely derivative of, and no greater than, the policyholder's right (a chose in action) against the responsible party. *E.g., Fireman's Fund Ins. Co. v. Maryland Cas. Co*., 65 Cal. App. 4th 1279, 1292 (Cal. Ct. App. 1998). Subrogation applies both by operation of law and generally pursuant to the contractual terms of an insurance policy.

As is often the case, a policyholder is not fully compensated for its loss by insurance because of, among other things, deductibles, policy limits, and/or exclusions to coverage. In this situation, the policyholder and the insurer split a single right of action against the responsible party for recovery—the policyholder has a right for the uninsured amounts; the insurer has a right to recover the amounts it paid (subject to its insured being made whole). *See, e.g*., *Garbel*, 193 Cal. App. 4th at 1571; *Allstate Ins. Co. v. Mel Rapton, Inc.*, 77 Cal. App. 4th 910, 908 (Cal. Ct. App. 2000). The insurer can enforce its claim directly against the responsible party, or it might seek reimbursement out of the damages award obtained by the policyholder. *E.g.*, *Plut*, 85 Cal. App. 4th at 104. Insurers frequently assert their subrogation claim directly by intervening in their policyholder's action or, as State Farm did in *De Anza*, by filing a separate action, which generally is joined with the tort action.[2]

B. Collateral Source Rule Does Not Prohibit Offset of Subrogation Claim

After the defendants in *De Anza* settled State Farm's subrogation claim, they sought to offset De Anza's damages award by the amount of the subrogation claim. 2011 WL 6402146, at *1. De Anza objected, contending that the collateral source rule barred the offset.[3] The collateral source rule provides that if an injured party is compensated for its loss from a source wholly independent of the tortfeasor, that payment should not reduce the amount the tortfeasor owes the plaintiff. *E.g., Helfend v. S. Cal. Rapid Transit Dist*., 2 Cal. 3d 1, 6 (1970). The rationale behind the rule is that a tortfeasor should not be allowed to escape liability for the full amount of the loss and benefit from the injured party's foresight to obtain insurance. *See id*. at 9.[4]

Since an injured party's insurer is a source wholly independent of the tortfeasor, De Anza argued that its recovery against the defendants should not be reduced by the amount of insurance proceeds it received from State Farm. The Court of Appeal rejected this argument, recognizing that the collateral source rule is inapplicable to subrogation claims. *De Anza*, 2011 WL 6402146, at *4-6. The court reasoned that because both De Anza and State Farm effectively share a single right to damages against the defendants to the extent of State Farm's insurance proceeds, "the insurer's status changes from being a collateral source to that of a co-injured party entitled to damages for the injury; the amount of benefits paid becomes the measure of the insurer's share of the damage award." *Id*. at *4.

The subrogation doctrine "modifies the collateral source rule" and prevents double payment by the tortfeasor to the injured party and its subrogated insurer, who share a single right of action against the tortfeasor. *Garbel*, 193 Cal. App. 4th at 1572. The rule "addresses whether the insured may recover against tortfeasors even though it has been compensated by the insurer; it does not address the insurer's right to recover in a subrogation action for its payments to the insured." *Id*. Once the insurer is subrogated to the claim against the responsible party, "the payment of insurance proceeds is no longer a 'collateral source.'" *Id*. (quoting *Ferraro v. S. Cal. Gas Co*., 102 Cal. App. 3d 33, 47 (Cal. App. Ct. 1980)).

Courts outside California that have addressed scenarios analogous to the one in *De Anza* have similarly recognized that the collateral source rule does not apply to subrogation claims. For example, in *Ferrellgas, Inc. v. Yeiser*, 247 P.3d 1022 (Colo. 2011), a homeowner's house pipes froze and burst after Ferrellgas, Inc. failed to timely deliver propane. The homeowner's insurer covered part of the loss and brought a subrogation action against the gas company. *Id*. at 1024. After it settled its subrogation action, the gas company sought to offset the damages award in the homeowner's suit. The homeowner objected, asserting the collateral source rule. *Id*. at 1027. The Colorado Supreme Court held that the collateral source rule did not apply, since the insurer's subrogation interest allowed it to stand in the homeowner's shoes with respect to that amount, and by settling the subrogation claim, it "extinguished" the homeowner's right to seek that amount from the gas company. *Id*.; *accord Hayes Sight & Sound, Inc. v. Oneok, Inc., et al.*, 281 Kan. 1287 (2006) (holding that collateral source rule does not apply to bar setoff of amount of subrogation claim settled between defendant and plaintiff's insurer); *Sunnyland Farms, Inc. v. Central New Mexico Electric Cooperative, Inc*., 149 N.M. 746, 781 (N.W. App. Ct. 2011) (cert. granted) (same).

