UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA

In Re:

PROFILE SYSTEMS, INC., BKY 4-93-6080

Debtor. MEMORANDUM ORDER DENYING MOTION TO APPROVE SETTLEMENT

At Minneapolis, Minnesota, this 19th day of January, 1996.

The above-entitled matter came on for hearing before the undersigned on December 19, 1995, and arises by motion of the Chapter 7 Trustee, Phillip L. Kunkel ("Trustee"), for approval of a settlement of all claims related to a lawsuit pending in state court pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure. Appearances were as noted in the record. The Court, having heard the arguments of counsel, studied the papers, and being duly advised in the premises, has determined as follows:

FACTS

1. Charter Oak Fire Insurance Company, a wholly-owned subsidiary of the TravelersGroup ("Travelers"), insured the Debtor in this case, Profile Systems, Inc. ("Debtor"). As a result of a shelving collapse which occurred on September 25, 1993, on the premises in which the Debtor and an entity known as Security Archives of MSP, Inc. ("Security Archives") operated their business, Travelers, pursuant to its insurance policy, paid the Debtor $515,000 for damage to its business. The aforementioned sum, although representing the full limits under the insurance policy, apparently constituted only a portion of the Debtor's claimed loss.

2. Shortly after the collapse of the shelving, the Debtor filed for protection under Chapter 11 of the United States Bankruptcy Code. The petition commencing the Chapter 11 case was

NOTICE OF ENTRY AND FILING ORDER OR JUDGMENT
Filed and Docket Entry made on 1/22/96
Patrick G. Du Wane, Clerk, By

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filed on October 22, 1993. By Order dated December 1, 1993, Phillip L. Kunkel was appointed trustee in the Chapter 11 case. The Chapter 11 case was subsequently converted to a case under Chapter 7 and Phillip L. Kunkel was appointed the Chapter 7 trustee.

3. In May of 1994, Security Archives initiated a lawsuit in Ramsey County District Court, Court File No. CX-94-1419, for damages sustained in connection with the collapse of the shelving. The suit was commenced against several defendants who were allegedly responsible, at least in part, for the collapse of the shelving: The Interlake Companies, Inc., D.L. Systems, Inc., Lift, Stak & Stor, Inc., and Kahlstorf Brothers Installation Co. Inc.

4. By Order dated May 2, 1994, this Court granted Security Archives relief from the automatic stay in order to allow service of the summons and complaint in the state court action to be made upon the Debtor. Since the Debtor sustained uninsured losses, the stay was also lifted in order to permit the Trustee to assert a counterclaim and cross-claim under a number of theories against the various parties.

5. The Debtor tendered the lawsuit to Travelers which accepted the defense thereof under the general liability coverage provisions of the insurance contract between the Debtor and Travelers. By Order dated May 4, 1994, Travelers was authorized to retain the law firm of Rajkowski, Hansmeier, Ltd. ("Rajkowski") to represent the estate on the liability issues. The Trustee retained the law firm of Hall, Byers, Hanson, Steil & Weinberger ("Hall-Byers") to represent the estate's uninsured or nonsubrogated interest. Travelers also obtained relief from the automatic stay

on May 10, 1995, in order to retain the law firm of Pustorino, Pederson, Tilton & Parrington ("PPTP") "for the purposes of prosecuting Travelers' subrogation claim."[1] Rajkowski, PPTP, and Hall-Byers thereupon formed an association and representatives from each firm acted as co-counsel and actively participated in the state court action.[2] Indeed, all counsel apparently participated

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[1]Travelers' insurance contract with the Debtor expressly and unambiguously provides for subrogation:

> I. TRANSFER OF RIGHTS OF RECOVERY AGAINST OTHERS TO US
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> If any person or organization to or for whom we make payment under this Coverage Part has rights to recover damages from another, those rights are transferred to us to the extent of our payment. That person or organization must do everything necessary to secure our rights and must do nothing after loss to impair them. But you may waive your rights against another party in writing:
>
> 1. Prior to a loss to your Covered Property or Covered Income.
>
> 2. After a loss to your Covered Property or Covered Income only if, at time of loss, that party is one of the following:
>
> a. Someone insured by this insurance;
> b. A business firm:
> (1) Owned by you; or
> (2) That owns or controls you; or
> c. Your tenant.

