SUBROGATION AND RECOVERY OF PROPERTY LOSSES UNDER ILLINOIS LAW

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INTRODUCTION

Subrogation encompasses the legal right of an insurer, upon payment to its insured for losses covered under its policy, to seek recovery against liable third parties. The most commonly used description of the legal concept of subrogation is that the insurer steps into the shoes of its insured and can only enforce those rights that the latter could enforce.[i] Subrogation has its origins in chancery and is based on the important public policy that the party causing a loss in the first place should bear the ultimate economic burden.[ii] This both prevents a wrongdoer from benefiting from insurance paid for by the insured in the event that the insured would forego suit once made whole by his insurer, and imposes a burden that might act to deter the commission of torts.[iii] An equally important policy behind subrogation recovery rights is to prevent an insured from obtaining a double recovery, once from the insurer and once from the wrongdoer, and profiting from the loss.[iv]

The right of subrogation may be grounded in equity or based on an express or implied agreement.[v] Equitable subrogation, as its title suggests, is based on principles of equity or fairness.[vi] It occurs by operation of law and does not require a contractual relationship.[vii] Alternatively, conventional subrogation arises from the contractual relationship of the parties (i.e., a clause in an insurance contract granting the insurer subrogation rights).[viii] Similar to equitable subrogation, subrogation contracts give insurers the right to recover money paid out on claims from third parties who are legally responsible for the injuries or damages.[ix] Where a contract expressly provides for subrogation and the agreement is otherwise enforceable, the express contract terms should govern the recovery and should not be overridden by application of equitable

subrogation principles.[x] A more detailed discussion of the two forms of subrogation follows.

EQUITABLE VS. CONVENTIONAL SUBROGATION

If the requirements for equitable subrogation are not supported by the facts in a particular case, subrogation rights may still exist by contract. Conversely, although subrogation agreements are now prevalent, where a contractual relationship does not exist, or is not enforceable for other reasons, an insurer may still seek recovery under a theory of equitable subrogation.

EQUITABLE SUBROGATION

In Illinois, equitable subrogation in the insurance context is available if: (1) a third party is primarily liable to the insured for the loss; (2) the insurer is secondarily liable to the insured for loss under an insurance policy; and (3) the insurer has paid the insured under that policy, thereby extinguishing the debt of the third party.[xi] A recent Illinois Supreme Court decisions allowed an excess insurer to recover against a primary insurer, for amounts it paid to settle an underlying personal injury claim, based on a theory of equitable subrogation. *Home Insurance Co. v. Cincinnati Insurance Co.*, 213 Ill.2d 307, 821 N.E.2d 269 (2004). In claims for equitable subrogation, also referred to as legal subrogation, most jurisdictions, including Illinois, endorse the general rule that an insurer is entitled to subrogation only after the insured receives full compensation for their loss.[xii] This principle is frequently referred to as the "made whole" rule[xiii] (as is discussed below, the made whole requirement does not apply in the conventional subrogation context).

In *Capitol Indemnity Corp. v. Strike Zone, S.S.B. & B. Corp.,* 269 Ill.App.3d 594, 646 N.E.2d 310 (4th Dist. 1995), a building and business owned by the defendant was destroyed in a fire caused by the crash of a private aircraft. Pursuant to its insurance policy, the defendant-business owner received $461,759.29 for its losses, the applicable

policy limits. Initially, the plaintiff-insurer filed a complaint for a declaratory judgment seeking a declaration of its right to enforce the subrogation provisions under the policy against any recovery obtained from responsible third parties. The insurer and insured subsequently entered into a settlement agreement with the third-party tortfeasor for the sum of $692,997 from the responsible third-party tortfeasor in settlement of the property damage claim.

The insurance carrier then brought an action seeking reimbursement from its insured in accordance with a subrogation agreement in their policy. The defendant-business owner appealed a grant of summary judgment entered in favor of the plaintiff-insurer, awarding it $461,759. The insured argued that its actual losses exceeded the combined payments of the policy proceeds and the tort recovery–thus, under equitable subrogation principles, the business owner was not "made whole." The insured also argued that, even though its contract of insurance expressly provided for subrogation where the insurer paid its obligation under the contract even if the insured was not made whole, nevertheless, equitable principles required a balancing of those rights against the right of the insured to be made whole first through combined payments received from its insurer and third-party tortfeasors. The court declined "to upset the settled expectations of the parties as reflected in the policy of insurance by overlaying inapplicable equitable principles which contravene[d] the contract terms and forge a new agreement between the parties."

StrikeZone demonstrates that *equitable* subrogation principles, relied upon by the insured, require that an insured is made whole before subrogation applies. However, where conventional subrogation exists, its operation takes precedent over equitable

subrogation principles and requirements. Accordingly, insurers are able to contract around the "made whole" requirement of equitable subrogation, and achieve conventional subrogation to whatever extent they provide payment to an insured.

In Illinois, and a minority of other jurisdiction, the rule applied allows the insurer to be reimbursed first out of any recovery against the wrongdoer, with the insured receiving the balance. For example, an insured suffers damages of $1,000,000.00 from a third-party wrongdoer. The insurer pays the insured $300,000.00, the applicable policy limits. A judgment is entered against the wrongdoer for $500,000.00. Should the insured receive all $500,000.00; should the insurer receive $300,000.00 first, leaving $200,000.00 for the insured; or should the insurer and insured share the $500,000.00 on a pro-rata basis—here, 3/10ths to the insurer and 7/10ths to the insured? In Illinois, the insurer receives $300,000.00 and the insured receives $200,000.00—the insurer is made whole first.

Although Illinois courts follow the "made whole" rule in claims for equitable subrogation, the determination of when the insured has obtained a full recovery is not always clear. Two scenarios have resulted in considerable litigation: first, where the insurer pays only a portion of the amount it is required to pay under the policy, or second, even though the insurer pays the insured the full amount due under the policy, such sum is insufficient to completely compensate the insured for their loss.[xiv]

Some courts, sitting in equity, have held that the insurer has no right of equitable subrogation in either scenario. In those instances, the claim against the responsible third party belongs to the insured and, if the insured sues the wrongdoer and recovers, only if

the recovery exceeds what is necessary to make the insured whole must the insured account for the excess to the insurer.[xv]

Equitable subrogation prerequisites, such as the denial of subrogation to a volunteer or to a subrogee who has not paid the claim in full may not apply to conventional subrogation.[xvi] The issue that arises in this context is whether parties can contract to create conventional subrogation rights for an insurer that are greater than what equitable subrogation allows.[xvii] For example, courts in other jurisdictions have concluded that parties may agree to vary the rule that the insured is made whole first.[xviii]

CONVENTIONAL SUBROGATION

Conventional or contractual subrogation rights can allow the subrogee the right to pursue recovery against a responsible third party even though it has not paid a claim in full.[xix] To take advantage of these important rights, insurers routinely assert subrogation rights in situations where the insured is not reimbursed completely.[xx] For example, the insured's coverage will commonly be subject to a deductible and one may argue that, until the insured is reimbursed for the amount of the deductible, the insured has not been paid in full. However, in practice, insureds commonly agree to give the insurer a right of conventional subrogation to the extent the insurer makes payment to the insured, regardless of whether it is reimbursed for its deductible.

The typical homeowner's insurance policy contains a provisions reserving to the insurer an assignment of rights of recovery for a loss to the extent that payment is made. The insurer can then assert a right of subrogation against a third party even though the insured has not been paid in full (and even though the same insurer would have no right

to *equitable* subrogation). This answer is not however universally favored; other courts have held that the "made whole" rule cannot be trumped by contract language.[xxi]

RECOVERABLE DAMAGES

APPORTIONMENT OF SUBROGATION PROCEEDS

In jurisdictions such as in Illinois, where the "made whole" rule does not apply to conventional subrogation, when a sum is recovered from a third party pursuant to the insurer's assertion of a subrogation right, the question arises: how should the sum be apportioned?[xxii] The "made whole" rule requires reimbursement of the insured first until the insured is reimbursed in full, with any excess going to the insurer.[xxiii]

In Illinois, insurers have an advantage in attempting to recover all of the proceeds paid to their insureds. The law applied in Illinois allows insurer's to receive complete compensation for the proceeds paid on an insurance policy from a judgment obtained against a wrongdoer before reimbursement is granted to the insured for any outstanding losses against them not covered by their policy of insurance.

