Subrogation

by
Michael J. O'Hara, J.D., Ph.D.
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Abstract: Snatching defeat from the jaws of victory is one way to think of subrogation. In the civil law generally, and specifically in the law of damages, subrogation is a right of party #3 to stand in the shoes of party #1 for the purposes of #1's right to sue party #2. Insurers, after having paid an insurance claim, typically, have a right of subrogation against a plaintiff's recovery from a defendant. Accordingly, a "successful" law suit by an insured plaintiff might be all cost and no benefit for the plaintiff personally. When does that foster the public policy of equitable and efficient risk allocation?

The law allocates risk via general rules but subject to specific exceptions (i.e., the specific controls the general). An attentive AEF reader of this manuscript ought to be able to see much of the genesis of the fall 2008 financial debacle in the fundamental error of equating a clearly recognized legal allocation of risk with actually recovering on such legal claims (e.g., CDOs of bundled subprime mortgages). This manuscript is about legal claims and the allocation of legal risk; and, is not about whether any one of a creditor's multiple debtors is good for that debt. The core of the intended audience for this manuscript are those many readers whose schooling in the law is ordinary for an AEF audience. For most AEF readers this manuscript will be quite informative as to how the law allocates risk. Other readers whose schooling in the law is a bit long in the tooth with find this manuscript ranging from remedial to enlightening. Lastly, are those few AEF readers who are well schooled in the law, for you this manuscript is apt to appear rudimentary. However, it is hoped that this synthesis might fill a few gaps and/or reveal linkages in the law's risk allocation via subrogation that had escaped your earlier notice.

At its core, subrogation is about preventing **unjust enrichment**. Unjust enrichment can occur in an infinite variety of transactions. The breadth of unjust enrichment spring from its foundations in equity rather than in law.[1] Subrogation addresses but one subset of unjust enrichment. Subrogation seeks to prevent unjust enrichment in a transaction with at least three parties; one of whom pays the debt of another. To prevent unjust enrichment subrogation substitutes the party (i.e., subrogee) paying the debt of another (i.e., debtor) for the party owed (i.e., creditor *qua* subrogor) the paid debt in that party's relationship with the other party who owed the debt. Note, two forms of unjust enrichment are being prevented. First, the recipient of the benefit (i.e., subrogor *qua* creditor) is being prevented from obtaining double payment of the debt (i.e., first from the subrogee and second from the debtor). Second, the debtor indirectly received benefit via the subrogee's performance of the debtor's legal duty; which reduces the likelihood the creditor qua subrogor will be sufficiently motivated to pursue payment from the debtor. Primarily, but far from exclusively, subrogation is found within equity rather than the law. In particular, in the law all contracts always are enforced using the principle of subrogation even though, ordinarily,

[1] See footnote 36 and surrounding text for a discussion of some of the differences between law and equity.

equity would not be used in law.

Generically, both law and equity, but especially equity, vary widely across legal jurisdictions. Accordingly, to rein in some of that variability this manuscript will be limited to the jurisdiction of Nebraska. Additional limitations on this manuscript will be noted later in this manuscript.

Subrogation prevents unjust enrichment via the substitution of one person who is not a volunteer, the subrogee, for another, the subrogor, as the result of the subrogee's payment of a debt owed to the subrogor, so that the subrogee succeeds to the subrogor's right to recover the amount paid by the subrogee from the subrogor's debtor.[2] The objects sought by subrogation are the prevention of unjustice and the promotion and accomplishment of justice via compelling the ultimate payment of a debt by that person who in justice, equity, and good conscience, ought to pay it.[3]

The key is the subrogee pays a debt owed to the subrogor; and that payment is made not as a volunteer with respect to the debtor of the subrogor. Equity recognizes that the subrogor receives a benefit from the subrogee as well as recognizes that the debtor of the subrogor also receives a benefit from the subrogee via the subrogee's payment to the subrogor. Accordingly, if the debtor were to pay the subrogor, and if the subrogor were not to reimburse the subrogee, then the subrogor would be unjustly enriched via double payment. The subrogee's right of subrogation is the right to either [a] require the subrogor's debtor to make payment directly[4] to the subrogee; or [b] require the subrogor to transfer to the subrogee payment received from the subrogor's debtor.

In short, if party #3 owes party #2 a debt, but party #1 pays #3's debt, then to prevent unjust enrichment by #2 equity will require either #3 to pay #1 instead of #2; or, if #3 pays #2, then #2 pays #1. Party #2 is the subrogor. Party #1 is the subrogee. Party #3 is the debtor of the subrogor *qua* creditor. To prevent unjust enrichment by either the subrogor or the debtor of the subrogor, the subrogee has a right of subrogation against the subrogor. The subrogee's right of subrogation (i.e. substitution) against the subrogor also means the subrogee can enforce that right *vis-à-vis* the debtor of the subrogor.

There are several elements required for subrogation: [i] a debt; [ii] third party owes subrogor that debt; [iii] subrogee pays the debt of another; [iv] subrogee pays not as a volunteer; and [v] subrogation in favor of the subrogee required to prevent unjust enrichment by either the subrogor or the third party.

What is a debt will be read very broadly[5] because subrogation originates in equity.[6] Accordingly, nearly any obligation discharged with suffice for a debt paid. For our purposes it is wise to not minimize the importance of this element because who owes what to whom is central to whether unjust enrichment is present. Keep your eye

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[2] *Combined Ins. v. Shurter*, 258 Neb. 958, 607 N.W.2d 492 (2000).