C. Amount of Offset Not Limited to Defendant's Settlement Payment to Insurer

After holding that an offset was required, the *De Anza* court next addressed the amount of the offset. The plaintiffs argued that the defendants were not entitled to an offset of the entire amount of State Farm's subrogation claim, $475,000, because they settled that claim for $300,000. 2011 WL 6402146, at *18. The plaintiffs contended that by settling the claim for $300,000, State Farm waived the right to seek reimbursement for more than that amount, and as assignees of that claim, defendants were not entitled to an offset of more than $300,000. *Id*.

The Court of Appeal rejected the plaintiffs' position. First, it found that the elements of a waiver had not been established because, among other things, the settlement agreement did not contain a waiver of any subrogation right, and the fact that State Farm settled for less than $475,000 "was not inconsistent with an intent to assign the full value of that claim." *Id*. at *19. The court then recognized that State Farm and the defendants made calculated decisions about resolving the dispute prior to an uncertain end of the litigation:

> State Farm's agreement to settle more reasonably reflects its calculated determination that it was worth discounting its subrogation claim in order to avoid further litigation expenses and the risk of not recovering anything if the jury found that defendants were not liable for the fire losses. Conversely, the agreement reasonably represented a calculated hedge by [defendants' insurer] against the possibility of a plaintiffs' verdict: if plaintiffs prevailed, then for a discount, [defendants' insurer] obtained for the defendants a substantial subrogation setoff against the damage award.

Id. By holding that the defendants were entitled to an offset of the entire value of State Farm's subrogation claim, the court made it theoretically possible for the defendants to pay less than the full amount of plaintiffs' loss.[5]

This result is consistent with the principles of subrogation, since the defendants were asserting the subrogation right of State Farm. Had State Farm not settled its claim, it would have been entitled to recover the full value of its claim from the plaintiffs' award against the defendants. The plaintiffs, therefore, would not have recovered the $475,000 from the defendants. As the *De Anza* court observed, the fact that State Farm made the calculated decision to hedge its risk of an unfavorable outcome and settle its claim for less than its full value should not change the result.

Most of the courts from other jurisdictions that have addressed this situation have agreed with the holding in *De Anza*. In *Brinkerhoff, et al., v. Swearingen Aviation Corp*., 633 P.2d 937 (AK 1983), the plaintiffs' plane was damaged as the result of defendant's defective manufacturing. The plaintiffs' insurer paid $672,000 to cover those losses and then settled its subrogation claim against the defendant for $375,000. *Id*. at 939. In the plaintiffs' action, the defendant sought an offset in the amount of the insurance payout. The plaintiff objected, contending that the defendant was only entitled to an offset in the amount of its settlement payment to the insurer. *Id*. at 942. The Alaska Supreme Court rejected the plaintiffs' argument: "Although [plaintiff] could have sued to recover the full amount of damage and held the appropriate portion of that recovery… in trust for his insurer whose subrogation rights arose upon payment under the policy… the insurance company's decision to settle its claim foreclosed this option." *Id*. The court also held that an "insurance company is free to settle its subrogation claims for any amount." *Id*.

Similarly, in *Ferrellgas, Inc. v. Yeiser*, 247 P.3d 1022 (Colo. 2011), the Colorado Supreme Court reversed the appellate court and held that the defendant was entitled to offset the entire amount of the subrogation claim, regardless of the fact that it paid less than that amount to settle that claim. *Id*. at 1027. The court held that the settlement between the plaintiff's insurer and the defendant "extinguished [plaintiff's] right to seek [the insurance amount] from [the defendant]." *Id*. Like the *De Anza* court, the Colorado Supreme Court held that the insurer's decision to resolve its subrogation claim for less than its full value did not change the outcome. As a subrogee, the insurer stood in the shoes of the plaintiff and was free to "resolve the claim without litigation by settling for less than the full value, and its doing so had no effect on the inevitable extinguishing of [plaintiff's] interest in [the subrogated amount]." *Id*. at 1028. In a footnote, the court noted that had the insurer not settled its subrogation claim, the plaintiff would have had to reimburse the insurer for the full amount of its insurance payment out of the damages award. *Id*. at n.4.