In Illinois, along with a minority of other jurisdictions, the insurer is reimbursed first out of any recovery against the wrongdoer, with the insured receiving the balance.[xxiv] Thus, instead of requiring that the insured be made whole first, in Illinois *the insurer* is made whole first in cases of conventional subrogation.[xxv] This approach does not allow the insurer to profit before the insured is made whole, but it does grant priority to providing full relief for the insurer instead of for the insured.[xxvi] This approach also gives priority to conventional subrogation principles because the insurance contract's specifications, that the insurer be reimbursed before the insured is made whole, trump any equitable notion that the insured is entitled to a full recovery before the insurer receives reimbursement.[xxvii] Alternate approaches taken in other jurisdictions include: [1] treating the insurer as the owner of the insured's claim and allowing the insurer the full amount recovered regardless of whether it exceeds the amount paid by the insurer to the insured or, [2] requiring the insurer and insured to prorate the recovery in accordance

with the percentage of the insured's loss that the insurer paid or according to another equitable formula.

The Supreme Court of Illinois enunciated the Illinois approach in *Pontiac Mut. Cty. Fire & Lightning Ins. Co. v. Sheibley.*[xxviii] In *Sheibley*, the insured owned a barn insured for $800. A fire, allegedly started by sparks from the locomotive engine of a railroad company, destroyed the barn. The insurer paid the insured the amount of his policy ($800.00), and soon afterward, the insured commenced suit against the railroad company. The insurance company, through its attorney, assisted the insured in preparing and litigating the matter. In the civil action, the insured claimed that the total amount of his loss was actually $4,800, even though he had only insured it for $800. He secured a verdict in his favor for $4,000. The issue over how that judgment was apportioned went all the way to the Illinois Supreme Court. The insured's contention was that, since the total amount received from the insurer and the wrongdoer is less than the amount of the loss, he was not liable to the insurer for the return of any portion of the amount paid under the policy. The Illinois Supreme Court sided with the insurance carrier and allocated $800 out of the $4,000.00 judgment to the insurance company (i.e., the amount it paid the insured upon its policy of insurance).

In the subrogation context, problems also arise regarding how the costs of investigation and litigation are apportioned between the carrier and its insured. Illinois courts utilize an equity approach for the apportionment of attorney's fees and costs absent previous agreement by the parties.[xxix] To the extent the insured and insurer share in the recovery, each party is responsible for their pro rata share of the attorneys' fees and costs incurred in the joint prosecution of the action.[xxx]

This rule does not apply when the insured maintains its own action for its uninsured losses and employs its own counsel to do so.[xxxi] Where the separate prosecution of claims occurs, only the costs generated by factors that benefit both parties mutually are shared by the parties on a pro rata basis.[xxxii] This occurs, for example, when an insurer intervenes in an action by an insured against a party allegedly causing loss and the insurer employs separate counsel but relies on identical expert testimony, exhibits and documents to perfect its claim.[xxxiii]

"The insurance contract itself may stand in the way of a full recovery for a subrogated insurer, as when it requires payment of replacement value of property when the law of the state of the loss permits recovery only of fair market value."[xxxiv] When the terms are not spelled out in the contract, reliance on common law rules can prove elusive. The law regarding recovery for property loss in Illinois is convoluted. One frequently cited federal district court case, *Williams-Bowman Rubber Co. v. Industrial Maintenance, Welding & Machining Co., Inc.*, provides a thorough discussion of the topic.[xxxv]

RECOVERY FOR DAMAGE TO PERSONAL PROPERTY

Personal property includes everything that is the subject of ownership not comprising real estate. The term is generally applied to property of a personal or movable nature as opposed to property of an immovable nature.[xxxvi] In Illinois, if the personal property is repairable, then the measure of damages is the reasonable cost of repairs.[xxxvii] If, however, the value of the personal property after repairs is less than the value before the injury, then the measure of damages includes the difference in value.[xxxviii] If the damage is not capable of repair, as where the personal property is totally destroyed, or if the repair costs exceed the fair market value of the personal property before the injury, then the measure of damages is the fair market value of the

property immediately before the damage.[xxxix] The purpose of this limitation is to compensate and make the injured party whole - not to allow them a windfall or profit on the transaction.

Table 1. Recovery for Damage to Personal Property

Condition of Property	*Recovery in Illinois*
Property is repairable	**Reasonable cost of repairs**
Value of the personal property after repairs < than the value before the injury	**Reasonable cost of repairs + difference in value**
Property is not capable of repair	**Fair market value of the property immediately before the damage**

RECOVERY FOR DAMAGE TO REAL PROPERTY

The rules governing the measure of damages for injury to real property are not as easily determined as those applied to situations involving personal property. Seeking to undertake a thorough review of Illinois law on the topic, the *Williams-Bowman* court cited numerous cases, beginning with 1902 case law providing various formulae for reaching the proper measure of damages to real property.

Ultimately, the *Williams-Bowman* court's lengthy review of Illinois decisions left it with the conclusion that:

> ***"On a day-to-day basis, the Illinois appellate courts do not measure damages for injuries to real property by employing the diminution of value rule. Rather, the courts apply the cost of repair or the diminution in value measure of damages depending upon the nature of the injury involved. If real property is partially injured, and the injury may be repaired in a practicable manner, then the proper measure of damages is the cost of restoring the property to its condition before the injury. If, however the real property is totally destroyed or damaged in a manner which renders repair impracticable, then the diminution in value [i.e. market value of the property from after the injury, subtracted from the market value of the property after the injury] rule applies."*** [xl]

Before arriving at these conclusions, the *Williams-Brown* court reviewed the history of sometimes conflicting Illinois decisions on this issue, beginning with *Fitzsimons & Connell Co. v. Braun.* In *Fitzsimons*, the defendant had detonated explosives in order to excavate a tunnel and thereby permanently and irreparably impaired the appearance, strength and stability of the plaintiff's building.[xli] The Illinois Supreme Court, despite the defendant's argument that the measure of damages was the depreciation in value resulting from the injuries, held that the costs of repairing the building and restoring it to its proper condition was the true measure of damages. The court explained that, in deciding which measure of damages to apply, a court should adopt the valuation that will prove most beneficial to the injured party, for he is entitled to the benefit of the premises intact and to the value of any part separated. The court recognized that the cost-of-repair measure of damages compensated a party for injuries to two distinct property interests: one's *ownership* interest in property and one's interest in the *use* of property. Thus, according to the *Fitzsimons* court, the damages for injury done to a house are measured by the cost of restoring it to its previous condition.

The *Williams-Bowman* court next analyzed a case decided only two years later - *Beidler v. Sanitary Dist. of Chicago.*[xlii] In *Beidler*, several dock owners sued the defendant who dug out a sanitary canal that caused the water level at the plaintiffs' docks to drop to a level rendering the docks unusable. The plaintiffs' endured considerable excavating expenses in order to return the water level to normal and they sued to recover their expenses. The court, however, held that, where real property is damaged because of a public improvement, the measure of damages is the depreciation in the value of the property that results from the improvement, not the cost of repair.

Illinois' First District Court of Appeals next addressed the issue in *Swanson v. Nelson*, where the defendant, via a trespass, caused the plaintiff's building to settle and crack.[xliii] The First District appellate court concluded that the proper measure of damages was the expense that the plaintiff incurred in repairing the building, citing neither previously decided Supreme Court case (*Fitzsimons* or *Beidler*). However, the Court did acknowledge that damages to real property are frequently irreparable because the conditions before the act of the defendant is committed cannot be restored at all, or can be restored only at a very great and disproportionate expense. If that is the case, the Court in *Swanson* concluded that another measure of damages could be utilized - the difference in market value of the property before and after the act complained of. Thus, the rule established by the First District appellate court in *Swanson* for the measure of damages to real property was either 1] the cost of restoration, or 2] the difference in market value, whichever is the lesser amount. This rule, similar to the measure of damages applied in personal property cases, was "squarely" at odds with the Illinois Supreme Court's *Fitzsimons* holding that the court adopt whichever valuation is most beneficial to the injured party according to *Williams-Bowman*.