[3] *Luikart v. Buck*, 131 Neb. 866, 270 N.W. 495 (1936).

[4] See footnote 11 and footnote 56 for a discussion of the law's strong reluctance to allow delegation of duties. Equity allows such delegations subject to the maxims of equity (see footnote 36).

[5] *Gillotte v. Omaha Public Power District*, 189 Neb. 444, 203 N.W.2d 163 (1973), modified on other grounds, *Nekuda v. Waspi Trucking, Inc.*, 222 Neb. 806, 388 N.W.2d 438 (1986). In a workers' compensation subrogation case the benefits bestowed are not measured solely by the damages recovered but also measured by the subrogor's liability relieved or discharged.

[6] See footnote 36 and the surrounding for a discussion of some of the differences between law and equity.

on whose debt's are paid and by whom.

A subrogee must pay the debt of another. This requirement prompts the legal rule that a primarily liable party can not obtain subrogation rights. However, since the language of the law can be quite flexible (some wags might allege extreme ambiguity), the rule "a primarily liable party can not obtain subrogation rights" is both completely true as well as can be very misleading given the vernacular of the law. The phrase primary liability is used with at least two meanings, one of which is materially different from what subrogation seeks to capture.

"**Primary liability**" often is paired with a companion word "**surety**" that similarly has two meanings that also vary. All sureties are primarily liable; but, some sureties can obtain subrogation rights. At this time let's focus on those two pairs of meaning.

To understand the rule that a primarily liable person can not be a subrogee requires a little knowledge external to that rule. Legal liability can be primary or can be secondary. Generically the law will use the word surety to identify a party who is primarily[7] liable, whereas the law will use the word guarantor to identify a party who is secondarily[8] liable. Surety, however, also can be used to identify a guarantor who all parties expressly agree will take up primary liability for a fee (e.g., bonding firm). For the purposes of this manuscript, focus on the debt paid by the purported subrogee.

A multi-party transaction will have at least one party with either primary liability or secondary liability. All transaction with guarantors or sureties are transactions with three or more parties. Most transactions are two party transactions.[9] Most multi-party transactions have zero guarantors and zero sureties. Both guarantors and sureties stand ready to act instead of another. A surety (e.g., co-signer) agrees to act as a primarily liable party. A guarantor (e.g., co-signer) agrees to act only upon the breach of the primarily liable party. A subrogee can not be primarily liable on the debt paid because the primarily liable party does not pay the debt of another.

The difference between primary and secondary liability is who has the obligation to pay first. A primarily liable person is a debtor who is legally obligated to pay first. A secondarily liable debtor has zero obligation to pay anything unless and until the condition precedent of the primarily liable debtor has breached to duty to pay the creditor; whereupon, the secondarily liable debtor becomes fully liable to the creditor. If the secondarily liable debtor pays the debt owed to the creditor, then the secondarily liable debtor has subrogation rights against a defaulting primarily liable debtor.

For an example let's consider a car loan in the form of a promissory note with two debtors each, co-signing the note. The terms of a promissory note specify who is primarily liable. If a promissory note has two debtors' signatures, then either there are [a] two primarily liable debtors, or [b] one primarily liable debtor and one secondarily liable debtor. If a bank wrote the promissory note, then you can be sure it specifies both

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7 Legal liability is primary or secondary. It is feasible (e.g., co-signers) to have multiple parties with primarily liability as well as multiple parties with secondary liability. A creditor may pursue the primarily liable party of the creditor's choice. In contrast, a secondarily liable party has zero obligation to pay unless and until a condition precedent occurs. (See footnote 13 re types of conditions.) Most frequently, but not necessarily, the event that must occur to transform the secondarily liable person into a primarily liable person is the default of the primarily liable party. Can you say "A.I.G."?

8 See footnote 7.

9 See footnote 56's discussion of third party rights.

co-signers are primarily liable. When there is a pair of primarily liable co-signing debtors both of the debtors are obligated to pay first; and, the bank is free to ignore one and demand payment solely from the other. A person who is primarily liable on debt personally owes that debt and has no *subrogation* right of recourse[10] against [i] any secondarily liable co-signing debtors, or [ii] any co-signing primarily liable debtors. In contrast, since the secondarily liable debtor owes nothing until the primarily liable debtor breaches and thereby creates the condition precedent for the secondarily liable debtor's primary liability, the secondarily liable debtor is the subrogee of the primarily liable subrogor.

The subrogor can not be the subrogee. Legally, you can not owe yourself money. Ordinarily, the phrase primarily liable is used globally to identify who, among all participants, is obligated to pay first: but, not always.

Who is another? There is no other among multiple primarily liable parties using the most common meaning of the phrase primarily liable. However, there are sureties with primary liability that are paying the debt of another. Such sureties start as guarantors, and thus are paying the debt of another.