The Trustee readily acknowledges Travelers' has both a contractual as well as an equitable right of subrogation.

[2]For strategic reasons, Travelers elected to pursue its subrogation claim in the name of the Debtor rather than in its own name. Indeed, subrogation claims are generally brought in the name of the insured rather than the insurer so that the controversy appears as a dispute between the insured and third parties. When, such as in this case, an insurer has paid only part of the loss and the insured continues to have a beneficial interest in the cause of action, such a practice can be further justified. It should be noted, however, that where there is only a partial reimbursement of the insured's loss and the insured has assigned or transferred its right of recovery against a tortfeasor with respect to its insured loss, both the insurer and the insured are essentially real parties in interest despite the fact that the case may be brought only in

in each phase of discovery and were involved in settlement negotiations. All parties to the lawsuit had full knowledge of the fact that the Debtor had been indemnified for a portion of its loss and of Travelers' claim for subrogation under the insurance contract.

6. During the course of the state court litigation that preceded a trial on the merits, which was scheduled to last three weeks and commence on October 23, 1995, the Debtor tendered to the several defendants a settlement demand of $900,000. The Trustee at that point agreed with Travelers that the amount would be split evenly between the bankruptcy estate and Travelers' subrogation claim.

7. Prior to the commencement of the trial, disagreements developed between counsel for the Trustee and counsel for Travelers over the merits of the case, the position of Travelers' subrogation claim in the trial, as well as appropriate trial and settlement strategy.[3] The parties were simply unable to reach a consensus and, consequently, the Trustee essentially took reign of the case.

8. Over the objection of Travelers, the Trustee separately negotiated a compromised settlement with the several defendants in the case "without regard to Travelers' subrogation interests." On October 31, 1995, the Trustee negotiated a settlement with the

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the name of the insured. See National Garment Co. v. New York C. & St. L.R. Co., 173 F.2d 32, 34-35 (8th Cir. 1949).

[3]The Trustee was of the view that any ultimate judgment or settlement would belong to the bankruptcy estate since it was prosecuted in the name of the Debtor and that the distribution of any funds received would be subject to approval of the bankruptcy court. Travelers, by contrast, apparently contended that it was entitled to receive those monies that represented its portion of the claim in the case on account of its right of subrogation.

defendants of $105,000 in exchange for a dismissal with prejudice of all claims asserted by or on behalf of the Debtor in the pending lawsuit, including Travelers' subrogation claim.

9. In order to assume a posture which more adequately protected its subrogation claim, Travelers brought a motion to intervene in the state court litigation. At the time of the hearing before this Court, that motion was still pending.

10. The Trustee is seeking this Court's approval of the settlement and authorization to execute a stipulation of dismissal with prejudice of all claims asserted in the name of the Debtor in the state court action including the claim by Travelers which asserts a subrogation interest. Travelers objects to the approval of the settlement to the extent that such approval prejudices its independent right of subrogation. Travelers further asserts that its claim for subrogation is not property of the estate and, therefore, falls outside the Trustee's authority to liquidate estate assets under Code § 704(1).

CONCLUSIONS OF LAW

Although subrogation is a normal incident of an insurance contract, subrogation is fundamentally a creature of equity that serves the ends of justice by placing the economic responsibility for injuries ultimately on the party whose fault caused the loss. See Great N. Oil Co. v. St. Paul Fire & Marine Ins. Co., 189 N.W.2d 404, 406 (Minn. 1971). It is axiomatic insurance law that an insurer who has paid benefits to an insured after a loss covered under a contract is subrogated pro tanto to the "rights" of the insured as a matter of law and may enforce those rights against third-party tortfeasors. Aetna Life Ins. Co. v. Town of

Middleport, 124 U.S. 534, 548-49 (1888). A payment thus made by an insurer because of its pre-existing duty does not extinguish the claim on which the payment is made but, rather, has the legally operative effect of transferring that claim, and all the insured's rights, remedies, and equities with respect thereto, from the insured to the insurer.