The Fourth District appellate court in *Donk Bros. Coal & Coke Co. v. Slata* and *Donk Bros. Coal & Coke Co. v. Novero* revisited the issue.[xliv] The cases involved allegations that the defendant's mining operation caused injury to the plaintiffs' buildings. In each case, the Fourth District court elected to follow *Fitzsimons* and determined that the proper measure of plaintiffs' damages was their costs of repair. The *Novero* court explained that the cost-of-repair rule was appropriate because:

> ***"[t]he value [of the real property] at any time depended upon the condition of the buildings and [t]he best evidence of the extent of the***

> ***injury to the buildings is the cost of restoring them to the condition before the injury. Or put in another way, the value of the property as affected by the buildings will be depreciated by injury to the building and a fair measure of that depreciation will be the necessary cost and expense to repair the building and restore it to its original condition."***

In so holding, the *Novero* court attempted to harmonize the competing calculations of damages for real property. Although the measure of damages for injuries to real property is the diminution in value caused by the injuries, a fair measure of that diminution is found in the restoration or repair cost.

According to the *Williams-Bowman* court, no decision since has endeavored to reconcile the different measures of damages in such a fashion. This is likely due to the reliance on the existence of a relationship between the cost of repairing real property and the fair market value of real property. Restoring property to its pre-injury condition may eliminate the depreciation in its fair market value that results from the injury, but it by no means follows that the cost of repairing property will coincide with the amount of depreciation caused by the injury.

In a 1915 decision in a case called *Peck v. Chicago Rys. Co.*, the Illinois Supreme Court faced a fact pattern very similar to that in *Fitzsimons.*[xlv] The plaintiffs sued the defendant for injuries to their building resulting from the defendant's use of explosives while excavating a tunnel. Unlike *Fitzsimons*, however, the court held that the proper measure of damages was the diminution in the value of the property because of the injury. The court thereby cast considerable doubt on the continued vitality of the rule set forth in *Fitzsimons*, stating that it was at variance with the diminution-in-value rule that was by then, frequently invoked.

Next, in *Clark v. Public Service Co.*, the defendant removed the plaintiff's water meter and severed the service wires to the plaintiff's water pump after a fire had started, allowing the plaintiff's house to burn to the ground.[xlvi] Citing *Peck*, the Second District appellate court held that the proper measure of damages was the depreciation in the market value of the property because of the fire. The court distinguished *Swanson*, *Slata*, *Novero* and *Fitzsimons* because they involved actions for trespass as opposed to negligence and because those courts had adopted the view that the buildings destroyed had a value apart from the real estate upon which they stood.

In *Johnson v. Pagel Clikeman*, another Second District appellate court case, the defendant negligently burned down the plaintiff's barn while repairing the plaintiff's tractor.[xlvii] The plaintiffs, relying on *Slata* and *Novero*, contended that the proper measure of damages was the replacement value of the barn. The court rejected the plaintiff's position and held that the measure of damages was the difference in the market value of the property before and after the fire. The court reasoned that *Slata* and *Novero* were inapplicable because in both cases the damaged buildings were not completely destroyed and remained repairable.

According to the *Johnson* court, a different rule of law existed in such circumstances. Underlying the court's decision was the realization that if the replacement value of the barn was the measure of damages, it could cost ten times as much to replace than it was actually worth. Thus, the court concluded that where a building is injured and cannot be repaired, the injury is considered permanent, and therefore the measure of damages is the diminution in the market value of the property because of the injury, not the cost of repairs that cannot be affected.

In the Fifth District case of *Arras v. Columbia Quarry Co.,* the defendants detonated explosives that caused the plaintiffs' water well to run dry.[xlviii] Although citing *Peck* for the proposition that the diminution in value formula was most applicable to cases involving injury to buildings and other improvements, the court held that the plaintiffs were entitled to recover the expense for digging a new well.

Openly acknowledging the existence of conflicting Illinois case law, the court enunciated a coherent set of rules that would avoid such inconsistencies in future cases. The rules the court fashioned focused on the nature of the injury involved: if the injury is repairable (i.e., temporary), then the measure of damages is the cost of repairs necessary to restore the property to its condition immediately before the injury. If, on the other hand, the injury is irreparable (i.e., permanent), then the diminution in value rule applies.

Thus, the critical inquiry becomes determining whether the injury is temporary or permanent. An injury is temporary if it is abatable, or capable of correction. Since a new well could be dug, the court reasoned that the plaintiffs' injury was abatable and therefore temporary.

Table 2. Recovery for Damage to Real Property

Condition of Property	*Recovery in Illinois*
Irreparable, i.e. damage permanent	**Depreciation in value**
Repairable	**Reasonable cost of repairs**
Damaged fixture with *distinct* value from the real estate it sits upon	**Replacement cost**

Table 3. Timeline of Illinois Cases on Real Property Damages

Case	*Applied Law of Recovery*
***Fitzsimons & Connell Co. v. Braun*, 199 Il. 390, 65 N.E. 249 (1902)**	**Reasonable cost of repair**
***Beidler v. Sanitary Dist. of Chicago*, 211 Ill. 628, 71 N.E. 1118 (1904)**	**Depreciation in value**
***Swanson v. Nelson*, 127 Ill. App. 144 (1st Dist. 1906)**	**Reasonable cost of repair or depreciation in value, whichever = the lesser amount**
***Donk Bros. Coal & Coke Co. v. Slata*, 133 Ill. App. 280 (4th Dist. 1907)**	**Reasonable cost of repair**
***Donk Bros. Coal & Coke Co. v. Novero*, 135 Ill. App. 633 (4th Dist. 1907)**	**Reasonable cost of repair**
***Peck v. Chicago Rys. Co.*, 270 Ill. 34, 110 N.E. 414 (1915)**	**Depreciation in value**
***Clark v. Public Service Co.*, 278 Ill. App. 426 (2nd Dist. 1934)**	**Depreciation in value**
***Johnson v. Pagel Clikeman*, 343 Ill. App. 346, 99 N.E.2d 148 (2nd Dist. 1951)**	**- Where real property damage irreparable, depreciation in value - Where real property repairable, reasonable cost of repairs**
***Arras v. Columbia Quarry Co.*, 52 Ill. App. 3d 560, 367 N.E.2d 580 (5th Dist. 1977)**	**- Where real property damage irreparable, depreciation in value - Where real property repairable, reasonable cost of repairs**
***Williams-Bowman Rubber Co. v. Ind. Maint. Welding & Machining Co.*, 677 F. Supp. 539 (N.D. Ill 1987)**	**- Where real property damage irreparable, depreciation in value - Where real property repairable, reasonable cost of repairs**

Although the *Williams-Bowman* conclusion summarizes the general application of the rule, one additional exception may apply. In *Rittenhouse v. Tabor Grain Co.*, a property owner brought action against an operator and owner of a storage facility for property damage when the defendant's grain bin collapsed onto his property and damaged a storage building on his farm. At trial, the plaintiff sought to introduce replacement cost evidence that the circuit court allowed over the defendant's objection.

On the defendant's appeal, the court noted that an award of damages aims at compensating the injured party for damages to his property. According to the court, the goal is to restore the party to the equivalent of his rightful pre-injury position.

Announcing the general rule that where a fixture is totally destroyed, or so damaged as to render repair impracticable, the proper measure of recovery is generally the diminution in the fair market value of the realty, the court noted that the rule may be supplanted with replacement cost evidence *only* when the damaged fixture possesses a distinct value without reference to the real estate upon which it stands. In *Rittenhouse*, the court viewed the damaged property in dispute as an income-producing fixture attached to realty.

Thus, the court concluded that the trial court properly allowed the plaintiff to introduce replacement cost evidence. The plaintiff established that his storage building, a relatively new structure, had been maintained in near-perfect condition for use as a display model until its destruction. Such facts were deemed sufficient by the court to support departure from the ordinary rule of recovery.

<u>BUSINESS INTERRUPTION/LOST PROFITS</u>

Lost profits are recoverable only if the loss is proved with a reasonable degree of certainty; the court is satisfied that the wrongful act of the defendant caused the loss of profits; and the profits were reasonably within the contemplation of the defaulting party at the time the contract was entered into.[xlix] When the profits sought arise from a breached contract, those profits are considered one of the elements of the contract and are presumed to have been within the contemplation of the defaulting party at the time he entered into the contract.[l] However, when the profits sought are those which would have

arisen only out of a collateral transaction, not only must such profits be proved with reasonable certainty, but an additional requirement, that it be shown that they were reasonably within the contemplation of the defaulting party when the contract was made, also applies.[li] For example, did the party that contracted to supply gasoline for a local filling station, contemplate that its failure to supply such gasoline, leaving the filling station inoperable, would impact the sales at the convenience store located within the filling station? Such matters present complicated legal questions for courts and parties.