Ordinarily, the term surety merely identifies a third party with primary liability. Surety also has a special meaning. Surety has a special meaning when it is used to describe a person who is in the business of being sufficiently financially secure to be able to accept the transfer of the obligation to pay debts of another and thereby reduce the total risk of a transaction both for the parties and for society. For example, a bonding firm is a surety who becomes primarily liable but also gains the right to subrogation. Generically, the new common law[11] governing the assignment of rights and the delegation of duties freely permits the former while severely constricting the latter. That is, it is easy to legally transfer your right to receive assets, but it is difficult to legally transfer your obligation to pay debts. The bonding firm's financial security relative[12] to the others in the transaction empowers the parties' delegation of duties so that the ordinarily secondarily liable bonding firm *qua* guarantor becomes a primarily liable surety. It's the bonding firm's original status as guarantor that allows the bonding firm

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[10] If there are multiple primarily liable parties and if only one makes payment on the debt, then there will be right of recourse provided by equity to prevent unjust enrichment. However, that right of recourse will not be subrogation. Instead, the payor primarily liable party with have a right to contribution from the other primarily liable parties. In many, but not all, circumstances the right to contribution and the right to subrogation will be nearly indistinguishable.

[11] The old common law of assignment of rights and delegation of duties was based upon a context of rural social relations where each individual was legally unique whereas the new common law of assignment of rights and delegation of duties is based upon a context of urban social relations where each individual is presumed fungible for the purposes of most transactions. Accordingly, the old common law of assignments and delegations held that all assignments and delegations violated the parties' reasonable expectations since all relationships were "personal" in nature. Today, the law views debts owed as personal, but the right to receive assets are seen as fungible. Accordingly, the parties' reasonable expectations enforced by the new common law generically allows free assignment and generically bars delegations. Both the old and the new common law focus on the parties' reasonable expectations; but, the old reasonable expectations are materially different than the new reasonable expectations.

A CDO of subprime mortgages is an assignment of cash flow off of those mortgages. AIG stepped in as bonding surety for the benefit of the purchasers of those CDOs. AIG's counter parties were made whole and in exchange AIG received subrogation rights to claim against mortgagor's in default (i.e., foreclosed jingle mail). What does a thief look like?

See also footnote 56 regarding third parties claiming on the contracts of others.

[12] Like A.I.G.?

to avoid the bar on a primarily liable party from becoming a subrogee.

As an example of this special meaning of surety, a firm that issues a construction performance bond is a surety. If a construction firm purchases a bond for the benefit of the building owner, and if the construction firm breaches, then, by contract between those three parties, the parties specify the bonding firm as primarily liable to the building owner for the breach of the construction firm. However, in fact, with respect to the construction of the building, the construction firm is primarily liable and the bonding firm is secondarily liable. The bonding firm's liability is transformed from secondary to primary liability by the occurrence of a condition precedent.[13] The bonding firm is primarily liable on the bond rather than primarily liable to construct the building. Accordingly, the bonding firm becomes a subrogee of the building owner as subrogor with respect to the building owner's subsequent recovery from the breaching[14] construction firm.[15] This special type of meaning for primarily liable routinely can be found in all forms of large transactions since those parties routinely seek to involve sureties for financially hazardous fractions of their transaction

Now let's use the generic meaning of surety but do so in a context where a person primarily liable on the debt paid is eligible for subrogation. A person originally with no liability on a debt may become primarily liable on that debt via the action of accommodation. For example, when you write a check you are secondarily liable and your bank has no liability on that check (i.e., no one is primarily liable on a check). If your payee presents your check to the drawee bank and requests that the bank honor your check by the bank granting an accommodation rather presently making the payment you ordered, then your bank might choose to presently set aside funds from your account and the bank add its signature to the face of the check as an accommodation party[16] rather than pay your check. Now (by virtue of its signature on the front of your check) the bank is primarily liable on your check, but your bank will have become your subrogee and you the subrogor if those segregated funds prove to not be yours.[17]

A prerequisite to subrogation is to pay a debt for which another is liable.[18]

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[13] Contract law uses conditions precedent, concurrent, and subsequent. Generically, a condition precedent turns on a legal duty; a condition concurrent binds two or more parties to simultaneous performance obligations (e.g., perfect tender of being ready, willing, and able to render complete performance); and a condition subsequent turns off a legal duty.

Breach by a bonded party is a condition precedent for the bonding party's duty to perform; thereby transforming the bonding party's secondary liability into primary liability.

[14] Contract performance can be complete performance, substantial performance, or material breach.

Complete performance discharges the party's contractual duty to perform; and, no damages are owed. Substantial performance is a breach. While substantial performance is a breach it is sufficient performance to discharge the contractual duty to perform; but, damages are owed. Substantial performance is performance less than complete performance (hence a breach) but is sufficient performance to satisfy most reasonable expectations; and, those defeated expectations can be adequately addressed with damages. Performance that is a material breach is far below reasonable expectations; thus the duty to perform is not discharged and damages are owed.

A student skipping some classes but sitting for all exams is substantial performance. A student skipping one exam is a material breach.

[15] *Barnes v. Hampton*, 198 Neb. 151, 252 N.W.2d 138 (1977).

[16] UCC 3-419.

[17] *Mead Co. v. Doerfler,* 148 Neb. 75, 26 N.W.2d 393 (1947).

[18] *Leader Nat. Ins. Co. v. American Hardware Ins. Group*, 249 Neb. 783, 545 N.W.2d 451 (1996).

Subrogation is not available where the debt paid by the subrogee is a debt for which the subrogee is primarily liable.[19] A subrogee stands in the shoes of the subrogor: the subrogee only gets those rights and bears (most of) the burdens of the subrogor as a plaintiff.[20] The subrogee, merely by virtue of subrogation, does not improve the position of the subrogee as a creditor.[21]

But recall, fewer than all persons[22] are natural persons (i.e., humans). Some persons are mere legal persons (e.g., corporations). While all natural persons within a jurisdiction also are legal persons, corporations and their ilk are mere legal persons.