The insurer's right of subrogation arises by virtue of its payment and vests when payment is made. The underlying debt, however, is not discharged by the payment but remains subsisting for the benefit of the insurer. Subrogation therefore makes an equitable adjustment between parties by creating a legal fiction that operates as a de jure assignment of the debt and the pro tanto substitution of the insurer to all the rights possessed by the insured with respect to that portion of the claim. See Rowe v. St. Paul Ramsey Medical Ctr., 472 N.W.2d 640, 643 (Minn. 1991)(indicating that a subrogee is substituted to the rights of the subrogor and effectively steps into his or her shoes). Since the right to subrogation contemplates a transfer of at least some portion of the insured's substantive rights, the insurer whose claim has vested has a legally protectable interest and not merely a naked right of reimbursement.[4]

The seminal issue governing the resolution of the dispute in this case is in all essential respects identical to the issue raised in both Travelers Indemnity Co. v. Vaccari, 310 Minn. 97,

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[4]It is significant to note that circumstances involving the ownership of two separate claims by a single entity, which is the holder of all of the legal and equitable interests in both claims, can be distinguished from situations in which one of the claims involves an insurer's subrogation interest and the other involves the insured's residual interests for uninsured losses.

245 N.W.2d 844 (1976), and Time Ins. Co. v. Opus Corp., 519 N.W.2d 470 (Minn. Ct. App. 1994): May the terms of a compromised, pre-trial settlement agreement between alleged tortfeasors and an insured that provides for a release of all claims be enforced against an insurer who has a contractual and equitable claim for subrogation where all parties have actual notice of the insured's subrogation interest? Stated differently, may the Trustee in this case unilaterally procure a general release from third-party tortfeasors that extinguishes all claims in the state court lawsuit in disregard of Travelers' known subrogation interest and over its objection? A careful examination of Minnesota state law requires this Court to answer these questions in the negative.

The Minnesota Supreme Court in Travelers Indemnity Co. v. Vaccari, 310 Minn. 97, 99, 245 N.W.2d 844 (1974), held that subrogation clauses which give an insurer the right of subrogation against a third-party tortfeasor for payments made to its insurer under an insurance policy are valid and enforceable contractual provisions. Id. 310 Minn. at 99, 245 N.W.2d at 846. The court expressly concluded that where a tortfeasor and its liability insurer willfully disregard the subrogation claim of the injured party's insurer and enter into a settlement that provides for a general release, the insurer's subrogation claim is not extinguished:

> The general rule in most jurisdictions is that when a tortfeasor or the tortfeasor's liability insurer, with notice of an insurer's subrogation claim, procures a general release by making a settlement with the insured, the release will not affect the insurer's right of subrogation. Such a settlement is deemed to be the equivalent of a fraud upon the insurer and thus can have no effect upon the insurer's subrogation rights.
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> To hold that such a settlement destroys an insurer's subrogation rights would have the practical effect of

> encouraging a tortfeasor or his liability insurer to disregard notice of an insurer's valid subrogation claim and attempt to procure a general release from the insured. We believe that the tortfeasor and his liability insurer have a duty to act in good faith under such circumstances. Therefore, we hold that where a tortfeasor and his liability insurer willfully disregard notice of the subrogation claim of the injured person's insurer and enter into a separate settlement with the injured person, such a settlement does not defeat his insurer's subrogation rights.

Id. 310 Minn. at 103, 245 N.W.2d at 848.

The insured in Time Ins. Co. v. Opus Corp., 519 N.W.2d 470 (Minn. Ct. App. 1994), Steen, was seriously injured in a construction accident in which Opus was the general contractor. Pursuant to Steen's health insurance policy, which unlike the policy in the case at bar contained no subrogation clause, Time indemnified Steen nearly $97,000 for medical expenses, said amount only constituting a portion of his loss. Time discovered that Steen had commenced a personal injury action against Opus and informed Steen, Opus, and their respective attorneys of its subrogation interest. Opus's attorney, after reviewing Steen's insurance contract, decided that Time had no legal right of subrogation. Opus and Steen entered into a settlement of the case whereby Opus agreed to pay Steen $150,000 in exchange for a complete release of all claims. The agreement expressly provided that it did not represent a payment for medical expenses or constitute full recovery for the harm suffered. Time never consented to the terms of the agreement.

The Minnesota Court of Appeals, following the lead of the court in Vaccari, concluded that an alleged tortfeasor may not willfully disregard the insurer's subrogation claim upon receiving notice of it by entering into a separate settlement agreement with

the insured. Id. at 474. Any such settlement, despite the inclusion of language providing for a release of all claims, will not, ruled the court, defeat the insurer's subrogation rights. Id. The court expressly rejected as a "novel" theory the notion advanced by the Trustee in this case that the insurer should have intervened in the lawsuit in order to preserve its right of subrogation.[5] See id.