Parties causing losses frequently argue that insurers are not entitled to recover their payments for business interruption and lost profits because such damages are speculative.[lii] The general rule is that the question of damages is one of fact, and appellate courts are reluctant to interfere with the discretion of the jury in assessing damages.[liii] However, on review, a court will depart from the general rule in a number of situations, in particular when damage awards are based on speculation or conjecture.[liv] Illinois courts have long rejected the use of speculative, inaccurate or false projections of income in the valuation of a business.[lv]

The amount of lost profits does not need to be proven with absolute certainty. Instead the plaintiff bears the burden of proving such damages with "reasonable certainty."[lvi] Nevertheless, Illinois courts do not hesitate to reverse damage awards based on false assumptions or speculative data.[lvii]

Because lost profits are frequently the result of several intersecting causes, the plaintiff is required to show with reasonable certainty that the defendant's conduct caused a specific portion of the lost profits claimed.[lviii] Illinois courts have found an expert's

opinion to be based on speculation or conjecture when the expert failed to account for their party's actions or other significant factors.[lix]

Evidence of profits generated after the loss occurrence are not accepted by Illinois courts as evidence of lost profits during the interruption caused by the occurrence. Prior profits, generated by an established business, will suffice for demonstrating evidence of lost profits in general. However, evidence of prior profits is not the "*sine qua non*" of proof of damages suffered by a business in all cases.[lx] The long-standing rule in Illinois holds that lost profits may be a measure of damages where a business is interrupted; however, the business must have been established before the interruption so that the evidence of lost profits is not speculative.[lxi]

This rule is justified by the lack of certainty inherent in showing lost profits for a new business that is yet to show what its profits actually are.[lxii] Importantly however, in certain situations, Illinois courts have found that the rule, that a new business's profits are too speculative, did not fit the circumstances presented them.

Three oft-cited examples of this are *Malatesta, Fishman* and *Rhodes*. In *Malatesta v. Leicther*, the plaintiff was prevented from acquiring a car dealership and the court allowed that the profits of the individual who operated the dealership during the time in question were not too speculative to establish damages.[lxiii] Similarly, in *Fishman v. Estate of Wirtz*, the court awarded plaintiffs, who never owned a sport franchise, lost profits based upon the profits of the team's prior owner.[lxiv] Additionally, in *Rhodes v. Sigler*, the court found evidence of profits of a person other than the plaintiff in the same period of time that the plaintiff was seeking damages provided the required degree of certainty.[lxv]

Perhaps the Illinois case most favorable to an insurer seeking to establish lost profits due to business interruption is *Milex Products Inc. v. Alra Laboratories, Inc.* [lxvi] In *Milex*, the plaintiff filed a complaint seeking damages for breach of contract and, following a bench trial, received a judgment for $3.27 million. The defendant appealed, contending among other issues, that the court erred in assessing damages.

The plaintiff manufactured a comprehensive line of obstetrical and gynecological specialty products, with a high concentration in the area of infertility. The defendant was a manufacturer of prescription and over-the-counter drugs. The plaintiff became aware that the patent on a drug used to induce ovulation was about to expire. The plaintiff was interested in marketing a generic version of the drug and hired a company to survey the existing market for such a product. In order to market the proposed new drug, the plaintiff filed an Abbreviated New Drug Application with the Food and Drug Administration showing that their product would contain the equivalent active ingredients as the drug about to lose its patent and worked as well as the original product.

However, before the plaintiff could file its application, it had to secure a manufacturer of the new generic drug. The ANDA application required specific information as to how the product would be manufactured, where it would be made, what equipment would be used and concerning the controls utilized in the manufacturing process. The plaintiff's president and the defendant's president met at the defendant's laboratories where they toured the facility. The defendant assured the plaintiff that it was equipped to produce two million tablets per year of the drug in question, the amount desired by the plaintiff. The defendant presented a proposal to the plaintiff for manufacturing the product that the plaintiff ultimately accepted. Thereafter, the plaintiff

received certification from the FDA to manufacture the product, specifying the defendant as the product's manufacturer. Subsequently, the defendant informed the plaintiff that it was not economically feasible for it to produce two million tablets as the plaintiff previously requested.

During trial, the plaintiff testified that the two million-tablet manufacturing goal was the result of marketing research. Over the objection of the defendant, a consultant to pharmaceutical businesses testified that he was retained by the plaintiff to assess the damages incurred due to defendant's failure to manufacture the product and the competitive impact of not having the proposed product on the market. In order to determine the basic economic structure of the market the consultant compiled market research on two other, pharmacologically identical, products to determine such information as the prices at which the products were sold, the number of prescriptions in the marketplace and the average size of a prescription. The consultant further testified that, in trying to determine the plaintiff's losses, he conducted an examination of what happened in the marketplace when a product lost patent protection and competitors entered with generic copies. He observed a variety of products under many varying scenarios over a wide period. According to the consultant, one pattern in pricing was that the innovator company almost always raised the price of its product before the expiration of its patent.

Compiling his data, the consultant concluded that the plaintiff would have secured a 10% market share with their generic drug and calculated that the plaintiff lost between $7.5 and $11.5 million because of the failure to have their proposed product on the

market. His calculations considered expenses the plaintiff had already paid the defendant.

Based on this evidence, the appellate court concluded that while the product was a new one, the evidence showed that it had an established market. That fact, together with the consultant's testimony, led the court to conclude that the proof of lost profits offered by the plaintiff was neither speculative nor the product of conjecture, but rather was based upon a reasonable degree of certainty sufficient for the plaintiff to recover.

Accordingly, where a subrogated insurer seeks to recover the payments for lost-profits made to its insured, several hurdles may alter the outcome. Nevertheless, the cited Illinois case law demonstrates that Illinois courts may prove receptive to cogently presented bases for recovery. However, where no prior market for a product exists, or a product is new, unique or novel, demonstrating lost profits through means other than the profits of the insured business itself, is likely impossible.

There are numerous examples of cases where courts rejected claims for lost profits. In *Drs. Sellke & Conlon Ltd. v. Twin Oaks Realty, Inc.*, 143 Ill. App. 3d 168, 491 N.E.2d 912 (2nd Dist. 1986), plaintiff, a professional corporation, entered into a five-year written lease for approximately 900 feet of vacant space in a building owned by the defendant to convert the premises into an orthodontic office.

Construction on the office began in June and was not completed until October, due to restrictions set by the defendant. The contractor testified that construction took two-months longer than anticipated or necessary because of this interference. The defendant also refused to allow a telephone serviceman to use space above the rear ceiling to install a telephone line to the orthodontic office, because the plaintiff did not

rent that portion of the building. Accordingly, a telephone was not installed until September. This caused the plaintiff to miss the deadline for publication of its telephone number in the McHenry phone directory. The defendant also failed to fix a leaking roof, which he promised to do prior to execution of the lease, which caused water to stain the walls and carpeting of the orthodontic office and dripped on patients in the plaintiff's waiting area. Finally, the defendant refused to allow the plaintiff to post his name on the building's business directory, stating that the plaintiff rented the office and not the sign.

At trial, the plaintiff made an offer of proof that he lost approximately twenty patients each month the office was not open. He also offered proof that, based on his experience, September and August were the most productive months for acquiring new patients, and offered a five-year breakdown of examinations at the McHenry office to support these assertions. Plaintiff asserted that the vast majority of his examinations led to the insertion of braces, with an average fee of $1,800.00 and that his profit varied from 45 to 65 percent for such services. He further claimed that the two-month delay in opening his office reduced his net income by $16,200.00 to $23,400.00. The trial court excluded all evidence of lost profits on grounds that they were based on post-occurrence historic data and were speculative.

Concurring, the appellate court concluded that an award of lost profits based on this evidence would be speculative. Although mathematical certainty is not required, the loss must be proved with a reasonable degree of certainty.

The long-standing rule in Illinois is that lost profits may be a measure of damages where a business is interrupted, but the business must have been established before the

interruption so that the evidence of lost profits is not speculative. Past success in similar enterprises is not sufficient, as conditions may vary with each endeavor.