Is there a **debt of another** when a corporation is present? A corporation with a single human as its sole shareholder, and as its sole director, and as its sole officer might appear to be a single person, but, in the eyes of the law, there is a natural person present as well as mere legal person present. There are two persons present: the human and the corporation. Accordingly, for example, Jane Smith *qua* self could be secondarily liable on a debt for which Jane Smith *qua* sole shareholder/director/officer acting instead of and on behalf of her mere legal person the corporation is primarily liable. To the untrained eye, it might appear that Jane was the subrogor for Jane the subrogee. Not so. The legal person (i.e., her corporation) is the subrogor and the legally distinct natural person (i.e., Jane) is the subrogee. Jane is not personally[23] primarily liable.

When you are married, is there another[24] present? While in a marriage the husband and the wife cleave unto each other and become one, that does not equate with only one person being present in all transactions. Sometimes there are three persons present (i.e., the legal person the marriage, the natural person the wife, and the natural person the husband). Some interests springing from the marital estate[25] are personal in

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[19] *Chadron Energy Corp. v. First Nat. Bank of Omaha*, 236 Neb. 173, 459 N.W.2d 718 (1990).

But, recall footnote 7. The primarily liability barring subrogation rights is in the form a co-signor's primarily liability. A bonding surety has secondary liability unless and until one of the primarily liable parties defaults, thereby providing the condition precedent for triggering the bonding surety's primarily liability. Accordingly, a bonding surety who pays on the bond does pay the debt of another and does obtain subrogation rights.

[20] *Rice v. Winters*, 45 Neb. 517, 63 N.W. 830 (1895).

[21] *Rice v. Winters*, 45 Neb. 517, 63 N.W. 830 (1895); *Motor Club Ins. Ass'n. v. Fillman*, 5 Neb.App. 931, 568 N.W.2d 259 (1997).

[22] The USA *Constitution* expressly grants some constitutional rights to citizens and other constitutional rights to persons (e.g., Amendment XIV, section 1). The relative quantity and the relative quality of those rights are greatest for [A] citizens; which exceed those of [B] natural persons; and, in turn, those of natural persons exceed those of [C] mere legal persons; and the constitutional rights of mere legal persons exceed those of entities that are [D] not even mere legal persons. All citizens and all "consumers" are natural persons; but, not all natural persons are citizens or "consumers" (e.g., sole proprietorship).

To test your grasp of the above paragraph try answering the following two questions: [A] What percent of illegal aliens in Houston are both natural persons and legal persons?; and, [B] Why was the underpants bomber read the *Miranda* warning?

[23] "Personal" is used in the law to facilitate distinguishing the liability of a natural person from the liability of that natural person while exercising authority as another person (e.g., corporate CEO). Legally, the actions of a CEO are the actions of the corporation rather than the actions of the natural person who is occupying the position of CEO. However, must like equity which focuses more on substance while the law focuses upon form, ethics pins on the natural person acting as CEO personal ethical responsibility.

[24] All have heard of the privilege of a spouse to not testify against one's spouse. That springs from the legal fiction of the two persons who are married being but one person.

[25] Marriage is a special multi-party relationship. The law recognizes other multi-party relationships (e.g., partnership). Subrogation is more likely when the parties knowingly and voluntarily joined together prior to the action triggering subrogee's payment of the debt of another.

nature and are not by implication captured by some transactions that capture other non-personal interests that spring from the marital estate. Sometimes each spouse is a person separate and distinct from the other spouse, and sometimes they are together but one person (i.e., the marriage).[26]

Subrogation is created when the subrogee pays a debt owed by another to the subrogor; and, does so not as a volunteer. Context is critical. The relationship between the parties influences whether there is any unjust enrichment.

A subrogee is not a **volunteer**. A volunteer acts from a motivation other than an exchange or compensation. A volunteer often, but not necessarily, gives a gift. Clearly, parties with contractual obligations voluntarily taken up in a bargained for exchange of legally sufficient value are not volunteers. They act voluntarily but they are not volunteers.

Who is a volunteer? Subrogation requires that the payor of the debt not be a volunteer. If the payment is made with the intent to merely aid the debtor, then that payor is a volunteer. In contrast, if the payment is made with the intent of being substituted for the debtor, then it is certain that the payor is entitled to the status of subrogee. In between those two ends of the continuum is a payment made as a loan (i.e., with an expectation of repayment). Clearly, a payor extending a loan is not a volunteer, but that payor might not be entitled to the right of subrogation. Subrogation recognizes a linkage between the subrogee and the original subrogor's creditor. A mere loan does not prove that linkage. Subrogation requires proof of a payor not acting as a volunteer as well as proof that payor is linked to the original debtor of the subrogor. Less than that raises the question of whether the payment was made as a volunteer.[27]

Volunteers can be identified via several different avenues. Most directly, the parties' express[28] agreement may identify a payor as a volunteer. Less directly, the status of volunteer might be implied[29] from the totality of the parties' acts, words, and/or circumstances; which either do or do not amount to a contract between the

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With respect to property being owed by multiple parties, there are three major forms of multi-party ownership of property: tenants in common, joint tenants, and tenancy by the entirety.

Tenants in common each own an undivided fractional interest in the whole; and each such interest may be separately sold or inherited. Tenants in common may petition the court for a partition of their fractional interests (i.e., divide the whole).