Regardless of whether the right to subrogation is the result of an express provision in an insurance contract or is merely of equitable origin, the majority of courts and commentators that have considered the issue are in resounding agreement with the fundamental tenets set forth in Vaccari and Opus. See, e.g., National Ins. Underwriters v. Piper Aircraft Corp., 595 F.2d 546, 551 (10th Cir. 1979); Lone Star S.S. Co. v. Kirby Lumber, 37 F.2d 474, 475 (5th Cir. 1930)(opining that once the right to subrogation has attached, the insured may not release the claim of the insurer); Schmidt v. Clothier, 338 N.W.2d 256, 261-62 (Minn. 1983); St. Paul Fire & Marine Ins. Co. v. Amerada Hess Corp., 275 N.W.2d 304, 308 (N.D. 1979)(holding that a subrogee does not, absent its consent, waive its right of subrogation; any attempt to limit the insurer's right of subrogation by a full release to which it is not a party is a nullity and does not preclude a subsequent action by

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[5]It is significant to parenthetically note, in light of Travelers' pending motion to intervene, that:

> After the insurer has intervened in an action by the insured against the wrongdoer, and has shown a monetary interest in the result thereof, the court will not permit a settlement between the insured and the wrongdoer to the detriment of the insurer, but will protect the rights of all the parties.

16 Couch on Insurance § 61:200, at 261 (2d ed. 1983).

the subrogee); Liberty Mut. Ins. Co. v. Nutting Truck & Caster Co., 295 Minn. 211, 216, 203 N.W.2d 542, 545 (Minn. 1973); Sentry Ins. Co. v. Stuart, 439 S.W.2d 797, 799-800 (Ark. 1969); Lang v. William Bros. Boiler & Mfg. Co., 250 Minn. 521, 528, 531, 85 N.W.2d 412, 417, 419 (1957)(opining that a subrogee, having been accorded the right of indemnification for that which is paid, may not have its right affected by a settlement and release to which it is not a party); Jackson v. Zurich Am. Ins. Co., 530 N.W.2d 804, 806 (Minn. Ct. App. 1995)(disagreeing with the argument that even if the subrogee does not consent to a settlement, the insured may agree to a general release of all claims and foreclose any action by the subrogee against third-party tortfeasors); Group Health, Inc. v. Heuer, 499 N.W.2d 526, 529 (Minn. Ct. App. 1993); Donohue v. Highlands Underwriters Ins. Co., 198 Cal. App. 3d 1176, 1182 (Cal. Ct. App. 1988); Allum v. MedCenter Health Care, Inc., 371 N.W.2d 557, 559-60 (Minn. Ct. App. 1985)(following Vaccari). See also 16 Couch on Insurance §§ 61:191, 61:201, at 247 & 262-65 (2d ed. 1983); Appelman, 6A Insurance Law & Practice § 4092, at 246 (1972); Annotation, Rights & Remedies of Property Insurer as against Third-Person Tortfeasor who has Settled with Insured, 92 A.L.R.2d 102, 147-48 (1963)("[W]here a tortfeasor chargeable with notice of an insurer's rights makes a compromise settlement with the insured to which the insurer is not a party, the tortfeasor either waives his right to invoke or is estopped to rely upon the rule [against splitting a cause of action] as a defense to an action by the nonconsenting insurer as subrogee. Under such circumstances [any] settlement is regarded as having been made subject to and with a reservation of the rights of the insurer . . . ."). Courts have

thus generally not permitted an insured to "freeze out" an insurer and bargain away its known right of subrogation as consideration for a settlement with alleged tortfeasors.[6]

It is significant to note that the rights as between an insured and its insurer are governed and generally determined by the provisions of the insurance contract itself. The language of the insurance contract in this case expressly and unambiguously accords Travelers a right of subrogation to the extent of its payment. Indeed, the contract provides that the Debtor agreed to "transfer" any rights which it had to Travelers to the extent of the indemnified loss, and effectively precludes the Debtor from waiving its rights against third-party tortfeasors in contravention