The *Sellke* plaintiff attempted to prove his lost profits from the two-month delay by citing the average number of new patients acquired each month after the opening of his orthodontic office and by testifying that September and August were the peak months for acquiring new patients. However, plaintiff's orthodontic office was a new business, and his offer of proof consisted only of profits realized after defendant's tortious interference ceased. The court held that post-occurrence evidence was insufficient to establish lost profits with a reasonable degree of certainty.

DEFENSES TO SUBROGATION

Whether one is counsel for an insurer pursuing a subrogation claim or the attorney for an insurer whose insured is a defendant in such an action, it is necessary to be fully conversant with defenses which may be raised. The following is a summary of the defenses unique to or possessing some peculiar applicability to subrogation cases. Whenever possible, examples of Illinois case law are provided to demonstrate the issue's operation in this jurisdiction. Occasionally, the case law of foreign jurisdictions is cited by way of explanation or where Illinois lacks specific conclusions on the subject.

WAIVER

In *Home Ins. Co. v. Cincinnati Insurance Co.,* the general contractor/insured tendered its defense of the underlying action to both Home Insurance and Cincinnati Insurance. In a June 23, 1997, letter, Cincinnati Insurance accepted the tender under a reservation of rights. Home Insurance also accepted the tender, agreed to share the cost of general contractor's defense and indemnity with Cincinnati on a 50/50 basis.

When the claim against the general contractor settled for $600,000, Home Insurance contributed $500,000 toward this settlement and Cincinnati paid only $100,000. In Home Insurance's claim for equitable subrogation against Cincinnati Insurance to recover the $500,000 it had contributed, the Illinois Supreme Court ruled that Home Insurance had waived the right to recover a portion of its full contribution it was otherwise entitled to because it agreed to the general contractor's tender on a 50/50 basis with Cincinnati Insurance. In this case, the Supreme Court concluded that the plaintiff was entitled to recover only $200,000.00 ($300,000.00 minus the $100,000.00 already received) from the defendant, having waived the remainder of its claim.

Waiver is an important concept for insurers to consider in a subrogation context and most frequently arises out of an affirmative act by the insurer, is consensual and consists of an intentional relinquishment of a known right. A waiver may be either express or implied, arising from acts, words, conduct or knowledge of the insurer. An implied waiver arises when conduct of the person against whom waiver is asserted is inconsistent with any intention other than to waive it. Where there is no dispute as to the material facts and only one reasonable inference can be drawn, it is a question of law as to whether waiver has been established.

The failure of a paying insurer to reserve its rights against a non-paying insurer may constitute a waiver of the right to equitable remedies. Insurers must remain guarded in their post-loss communications in order to avoid waiving their rights to complete compensation under the doctrine. An insurer desiring to reserve its rights against a second insurer must make this position clear in its correspondence with the second insurer and it is also good practice to include such reservation language in any settlement agreement or order and provide a copy of such to the nonsettling insurer.

<u>Rights of the Insured</u>

The insurer is subrogated only to such rights that the insured has against other parties at the time of loss.[lxvii] Therefore, any defense that the third party has that is good against the subrogor (insured) is also good against the subrogee (insurer).[lxviii] When analyzing the merits of its claim, an insurer should look at the merits of a direct action by the insured against the wrongdoer. Many issues arising in a subrogation suit will not be unique to the subrogation context, but instead causes of action and defenses common to a suit by any party suffering losses at the hands of a wrongdoer.

Benefit of Insurance Clauses

The general rule is that no right of subrogation exists in favor of an insurer against its own insured.[lxix] Subrogation rights exist only against third parties because allowing the insurer subrogation against its own insured would allow the insurer to pass the loss from itself to its own insured, thereby avoiding the coverage that the insured purchased.[lxx] "An insurer can be subrogated only to rights of an insured against third parties to whom the insurer owes no contractual duty."[lxxi] This fundamental subrogation principle becomes complicated in a common scenario where an insured agrees to give another the benefit of the insured's coverage and the other asserts the prohibition against an insurer's suing its insured as a defense to a subrogation action.[lxxii]

Illustrative of this dilemma in Illinois is the case of *Dix Mutual Ins. Co. v. LaFramboise.*[lxxiii] In *LaFramboise*, the insurer paid its insured landlord $40,579.00 for a fire loss on property the landlord rented to the defendant. The insurer brought a subrogation action against the tenant alleging that he caused the fire loss due to his negligence.

The tenant, with the landlord's approval, attempted to strip paint from the exterior of the property with a power stripper that removed paint by heat application, thereby damaging the property by fire. After paying the landlord for the loss, the insurance company brought a subrogation action, alleging negligence, against the tenant to recover the amount it paid to the landlord for the fire loss.

The insurer contended that the tenant was liable for negligently causing the fire damage because the lease did not contain a provision expressly relieving the tenant of that liability. However, viewing the lease as a whole, the court concluded that the insured

and tenant intended that the tenant was not liable for any fire damage to the premises and that instead the landlord would look solely to the insurance as compensation for any negligent damage to the premises.

The court determined that the tenant, by payment of rent, contributed to the payment of the insurance premium, thereby gaining the status of co-insured under the insurance policy. Thus, because it "is well settled that an insurer may not subrogate against its own insured or any person or entity who has the status of a co-insured under the policy" and since both the landlord and tenant intended that the policy would cover any fire damage to the premises no matter who caused it, the court concluded that the insurer did not possess a right of subrogation against the tenant under the facts of the case.

The decision was not unanimous. Dissenting, one justice declared that "[t]he effect of [the majority's] unfortunate decision was to make all tenants at any time and at any place co-insureds with their landlords."[lxxiv] The only exception, according to the dissenting justice would be where the parties possessed a clear agreement to the contrary. The dissenting justice feared that the rule of law pronounced by the majority constituted bad public policy. The dissent continued:

> ***"The fire insurance contract contemplated that the insurance company, by way of subrogation, could recover the loss paid from any responsible party other than the insured. In other words, the insurance company in that regard would occupy the same position as the insured himself. There is nothing in law to require an insured to look either first or only to his insurance carrier for recovery of loss caused by another's negligence. The landlord, in this case, could have sued the tenant directly. There is also nothing in law to require a landlord to carry fire insurance at all. How can it be said that a tenant is deemed to be a co-insured in a lease when the lease does not even mention or contemplate insurance? Suppose that the landlord in this case had not taken out an insurance policy. Would the majority say he was barred from suing his***

tenant for negligently burning down the premises? That is to say, would the loss be shifted away from the negligent tenant and onto the guiltless landlord?" [lxxv]

Clearly, the dissenting justice believed that the public is better served if negligent actors are held responsible for the damage or injury they cause. Although he concurred that parties to a lease should be allowed to agree to exculpate a tenant for negligent conduct which damages the premises and that a lease may be drawn in a manner so as to regard the tenant as a co-insured, the justice disagreed with the conclusion that the mere payment of rent in the absence of other language should operate to exculpate a tenant who negligently causes damage to the premises.

In Illinois, the law exculpating residential tenant in such fact patterns is well-settled and deserves the consideration of insurers in formulating their policies.

AGREEMENTS BETWEEN THE INSURED AND THE WRONGDOER

PRE-LOSS AGREEMENTS. "A subrogated insurer, standing in the shoes of its insured, may be limited or prejudiced because of an agreement between the insured and a third party whose actions give rise to a loss."[lxxvi] If the insured before loss or becoming an insured releases a third party from prospective liability, that release is good against the insurer due to the rule that defenses good against the subrogor are also good against the subrogee.[lxxvii] Such a release does not, however, constitute interference with the insurer's subrogation rights and the insured does not lose coverage on the account.[lxxviii] The logic underlying the conclusion that the insured's coverage is unaffected by giving the release treats the insurer's subrogation right as something that vests at the time of the loss.[lxxix]

When providing coverage, insurers should realize that agreements entered into by their insureds before obtaining coverage may limit the insurer's right to recover via subrogation for a loss, but will not allow the insurer to avoid paying their insured under the policy.

Blume v. Evans Fur Co., illustrates this principle in Illinois. In *Blume* the defendant-fur company stored a black mink coat owned by Blume and subsequently lost it.[lxxx] The receipt for storage issued by the defendant stated the value of the coat at $300.00 and limited the defendant's liability "for any reason whatsoever" to $100.00. The coat was previously appraised for insurance purposes at $4,296.00.