Joint tenants each own an undivided fractional interest in the whole; but, each joint tenant owns a right of survivorship (i.e., fraction interest of a deceased joint tenant is inherited pro rata by the surviving joint tenants). Each joint tenant may petition the court for a partition of their fractional interests either to create a tenancy in common or to divide the whole.

Tenancy by the entirety is a marital estate. Only married persons can own by tenancy by the entirety. A tenancy by the entirety is like a joint tenancy; but, while either spouse may purchase assets, sale only may be by both spouses jointly; and, division requires use of the legal processes of divorce of annulment.

[26] *Marmet v. Marmet*, 160 Neb. 366, 70 N.W.2d 301 (1955) as well as Neb.Rev.Stat. §42-202 and §62-1,192; *Scott v. Langvardt*, 213 Neb. 854, 331 N.W.2d 799 (1983).

[27] *Rapp v. Rapp,* 173 Neb. 136, 112 N.W.2d 777 (1962).

[28] Express and implied are two forms of objective (i.e., what a Reasonable Person would perceive) evidence. The law prefers the objective over the subjective because of the relative ease and relative certainty of objectively proving the objective versus objectively providing the subjective. The law prefers express objective evidence (i.e., words) over implied objective evidence (i.e., acts, words, and/or circumstances). Equity also uses objective evidence, but leans less heavily on the rules of evidence when doing so. See footnote 36 and footnote 40 re law versus equity.

[29] See footnote 24.

parties. Alternatively, public policy as stated in statute or in precedence can designate a person in a particular context as either a volunteer or as not a volunteer. Lastly, as always, equity will appraise the volunteer status of the parties from the facts and circumstances particular to that case.

The word "surety" can be used to identify more than one type of party. A surety can be a primarily liable co-signer. Alternatively, a surety can be a secondarily liable third party to a contract of others who stands financially ready to cure a default by one of those contracting parties (e.g., bonding firm). A surety via bonding pays debts owed by another per contractual obligation, and due to the express contract terms of the three parties is not a volunteer.[30] Nor is a volunteer payment made when a subordinate creditor of the subrogor seeks subrogee status via paying the subrogor's debt owed to a superior creditor for the purpose of protecting the subordinate creditor subrogee's interest in the collateral of the subrogor.[31]

Subrogation only applies when the subrogee pays the debts of a third person due to the subrogee's legal obligation, moral obligation,[32] or to protect the subrogee's own rights, interests, or property.[33] The contractual basis for subrogation may arise either before the event triggering the subrogor's loss (e.g., insurance policy) or may arise out of a subsequent agreement whereby the subrogor finances that loss (e.g., champerty[34]).[35]

A subrogee is not a volunteer, but subrogation might spring from a moral obligation discharged. For example, if sibling #1 is wrongfully injured in an automobile accident, then sibling #2 has a moral obligation to sibling #1, but (ordinarily) not a legal obligation, to render aid in the form of home health care. If sibling #2 does render that aid, then *vis-à-vis* sibling #1 that discharged moral obligation might appear to be rendered as a volunteer. However, did sibling #2 volunteer to provide a benefit to the wrongful driver in the form of reducing the dollar damages owed by the wrongful driver to sibling #1? Not likely. Instead, more likely sibling #2 is the subrogee of sibling #2 *qua* subrogor when payments flow to sibling #1 from the wrongful driver since sibling

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[30] *U.S. for Use of First Continental Nat. Bank & Trust Co., Lincoln, Neb. v. Western Contracting Corp.*, 341 F.2d 383 (C.A.8, Neb., 1965); *Barnes v. Hampton*, 198 Neb. 151, 252 N.W.2d 138 (1977); *Nebraska Beef, Ltd. v. Universal Sur. Co.*, 9 Neb.App. 40, 607 N.W.2d 227 (2000).

[31] *Allyn v. Dreher*, 124 Neb. 342, 246 N.W. 731 (1933); *Seieroe v. Homan*, 50 Neb. 601, 70 N.W. 244 (1897).

[32] In this manuscript, a couple of paragraphs above this footnote's number 32, the manuscript uses the phrase "bargained for exchange of legally sufficient value". A contract requires consideration; and, consideration is a bargained for exchange of legally sufficient value. A moral obligation is not legally sufficient value; therefore, a moral obligation (e.g., help family members) is not consideration. A bargained for exchange including one's discharge of a moral obligation is not sufficient to create a contract. Accordingly, it is noteworthy that a moral obligation can trigger in the recipient a duty of subrogation. This helps display the difference between rules in law (e.g., contracts) versus equitable remedies (e.g., subrogation).

[33] *Nebraska Beef, Ltd. v. Universal Sur. Co.*, 9 Neb.App. 40, 607 N.W.2d 227 (2000).

[34] Champerty is the financing of litigation by a person who is not a party to that ligation. Most jurisdictions have a general prohibition on champerty. However, most jurisdictions also have specific authorizations for some narrowly defined forms of champerty. For example, a contingency fee agreement between a plaintiff and the attorney representing that plaintiff is a form a champerty since the attorney fronts the plaintiff the attorney's wages. The plaintiff has zero obligation to pay the attorney except upon the condition precedent of victory, and the attorney has subrogation rights in the proceeds of the defendant's payment to the plaintiff.

[35] *Kirwan v. Chicago Title Ins. Co.*, 9 Neb.App. 372, 612 N.W.2d 515, review sustained, affirmed in part, reversed in part 261 Neb. 609, 624 N.W.2d 644 (2000).