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[6]The Trustee's reliance on the "full recovery" rule is misplaced and has no applicability to the facts of this case. The argument the Trustee advances has in fact been rejected by the Minnesota state courts when raised in virtually identical factual contexts. See, e.g., Travelers v. Vaccari, 310 Minn. 97, 245 N.W.2d 844 (Minn. 1976). See Allum v. MedCenter Health Care, Inc., 371 N.W.2d 557, 559-60 (Minn. Ct. App. 1985):

> Respondents claim [the insurer] does not have a subrogation interest because the settlement did not fully and adequately compensate [the insured]. The same argument was raised before the Minnesota Supreme Court in Travelers. The Travelers court impliedly rejected this contention.
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> Respondents cite Westendorf v. Stasson, 330 N.W.2d 699 (Minn. 1983), as supporting their contention. . . . Westendorf does not apply to a situation where an insurer seeks to enforce its subrogation rights against a tortfeasor and his insurers. Application of Westendorf to preclude an action against the tortfeasor and his insured under these circumstances would eviscerate the rule set forth in Travelers and permit fraud upon insurers.

Id. at 560 (citations omitted). See also MedCenters Health Care, Inc. v. Ochs, 854 F. Supp. 589, 592 (D. Minn. 1993)(indicating that the full recovery rule will not displace an insurer's subrogation rights that are unambiguously provided for in the contract), aff'd, 26 F.3d 865 (8th Cir. 1994); Hershey v. Physicians Health Plan of Minnesota, Inc., 498 N.W.2d 519, 520 (Minn. Ct. App. 1993)(opining that the full recovery rule may be modified by contract).

of Travelers' subrogation interest after receiving payment for a covered loss. Moreover, the insurance contract imposes an affirmative obligation upon the Debtor to safeguard Travelers' right of subrogation and prohibits the Debtor from taking any action which may impair or prejudice that right. The enforcement of the proposed settlement in this case would prejudice Travelers' right of subrogation and could arguably constitute a breach of an express subrogation provision. See 16 Couch on Insurance § 60:38-39, at 35-37 (2d ed. 1983). See generally Sentry Ins. Co. v. Stuart, 439 S.W.2d 797 (Ark. 1969); National Union Fire Ins. Co. v. Grimes, 153 N.W.2d 152, 156 (Minn. 1967)(finding a breach of an agreement to repay insurer out of settlement proceeds to merit the allowance of an offset for expenses incurred).

As this case amply demonstrates, where separate counsel in a lawsuit are retained to represent the nonsubrogated interests of the subrogor and the subrogated interests of the subrogee, tactical and strategical problems may arise. Those problems may be compounded even further when the insured is in bankruptcy and an additional layer of counsel is added to the mix. In such situations, subrogation is often akin to a shot-gun marriage--a forced partnership of what in reality may amount to competing interests for a limited pool assets. Even so, the Trustee's authority compromise and settle claims on behalf of the "estate" is derivative since the bankruptcy estate's interest in property generally remains as it was prior to commencement of the case. In re Squyres, 172 B.R. 592, 594 (Bankr. C.D. Ill. 1994). In that vein, "[t]o the extent that the legal or equitable interest of the debtor in property is limited in the debtor's hands, it is equally

limited in the hands of the estate." Id. Accord 4 Collier on Bankruptcy ¶ 541.01, at 541-7 (Lawrence P. King et al. eds., 15th ed. 1995)("Although the broad provision of section 541(a)(1) includes choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others beyond what rights existed at the commencement of the case. . . ."). A trustee cannot take any rights greater than the debtor itself possessed as of the commencement of the case and, therefore, has no authority to compromise those claims which do not belong to the estate or which may be subject to the interest of another. See id. Moreover, a court contravenes basic notions of fairness if it only reviews the terms of a settlement through the eyes of a debtor and settling claimants and ignores the rights of third parties. Feld v. Zale Corp. (In re Zale Corp.), 62 F.3d 746, 754 (5th Cir. 1995).

Although the Trustee has the authority to enter into a settlement which provides for a release of the estate's claim or nonsubrogated interest, that release must be structured so as to preserve the insurer's right of subrogation or, alternatively, be executed by Travelers. This Court will not approve a global settlement in this case which purports to waive or compromise Travelers' known claim for subrogation without its consent.

Accordingly, and for reasons stated, the motion of the Trustee, Phillip L. Kunkel, for approval of a settlement agreement is in all things DENIED.

SO ORDERED.

Nancy C. Dreher
United States Bankruptcy Judge