Blume received $300 from the defendant and $3,131 from her insurer. The insurer then notified the defendant of its subrogation claim. The insurer argued that it should not be bound by contractual limitations entered into by its insured with knowledge that the insured claim was of greater value. Both cases cited by the insurer for this proposition involved releases that were executed *subsequent* to the loss and thus impaired the right of the subrogee to recover against the wrongdoer. Under general subrogation principles, the subrogor's loss is a prerequisite to the accrual of subrogation rights and the subrogor's rights do not accrue until the subrogee has paid the debt. Thus, the legally binding limitation of liability prevented any additional subrogation rights from arising.

Aside from the reasoning presented in *Blume*, additional justification for the law's operation includes that fact that:

> ***"In situations where the release is given before the party becomes an insured, the insurer, if it had thought the matter important enough, could have inquired into whether the prospective insured had released any prospective wrongdoers. Because insurers do not do so, one can fairly assume that insurers are willing to provide coverage with a right to subrogation for prospective losses for which the insured gives a prior release. This is a good business practice, given that insureds and prospective insureds routinely give releases to third parties prior to loss in their daily affairs. The person who agrees to lease an apartment may well exculpate the landlord from future acts of negligence. The person who parks her car in a downtown parking garage may see a sign upon entering the garage, which is reinforced by language on the back of the parking ticket, that the garage is not responsible for damage to or theft***

of vehicles or their contents. The person who attends a sporting event or a concert probably gives some kind of release to the organizer or sponsor of the event in connection with the purchase and sale of the ticket to it. In all of these situations and more, the insured gives a prospective release; insurance would be worth much less if each of these acts eliminated the insured's coverage." [lxxxi]

Most policies specifically state that a release given by the insured before the loss does not impair a subrogation right, and the vast weight of authority holds that pre-loss releases by the insured, while providing a defense to the insurer's subrogation claim, do not eliminate the insured's coverage.[lxxxii]

POST-LOSS AGREEMENTS. If the insured, after a loss, releases a third party without the insurer's consent, the insured has interfered with the insurer's right of subrogation. With one exception explained below, a post-loss release is effective against the insurer.[lxxxiii] However, the insured's act of releasing the third party will discharge the insurer's obligations to the insured under the policy and will entitle the insurer to the return of any previous payments made to the insured.[lxxxiv]

KNOWLEDGE OF INSURANCE EXCEPTION. The exception to the rule allowing for post-loss agreements operates where the wrongdoer secures the insured's release after acquiring knowledge that an insurer has an interest in the insured's claim as a potential (before payment is made from insurer to insured) or actual (after payment has been made by insurer to insured) subrogee. In such cases, the insurer's subrogation rights are not lost.[lxxxv]

When the knowledge of insurance exception is applied, the insurer possesses a valid subrogation claim and thus it is not necessary for the insurer to retrieve the proceeds paid to the insured. Accordingly, it is possible that the wrongdoer may ultimately pay twice for the same loss. This occurred in *Home Ins. Co. v. Hertz Corp.*[lxxxvi]

In *Home Ins. Co.*, the plaintiff, an auto insurer, filed a subrogation action seeking to recover from defendants certain payments made to its insured under the property damage and medical payments provisions of the insured's auto policy. The defendant submitted, in support of its motion to dismiss, a full and final release of all personal injury and property damage claims arising from the accident, which was executed by the insured as consideration for a $6,000.00 settlement with him.

On appeal, it was undisputed that the defendants possessed notice of the plaintiff's subrogation rights before the settlement of the insured's suit and the signing of the release. Accordingly, the court concluded that the question before it was whether an unlimited general release by an insured of all claims against a tortfeasor barred a subrogation action where the torfeasor procured the release from the insured-subrogor with knowledge of the insurer's interest.

Overruling appellate court authority to the contrary, the Illinois Supreme Court concluded that the release did not bar a subsequent subrogation action by the insurer-subrogee against the tortfeasor, as long as the tortfeasor or his insurance carrier possessed knowledge of the insurer-subrogee's interest before the release.

<u>Real Party in Interest</u>

In all jurisdictions, the proper plaintiff in a lawsuit must be the real party in interest.[lxxxvii] When an insurer reimburses the insured in full or in part for a loss and the insurer is subrogated to some or all of the insured's rights, a question arises regarding who is the real party in interest for the purpose of asserting the claims against a third party.[lxxxviii] If the real party in interest is not the plaintiff, the defendant can obtain a stay of the proceedings until the real party in interest is substituted as the party plaintiff.[lxxxix]

The defense that a subrogation claim is not being brought by the real party in interest is likely to be faced whenever it may defeat the claim, whenever it is necessary to assert a defense peculiar to an entity other than the nominal plaintiff, or whenever there is the possibility that a defendant will be helped tactically by having the insurer as the named defendant.[xc]

Defendant's to subrogation actions brought by insurers frequently attempt to substitute the insurer for the insured as plaintiff in the case. Defendant's theorize that a jury is less sympathetic to a corporate insurance company for paying losses than to an individual plaintiff suffering out-of-pocket expenses because of the actions committed by a wrongdoer.

In Illinois, when an insurer fully compensates the insured for the loss and the insurer obtains the insured's claim against a third party, either by contract or pursuant to equitable subrogation, the insurer is the real party in interest and must prosecute the claim in its own name—this result is mandated by statute. 735 ILCS 5/2-403(c) provides in relevant part that:

> ***"[a]ny action hereafter brought by virtue of the subrogation provision of any contract or by virtue of subrogation by operation of law shall be brought either in the name or for the use of the of the subrogee; and the subrogee shall in his or her pleading on oath, or by his or her affidavit if pleading is not required, allege that he or she is the actual bona fide subrogee and set forth how and when he or she became subrogee."***

Where the insurer pays a only portion of the insured's loss and thereby succeeds to a portion of the claim, the issue is more complicated because the insured still has a claim and remains a real party in interest. The insurer has no right to control the action against the responsible third-party unless this right is given to the insurer by the terms of the insurance policy or a subsequent agreement between insurer and insured.[xci] Thus, the insurer should be viewed as having a beneficial interest in the insured's claim. The insurer does not have a subrogation right because the insured's loss has not been paid in

full, but the insurer has a right to reimbursement depending on the sum recovered by the insured.[xcii]

The widespread view is that the insured and insurer are both real parties in interest. Thus, the insured remains able to prosecute an action on their own against the wrongdoer. This is indeed the case in Illinois.

In *Brooke Inns, Inc. v. S&R Hi-Fi and TV*, the defendant argued that the trial court erred in denying its motion to dismiss the plaintiffs' amended complaint, asserting that the plaintiffs' insurer was the actual party in interest as insurer of the claim and that the plaintiffs had no interest to be adjudicated.[xciii] The plaintiffs countered that a subrogation action may be brought in the name of the insured if the insured retains a pecuniary interest, even for only a nominal sum over and above the subrogation claim. They contended that their actual loss was in excess of the amount they received from their insurer and that they also were charged a $5,000 deductible.

According to the court, subrogation of a claim does not by itself exclude the party who has the claim from bringing a suit if the insured retains some interest. The plaintiffs signed a subrogation receipt stating that they subrogated all rights, claims and interests that they possessed to the insurer for the purpose of suing, settling or compromising the claim. However, the plaintiffs also provided sworn testimony that their loss was greater than the amount received as compensation from insurance. Accordingly, the court concluded that, despite the subrogation receipt, the plaintiffs retained a pecuniary interest in excess of the subrogation claim and, on that basis, denied the defendant's motion to dismiss.

In federal court, the outcome may differ. When the insurance company is a real party in interest as to the damages sought in the action, the insurer-subrogee may be required to be named as a plaintiff.[xciv] However, an insurer may choose to ratify the prosecution of an action brought in the name of the insured pursuant to Federal Rule of Civil Procedure 17(a) as an alternative to being named a party.[xcv]

In a situation where the insured is unwilling to participate in the subrogation action to recover its uninsured interest, the insurer is left with no alternative but to file suit in its own name as subrogee.[xcvi] It is clear, however, that the right to subrogation by the insurer is not dependent on the consent of the insured.[xcvii]

LOAN RECEIPTS

Related to the real party in interest issue, loan receipts are another means employed by insurers to avoid appearing before the jury (due to the fear of prejudice).[xcviii] A loan receipt is an arrangement under which the insurer advances or loans to the insured the amount of loss up to the limits of the policy.[xcix] The loan is repayable only if and to the extent the insured recovers a judgment from the party who caused the loss in excess of the amount necessary to indemnify the insured.[c] As part of the agreement, the insured promises to sue the third party, so that a fund might be recovered out of which the insurer is repaid.[ci]

Certain courts have rejected loan receipt transactions as a complete surrender of an insured's right of action against a wrongdoer and view them as no different than payment. Those courts have further held that requirements that the action be brought in the name of the insurer as a real party in interest cannot be circumvented by the agreement.[cii]

The propriety of loan receipt transactions for purposes of bringing a subrogation suit presents an interesting legal question. Insurers should be aware that the outcome of this determination is jurisdictional and that some states and federal circuits approve of the transaction while others do not.