#2 has paid the debt of another and done so not as a volunteer.

So far this manuscript has been proceeding in a very legal manner. That is, the rules of law are inventoried in a coherent sequence for the analysis of risk allocation. It now is time to shift gears and open the door to equity.

Speaking broadly, the law has two subdivisions: **law and equity**. Speaking narrowly, the subdivision of the law known as law is structured around rules applied to groups of similarly situated persons and has as one of its prime objectives predictability of future results (e.g., precedence) so as to satisfy the reasonable expectations of the People. Equity has a different prime objective and a different structure. Equity is structured around maxims[36] applied to unique persons and has as one of its prime objectives fairness with zero interest in generating predictable outcomes. Another difference is that the remedies available from a court of law most often are limited to dollar damages, whereas a court of equity usually awards a command for action (e.g., specific performance) rather than dollars.

The hand of equity always presses on the law; but, in turn, equity always is tethered to the policies of the law. That said, most law suits can not access most equitable remedies. While the parties may start their case by pleading in the alternative[37], subsequently the election of remedies[38] will allow the court to focus[39] its decision either on the rules of law or on the maxims of equity. Generically, equitable remedies are not available unless and until a party proves that legal remedies (e.g., dollar damages) are not adequate. Subrogation is different.

While either statute[40] or contract may materially[41] alter the routine equitable

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[36] There are legal maxims and then there are equitable maxims. Legal maxims seek to state succinctly a rule of law. A rule in the law is inherently more precise and generates predictable results whereas a maxim in equity is intentionally vague. An example of a legal maxim is *Quod approbo non reprobo* (i.e., What I approve I do not disapprove). In stark contrast equitable maxims seek to broadly state the policy underlying the law rather than to provide clear rules to generate predictable outcomes. Equitable maxims intentionally only yield unique results when applied to each case's set of facts and circumstances particular to that case. A classic equitable maxim is *Illud ut peto justicia must operor justicia* (i.e. Those that seek equity must do equity.). Clearly, that is a circular definition. Most, but not all (look for it elsewhere in this manuscript), subrogation cases will require satisfaction of the equitable maxim *Illud ut peto justicia must adveho per tersus manuum* (i.e., Those that seek equity must come with clean hands.).

[37] To plead in the alternative is to present motions to the court that might be inherently inconsistent with each other. For example, a plaintiff's complaint might allege two mutually exclusive causes of action (e.g., [a] we have a contract and you breached it; and [b] we do not have a contract but you committed a tort). In an effort to both improve the justice produced via litigation as well as to improve judicial efficiency, early in the last century USA courts switched from refusing to welcoming pleading in the alternative.

[38] Many (but not all) jurisdictions require many (but not all) plaintiffs that have plead alternative and inherently inconsistent causes of action to elect (i.e., choose) between those alternatives at the conclusion of the plaintiff's case; that is elect remedies just prior to the start of the defendant's defense.

[39] Prior to legislatures making the shift towards pleading in the alternative many jurisdictions had physically separate courthouses for courts of law and for courts of equity. Today, the judge merely switches "hats" from using one judicial power to using a different judicial power.

[40] The law divides into the law and into equity. The law subdivision broadly divides into legislatively created law (e.g., statutes) and a judicial interpretation of existing legal policies (e.g., a case of first impression that is the basis of future precedence via *stare decisis*). Statutes often codify decades of case law precedence into succinctly stated legal rules that are organized for clarity and coherence. Additionally, when legislatures adopt statutes to codify precedence the legislature routinely resolves conflicts between precedence and/or fills policy gaps unaddressed by the existing inventory of precedence.

subrogation duties and rights between the subrogee and the subrogor, all contracts are enforced using the equitable provisions of subrogation.[42] So ubiquitous is the equitable limitation of subrogation in law suits involving contracts that the mere mention of subrogation rights within a contract does not in and of itself alter the parties' subrogation rights. Their contract clearly must specify more than the routine equitable limitation of subrogation if their contract is going to alter that standard.[43] The courts of law routinely apply the equitable doctrine of subrogation as do the courts of equity. Neither the court of equity nor the court of law is applying subrogation a pure component of that court's typical powers. A court of equity does not apply subrogation as a legal right; nor does a court of law apply subrogation as an equitable right. The principle of subrogation is applied to subserve the ends of justice and to do equity in the particular case under consideration. Subrogation does not rest solely on contract, and no general rule can be laid down which will afford a test in all cases for its application. Whether the doctrine is applicable to any particular case depends upon the particular facts and circumstance of such case.[44] Not surprisingly then, ordinarily to obtain the court's enforcement of subrogation the party seeking it must plead it and prove[45] the requisite facts.[46]

Roughly, the subrogee holds proceeds[47] in constructive trust[48] for the indemnification[49] of the subrogor.[50] Also, all of the flexibility of equity is retained when using subrogation even when it is being applied within the confines of law concerning a contract. The doctrine of subrogation does not rest on contract, and no general rule can be laid down which will afford a test for its application in all cases; rather, the facts and

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Alternatively, the legislature might reject a line of precedence and forge a new policy, especially when prompted by substantial social and/or technological change. The legislature is free to reformulate the legal policies underlying precedence unless that court decision went either to the constitutional jurisdiction of the legislature itself or went to the People's constitutionally guaranteed fundamental rights.