One decision has gone the other way and limited the offset to the amount paid to settle the subrogation claim. In *Hayes Sight & Sound, Inc. v. Oneok, Inc., et al.*, 281 Kan. 1287 (2006), after the defendants settled the subrogation claim with the plaintiff's insurer, they asserted that they were entitled to an offset against the plaintiff's damages award. *Id*. at 1300. After rejecting the argument that the collateral source rule barred any offset, the Kansas Supreme Court held that the amount of the offset could not be the amount of the insurers' subrogation claim. *Id*. at 1306. Instead, the offset was limited to the amount the defendants paid to settle that claim, and any difference in value would benefit the plaintiffs. According to the court, to do otherwise "would allow the defendants to escape paying the full amount of plaintiffs' damages. The defendants are entitled to a setoff in the amount they paid to the plaintiffs' insurers to settle the subrogation claim. If that payment was less than the amount of the insurers' subrogation claim, the plaintiffs can retain the difference, and to that extent double recovery is permissible." *Id*. at 1306.

The holding in *Hayes Sight & Sound* is based on the notion that the tortfeasor should not pay less than the full

amount of the damages he caused. But the result is becoming an outlier, as more courts like the *De Anza* court address the issue.

IV. Conclusion

The holding in *De Anza* that a defendant faced with both a plaintiff's tort action and a subrogation action brought by the plaintiff's insurer is entitled to offset any damages award by the full value of the subrogation claim—even if it pays less than full value for it—presents a tactical consideration for a defendant considering a settlement of an insurer's subrogation claim. Based on *De Anza*, by settling for less than the full value of that claim and then obtaining the subrogation claim by assignment, a defendant would leave open the possibility that it ultimately could pay less than the full amount of the plaintiff's loss. It could assert, as assignee of the insurer's subrogation claim, an offset of the full amount of that claim, even though it paid less to obtain the right to it. Of course, because subrogation is an equitable doctrine, a court may be reluctant to award this benefit to the defendant, even though it is being asserted by the defendant as assignee of the insurer's subrogation claim, not as tortfeasor. Nevertheless, *De Anza* presents a possible strategy for defendants to consider.

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[1] The court did agree with De Anza that the setoff amount should be reduced by a share of the attorney's fees incurred to successfully litigate the action, without which the assigned subrogation claim would be worthless. *Id*. at *18. The appellate court remanded the case to recalculate the setoff after deducting a pro rata share of the attorney's fees. *Id*. at *19.

[2] Since the insurer and the responsible party are not in privity with each other, and the insurer is too remote for it to be a foreseeable victim for purposes of imposing tort liability, some commentators have characterized the relationship between the responsible party and the injured party's insurer as "non-consensual suretyship," where the insurer effectively acts as a surety for the performance owed by the tortfeasor. *See* Morton C. Campbell, *Non-Consensual Suretyship*, 45 Yale L. J. 69, 76 (1935).

[3] The plaintiffs in *De Anza* did not challenge the effectiveness of State Farm's assignment of its subrogation claim to the defendants. 2011 WL 6402146, at * 6. The court held that the fact that State Farm's subrogation claim was asserted by the defendants as assignees would not change the analysis. *Id*. The court recognized that in California, a chose in action is presumptively assignable, and that this presumption extends to subrogation claims. *Id.*

[4] The rule also operates as an evidentiary rule that bars the introduction of evidence of independent payments to the plaintiff as irrelevant and prejudicial.

[5] Because the court also held that under the common fund doctrine, the defendants, as assignees of the subrogated claim, were responsible for part of the plaintiffs' attorney's fees, and remanded the case to recalculate the offset, *id*. at *18, this result may not have ultimately occurred.