The United States Court of Appeals for the District of Columbia provided a useful analysis of both views regarding the propriety of loan receipts in *City Stores Co., v. Lerner Shops of District of Columbia, Inc.*[ciii] In *Lerner*, the plaintiff sued the defendant for losses sustained in a fire which they alleged was caused by the defendant's negligence in permitting combustible materials to accumulate in an alley between their places of business. Through interrogatories, it became known that the plaintiff was insured against fire loss and had received from its insurance carrier a sum equal to the losses claimed by it. The plaintiff stated that it executed loan receipts in connection with the payments made to it because of its losses and that the loan receipts were executed in lieu of any subrogation agreement. Plaintiff contended that the loan receipt evidenced actual loans and not payments in settlement of claims and that the insurance companies were not subrogated to the rights of the insured and not the real party in interest.

The defendant argued that the loan receipts were not loans but were, in reality, settlement of the claim under the insurance policy and that the insurer was, by operation of law, subrogated to the rights of the plaintiff and therefore the real party in interest.

The court determined that the plaintiff executed the loan agreement, not in lieu of a subrogation agreement, but to avoid the equitable subrogation that arises from payment by the insurer. The court observed that the loan agreement between the plaintiff and the insurer was not an unconditional promise to pay at a time certain, and did not provide for interest. It was, according to the court, more accurately described as a complete surrender to the insurer of the insured's right of action against third parties. By executing

such a document, the insured effectively sold to the insurance company the right to use his name as a party plaintiff in a suit brought against a third party which was exclusively directed and controlled by the insurer at its expense and for its benefit. The only consideration, according to the court, to the insured for such a sale was that perhaps the settlement is received a bit earlier than if the loan agreement is not executed.

Rule 17(a) of the Federal Rules of Civil Procedure provides that every action shall be prosecuted in the name of the real party in interest. If the insurer-subrogee has paid an entire loss suffered by the insured, it is the only real party in interest and must sue in its own name. Accordingly, concluding that the only purpose of the loan agreement was to avoid the requirement of Rule 17(a), the court refused to give effect to such an evasion of a federal rule of practice and procedure. The court reversed the district court's decision and remanded with instructions to grant the defendant's motion that the insurance company be made plaintiff as the real party in interest.

In Illinois, contrary to the previous holding, the use of loan receipts by insurance companies is approved in both federal and state courts.[civ] However, the existence of such agreements may be admissible as evidence for the jury to consider when analyzing the credibility of a witness whose interest in the outcome of the case is not otherwise apparent.

STATUTES OF LIMITATIONS/STATUTES OF REPOSE

As the previous analysis makes clear, a subrogated insurer stands in the shoes of its insured and is entitled to no rights greater than those of its insured. The statute of limitations applicable to an insured's action against a wrongdoer also controls the insurer's subrogation claim. However, subrogated insurers have sought to avoid statute

of limitations defenses by arguing that, as in actions for indemnity or contribution, the statute does not begin to run until after the underlying claim is paid.[cv] This argument meets with success in certain situations.[cvi] In *Pennwalt Corp. v. Metropolitan Sanitary Dist. of Greater Chicago*, 368 F.Supp. 972 (N.D. Ill. 1973), a seller of ferric chloride filed suit against a buyer, the metropolitan sanitary district, alleging unjust enrichment because the sanitary district refused to reimburse the seller for its payment of the Illinois use tax liability that arose from the sale.

The plaintiff and the defendant entered into a contract under which the plaintiff agreed to sell, and the defendant agreed to purchase, quantities of real ferric chloride. At the time of the contract, and all times thereafter, Illinois levied a tax on the purchase of tangible personal property sold for use or consumption in Illinois (Illinois Use Tax). The defendant did not pay Illinois Use Tax to the plaintiff for its purchases of ferric chloride from 1961 through 1963. The Illinois Department of Revenue issued a Notice of Tax Liability to the plaintiff, which plaintiff ultimately paid, along with penalty and interest assessed on sales to the defendant.

By paying the tax judgment entered against it, the plaintiff discharged the primary legal obligation of the defendant to pay use taxes to the state. Accordingly, the plaintiff became subrogated to the right of the state to collect that tax from the defendant. The defendant argued that the plaintiff's cause of action sprang to existence when defendant refused to pay the plaintiff the use tax, and that the ten-year statute of limitations had run. However, the court held that any cause of action which may have arisen upon the defendant's refusal to pay the tax to the plaintiff was separate and distinct from the cause of action that arose upon the plaintiff's payment of the tax. The plaintiff's cause of

action arose not from the contract for the purchase of ferric chloride, but rather from the plaintiff's payment of a judgment entered against it in accordance with a state statute imposing a use tax measured by the defendant's purchases of tangible personal property. According to the court, Illinois case law firmly establishes that, in such actions, the statute of limitations begins running when the payment is made.

Additionally, a subrogated insurer may in some instances be permitted to intervene or join in a timely suit brought by an insured against a wrongdoer, notwithstanding that the statue of limitations would bar a direct action by the insurer.[cvii] This procedure is, however, limited and it is unlikely that a subrogated insurer would be permitted to join or intervene in an action after the statute of limitations has elapsed if the effect of the joinder or intervention is to add a new cause of action or to expose the defendant to new categories of damages.[cviii]

Table 4. Illinois Statutes of Limitation

Nature of Damages	Statute of Limitations
Injury to real property	**Five years from the date the cause of action accrues (735 ILCS § 5/13-205)**
Injury to personal property	**Five years from the date the cause of action accrues (735 ILCS § 5/13-205)**
Breach of unwritten contract	**Five years from the date the cause of action accrues (735 ILCS § 5/13-205)**
Breach of written contract	**Ten years from the date the cause of action accrues (735 ILCS § 5/13-206)**
Injury to property (real or personal) based on claim of strict liability	**Five years from the date the cause of action accrues (735 ILCS § 5/13-205)***
Injury caused by government entity	**One year from the date the cause of action accrues (745 ILCS § 10/8/101)**

* *see AllState Ins. Co. v. Menards, Inc.*, 202 Ill.2d 586, 782 N.E.2d 258 (2002); *see also* 735 ILCS § 5/13-213(b) (statute of repose for products liability claims is 12 years from date of sale to retailer or 10 years from date of sale to consumer, whichever is earlier).

ENDNOTES

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[i] *Dix Mutual Ins. Co. v. LaFramboise*, 149 Ill.2d 314, 597 N.E.2d 622 (1992).

[ii] *Dix Mutual Ins. Co. v. LaFramboise*, 149 Ill.2d 314, 597 N.E.2d 622 (1992); John F. Dobbyn, Insurance Law 282 (3d ed. 1996).

[iii] Dobbyn, at *Id.*

[iv] *Id.* at 284.

[v] *Wausau Ins. Co. v. All Chicagoland Moving & Storage Co.*, 333 Ill. App. 3d 1116, 1121, 777 N.E.2d 1062 (2nd Dist. 2002); *Bost v. Paulson's Enters., Inc.* 36 Ill. App. 3d 135, 343 N.E.2d 168 (2nd Dist. 1976).

[vi] Robert H. Jerry, Understanding Insurance Law 708 (3d ed. 2002).

[vii] *Id.*

[viii] *Id.*

[ix] *Hartenbower v. Electrical Specialties Co. Health Benefit Plan*, 977 F.Supp. 875 (N.D. Ill. 1997).

[x] *Capitol Indemnity Corp. v. Strike Zone, S.S.B. & B. Corp.*, 269 Ill. App. 3d 594, 646 N.E.2d 310 (4th Dist. 1995).

[xi] *Stewart*, 288 Ill. App. 3d at 686 (citations omitted).

[xii] Robert H. Jerry, Understanding Insurance Law 711; *Capitol Indemnity Corp.*, 269 Ill. App. 3d 594.

[xiii] *Id.*

[xiv] *Id.* at 713.