41 The law uses the word material to signify a magnitude of change of an input that generates a legally significantly different outcome.

42 *Jindra v. Clayton*, 247 Neb. 597, 529 N.W.2d 523 (1995); *Combined Ins. v. Shurter*, 258 Neb. 958, 607 N.W.2d 492 (2000).

43 *Shelter Ins. Companies v. Frohlich*, 243 Neb. 111, 498 N.W.2d 74 (1993).

44 *Aultman, Miller & Co. v. Bishop*, 53 Neb. 545, 74 N.W. 55 (1898).

45 Truth, as it is knowable by the law, is constrained by the rules of evidence. The law's truth is objective truth. For example, hearsay typically not admissible into evidence. It is hearsay when I say that I heard you say that she said. The elements of subrogation must be proved by the plaintiff to the trier of fact (i.e., either the jury or the judge without a jury) by the amount required by the relevant standard of proof (e.g., preponderance of the evidence in a typical civil trial).

46 *Nebraska Beef, Ltd. v. Universal Sur. Co.*, 9 Neb.App. 40, 607 N.W.2d 227 (2000).

47 Proceeds can be any form of asset that is the consequence of transforming the subrogor's original enrichment. For example, if you own a car and sell it for cash, then those dollars are the proceeds of the car.

48 A trust is a transaction wherein the grantor transfers legal title for and makes actual delivery of an asset (i.e., corpus of the trust) to the trustee, and then the trustee holds that asset as a fiduciary for the benefit of the beneficiary who owns beneficial title.

A constructive trust is a trust created by operation of law rather than via the agreement of the parties.

49 A person who is obligated to indemnify another is obligated to protect that other from specific losses. Some, but not all, subrogation obligations that originate from an indemnity. A bonding surety provides an indemnity. However, no bond is required when one contracting party grants another contracting party an indemnification via a hold-harmless clause.

50 *Horton v. Ford Life Ins. Co.*, 246 Neb. 171, 518 N.W.2d 171 (1994).

circumstances of each case determine whether the doctrine of subrogation is applicable.[51]

Equity's prevention of unjust enrichment is partially effectuated with the rules of tracing. **Tracing**[52] will seek to recover identifiable proceeds that equitably flow from the original enrichment. Similarly constraining the outer limits of recoverable subrogation would be terms of the parties' contract. For example, the terms of an insurance policy define the covered risks. That same contractual inventory of covered insured risks will constrain which creditors of the subrogor are feasible sources of recompense for the subrogee. As noted earlier, payment by the issuer of a construction performance bond can be triggered by the breach of the construction firm that transforms the insurer from a secondarily liable guarantor[53] into a primarily liable surety with subrogation rights against the construction firm and the building owner. But, may those subrogation rights reach further? May the bonding firm exert subrogation rights against potential holders of mechanics liens[54] (e.g., laborers and suppliers of material) compensated via the bond?

Context is critical. Far fewer than all lien holders are eligible to be a subrogor of the bonding firm. The lien does arise from a breach by a bonded party. The breach creating a mechanic's lien most frequently is a breach by the general contractor who has not paid for work completed. If the bonding firm pays that debt, then the bonding firm becomes the subrogee of the lien holder *qua* subrogor. However, most discussions of mechanic's/artisan's liens arises in the context of work performed followed by non-payment: hence the lien. Accordingly, until the lien is discharged via payment of the amount owed no such lien holder ordinarily would be subrogated to the bonding firm. Assuming no payment from the bonding firm, payments received for work done by the lien holder fails to create subrogation rights. The question posed in the prior paragraph seeks to capture a very different context. The context of that question is when payment from the bonding firm triggers the performance of the mechanics.

In both contexts the mechanic's liens are discharged by payment. The contexts are materially different in that discharge of an existing mechanics lien is equitably

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51 *Nebraska Beef, Ltd. v. Universal Sur. Co.*, 9 Neb.App. 40, 607 N.W.2d 227 (2000).

52 Tracing is the set of rules for following proceeds. See footnote 47 re proceeds.

Tracing is a topic of sufficient complexity that it easily could support an entire additional manuscript. Suffice it to say that the rules of tracing both expand the scope of identifiable proceeds as well as confine that scope. Tracing uses the maxims of equity to capture all proceeds and to capture all third parties appropriate for the facts and circumstances particular to that case.

For example, assume a subrogor obtains cash subject to the subrogee's rights; additionally assume the subrogor then deposits that cash into an existing bank account so as to comingle those fungible assets; further assume the subrogor comingles subsequent deposits; next assume the subrogor subsequently expends more than the deposit on purchases from multiple merchants of physical assets and services; finally assume the subrogor materially alters and/or resells some of those physical assets and/or services, some in and some not in the ordinary course of the subrogor's business with purchasing merchants and consumers. Which, if any, of those sellers and buyers hold the asset in their possession in constructive trust under a duty of subrogation for the benefit of the subrogee? That is tracing.

53 A guarantor is secondarily liable. A surety is primarily liable. A co-signor could co-sign either as a guarantor or as a surety. Recall paragraph containing footnotes 7 and 8.