[xv] *Id.*

[xvi] *Wausau*, 333 Ill. App. 3d at 1121.

[xvii] Robert H. Jerry, Understanding Insurance Law 708.

[xviii] *See, Culver v. Ins. Co.*, 559 A.2d 400 (N.J. 1989).

[xix] *See, Am. Nat'l Bank & Trust Co. of Chicago v. Weyerhaueser Co.*, 692 F.2d 455, 460 n. 12 (7th Cir. 1982) (conventional subrogation can allow subrogee standing to one who has not paid a claim in full); *see also, Capitol Indemnity Corp.*, 269 Ill. App. 3d at 596 (parties were free to negotiate the terms of the contract of insurance, including the subrogation provision).

[xx] Robert H. Jerry, Understanding Insurance Law 708.

[xxi] *Id.* at 713-714.

[xxii] *Id.* 714.

[xxiii] *Id.*

[xxiv] *Id.* at 715.

[xxv] *Id.*

[xxvi] *Id.*

[xxvii] *Id.*; *see also, Capitol Indemnity Corp.*, 269 Ill. App. 3d 594.

[xxviii] 279 Ill. 118, 116 N.E. 644 (1917)

[xxix] John B. McCabe and Martin C. Sener, Subrogation,10-13 (1998).

[xxx] *Id.* citing *Lemmer v. Karp*, 56 Ill.App.3d 190, 371 N.E.2d 655 (2nd Dist. 1977).

[xxxi] *Id.*

[xxxii] *Id.*

[xxxiii] *Id.* citing *Lemmer*, 56 Ill.App.3d 190.

[xxxiv] *Id.* at 627.

[xxxv] 677 F. Supp. 539 (N.D. Ill 1987).

[xxxvi] *In re Berman*, 39 Ill. App. 2d 175, 187 N.E.2d 541 (2nd Dist. 1963)(citing Black's Law Dictionary, Deluxe Edition, Page 1447).

[xxxvii] Citing *Wall v. Amoco Oil Co.*, 92 Ill. App. 3d 921, 416 N.E.2d 705 (5th Dist. 1981); and *People v. Tidwell*, 33 Ill. App. 3d 232, 338 N.E.2d 113 (1st Dist. 1975).

[xxxviii] Citing *Kroch's & Brentano's, Inc. v. Barber-Colman Co.*, 16 Ill. App. 3d 412, 305 N.E.2d 522 (1st Dist. 1973); *Trailmobile Division of Pullman, Inc. v. Higgs*, 12 Ill. App. 3d 323, 297 N.E.2d 598 (5th Dist. 1973).

[xxxix] Citing *Gannon v. Freeman*, 103 Ill. App. 3d 917, 431 N.E.2d 1303 (1st Dist. 1982); *Wall v. Amoco Oil Co.*, 92 Ill. App. 3d 921, 416 N.E.2d 705 (5th Dist. 1981);

[xl] *Id.* at 545.

[xli] 199 Ill. 390, 65 N.E. 249 (1902).

[xlii] 211 Ill. 628, 71 N.E. 1118 (1904).

[xliii] 127 Ill. App. 144 (1st Dist. 1906).

[xliv] 133 Ill. App. 280 (4th Dist. 1907); 135 Ill. App. 633 (4th Dist. 1907).

[xlv] 270 Ill. 34, 110 N.E. 414 (1915).

[xlvi] 278 Ill. App. 426 (2nd Dist. 1934).

[xlvii] 343 Ill. App. 346, 99 N.E.2d 148 (2nd Dist. 1951).

[xlviii] 52 Ill. App. 3d 560, 367 N.E.2d 580 (5th Dist. 1977).

[xlix] *Milex Products, Inc. v. Alra Laboratories, Inc.*, 237 Ill. App. 3d 177, 603 N.E.2d 1226 (2nd Dist. 1992).

[l] *Id.*

[li] *Id.*

[lii] *SK Hand Tool Corp. v. Dresser Inds., Inc.*, 284 Ill. App. 3d 417, 672 N.E.2d 341 (1st Dist. 1996)

[liii] *Id.*

[liv] *Id.*

[lv] *Id.*

[lvi] *Id.*

[lvii] *Id.*

[lviii] *Id.*

[lix] *Id.*

[lx] *Id.*

[lxi] *Milex Products, Inc.*, 237 Ill. App. 3d 177.

[lxii] *Id.*

[lxiii] 186 Ill. App. 3d 602, 542 N.E.2d 768 (1989).

[lxiv] 807 F.2d 520 (7th Cir. 1986).

[lxv] 44 Ill. App. 3d 375, 357 N.E.2d (1976).

[lxvi] *Milex Products, Inc.*, 237 Ill. App. 3d 177

[lxvii] Robert H. Jerry, Understanding Insurance Law 722.

[lxviii] *Id.*

[lxix] Robert H. Jerry, Understanding Insurance Law 721.

[lxx] *Id.*

[lxxi] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 621.

[lxxii] *Id.*

[lxxiii] 149 Ill.2d 314, 597 N.E.2d 622 (1992).

[lxxiv] *Id.* at 326.

[lxxv] *Id.* at 328.

[lxxvi] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 619.

[lxxvii] Robert H. Jerry, Understanding Insurance Law 723.

[lxxviii] *Id.* At least where the insured's policy is permitted it to, before loss, release others from liability for loss. Andrew C. Hecker, Jr., Subrogation - Potential Defenses 619.

[lxxix] *Id.*

[lxxx] 126 Ill. App. 3d 52, 466 N.E.2d 1366 (2nd Dist. 1984).

[lxxxi] Robert H. Jerry, Understanding Insurance Law 724.

[lxxxii] *Id.*

[lxxxiii] Robert H. Jerry, Understanding Insurance Law 726-727.

[lxxxiv] *Id.*

[lxxxv] *Id.*; in Illinois, this exception is illustrated in *Gattorna v. American States Ins. Co.*, 122 Ill. App. 3d 582, 461 N.E.2d 675 (2nd Dist. 1984).

[lxxxvi] 71 Ill.2d 210, 375 N.E.2d 115 (1978).

[lxxxvii] Robert H. Jerry, Understanding Insurance Law 729.

[lxxxviii] *Id.*

[lxxxix] *Id.*

[xc] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 615.

[xci] Robert H. Jerry, Understanding Insurance Law 731.

[xcii] *Id.*

[xciii] 249 Ill. App. 3d 1064, 618 N.E.2d 734 (1st Dist. 1993).

[xciv] John B. McCabe and Martin C. Sener, Subrogation,10-10 (1998) (citing *Wadsworth v. United States Postal Service*, 511 F.2d 64 (7th Cir. 1975)); *Bastian v. TPI Corp.*, 663 F.Supp. 474 (N.D.Ill. 1987).

[xcv] John B. McCabe and Martin C. Sener, Subrogation, 10-10 (1998) (citing *Towner v. Black & Decker, Inc.*)

[xcvi] *Id.* (citing *Nitrin, Inc. v. Bethlehem Steel Corp.*, 35 Ill. App. 3d 577, 342 N.E.2d 65 (1st Dist. 1976)).

[xcvii] *See Standard Acc. Ins. Co. v. Pellechia*, 15 N.J. 162 (1954); *see also*, *Bost v. Paulson's Enters., Inc.*, 36 Ill. App. 3d 135 (2nd Dist. 1976).

[xcviii] Robert H. Jerry, Understanding Insurance Law 733.

[xcix] *Id.*

[c] *Id.*

[ci] *Id.*

[cii] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 618.

[ciii] 410 F.2d 1010 (D.C.Cir. 1969).

[civ] *See, First Nat. Bank of Ottawa v. Lloyd's of London*, 116 F.2d 221 (7th Cir. 1940); *see also Marotta v. General Motors Corp.*, 18 Ill.2d 168, 483 N.E.2d 503 (1985).

[cv] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 626; *see also, Pennwalt Corp. v. Metropolitan Sanitary Dist. Of Greater Chicago*, 368 F.Supp. 972 (N.D. Ill. 1973).

[cvi] *Id.*

[cvii] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 626; *see also, Sikora v. AFD Industries, Inc.*, 18 F. Supp. 2d 841 (N.D. Ill. 1998)(mandating joinder of subrogee as real part in interest after passing of statute of limitations).

[cviii] Andrew C. Hecker, Jr., Subrogation—Potential Defenses 626

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