54 A mechanic's lien involves real estate. An artisan's lien involves personal property. A mechanic's lien in real estate or an artisan's line in personal property (e.g., car) arises automatically via equity when either [i] a laborer improves the property subject to the lien; or, [ii] the personal property of the lien holder is aggregated with the property subject to the lien.

distinguishable from inducing performance. However, equitably distinguishable does not equate with equity requires subrogation. Note the text above used the phrase "potential holders of mechanic's liens" rather than the typical phrase "holder of a mechanic's lien". The phrase potential holders of mechanic's liens assumes the bonding firm's payment induces the mechanics' performance rather than is made following the mechanics' performance. Context is critical.

Subrogation rights depend upon the scope of the performance bond. Generally, a performance bond only directly protects the building owner; and, generally, a performance bond ignores as tangential to the bonding transaction the potential mechanic's lien holders. For a performance bond's subrogation rights to reach out and include potential holders of mechanic's liens would require stretching a bond beyond its clearly defined limits.[55] A generic performance bond serves to guarantee performance owed by one of the parties rather than seeks to guarantee the bonding firm's recovery of all expenses. Also note, the subrogation rights springing from a contract between three parties to a performance bond (e.g., construction firm, building owner, and bonding firm) easily fit within an exception to the law's generally narrow[56] interpretation of third party's rights on contracts. In stark contrast, when a bonding firm seeks to reach out to the potential mechanics lien holders that bonding firm is seeking to reach out to fourth parties and to do so while clearly outside of that narrowly interpreted exception. However, if the express terms of a contract do not reach out to include such third parties, the court will be reluctant to provide inclusion via implication. If the parties to a performance bond were to create rights running in favor of those potential mechanics lien holders (i.e., the bonding firm has primarily liability to pay those lien holders' frustrated contractual expectations), then the bonding firm would be far better positioned to have subrogation rights against those potential lien holders as subrogors upon the bonding firm's payment those lien holders.[57]

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[55] *U.S. for Use of First Continental Nat. Bank & Trust Co., Lincoln, Neb. v. Western Contracting Corp.*, 341 F.2d 383 (C.A.8, Neb., 1965).

[56] The law strongly favors limiting the reach of a contract to the parties who created that contract. It is feasible for a contract to include third parties. However, to do so is analogous to assignment and delegation as discussed in footnote 11.

Generically, any third party that vests is part of the contract. Third parties exist along a continuum from intended to incidental as well as along a continuum from creditor to donee. Generically, <u>any</u> type of third party (e.g., incidental donee) <u>can vest; but</u>, an intended creditor third party is far more likely than an incidental donee third party to actually be able to surmount the legal requirements of vesting; and, <u>most</u> intended creditor third parties <u>fail</u> to surmount those legal requirements.

If the contracting parties specify that performance is to rendered to a third party and that third party is to enforce the quality of that performance (e.g., determine whether the performance equates with substantial performance or with material breach), and if that performance rendered to that third party is for the purpose of discharging a legal obligation owed by one or more of the contracting parties, then that third party is an indented creditor. That alone will not empower a third party to vest. In addition to being empowered to vest the third party also must accomplish vesting. Vesting will require some (varying widely by jurisdiction) detrimental reliance by the third party.

[57] But note, unjust enrichment comes in an infinite variety of forms and equity will impose subrogation to prevent unjust enrichment. The text above is a legal analysis of the law of subrogation springing from a contractually created right to subrogation. If a bonding firm induces performance by potential mechanic's lien holders with payments to the building owner, and if the building owner and/or the construction firm incorrectly render double payment to those mechanics, then equity will provide subrogation for the bonding firm's recovery of that double payment. But, a contract subrogation right can

Defeat snatched from the jaws of victory does have some limits. Recall, the focus is on unjust enrichment: which requires both enrichment and that it be unjust. Unjust enrichment is not present and subrogation is not available until the debt owed to the subrogor has been paid in full.[58] But, what is "paid" and what is "full"?

Clearly, one and all understand that a payment ordered by the court does not equate with payment received by the subrogor. Accordingly, merely possessing a court order would not be an enrichment triggering subrogation. However, as soon as the third party debtor's check clears the bank the subrogor is enriched. But, how much is "full"? When is "paid in full" reached? Is "full" to be measured one dollar at a time? Is "full" to be measured off of the amount the subrogee paid for the benefit of the subrogor? Is "full" to be measured off of the subrogor's loss prior to subrogee's payment?

Let's try an example to explore paid in full. Assume [a] the subrogor suffers a $10,000 loss; and assume [b] the subrogee paid the subrogor per their contract $6,000 of that loss; next assume [c] the third party debtor of the subrogor is ordered by the court to pay the subrogor $13,000, and finally assume [d] the third party debtor settles with the subrogor and the third party debtor does in fact pay to the subrogor a total of $11,000 in four monthly payments of $1,000; $4,000; $$4,500; and $1,500. What does subrogation demand? Clearly, the subrogor has been enriched and some fraction might be fairly appraised as unjust enrichment. However, there is ample room to quibble between the court order and the enrichment as to whether that enrichment is unjust. That is, does the subrogor owe the subrogee payment of: [i] $1,000 at the end of month #1, $4,000 at the end of month #2, and $1,000 at the end of month #3; or [ii] owes $6,000 at the end of month #3; or [iii] owes $6,000 at the end of month #4?

Since our time together is limited, but the topic expansive, your author must pick some arbitrary juncture to terminate this manuscript. And we are there. This manuscript only begins to scratch the surface of subrogation. For example, potentially expansive sections, such as tracing and statutory adjustments to precedent, were merely noted in passing. Those, other topics left unmentioned (e.g., sharing of litigation costs), will be reserved for future research. However, it is hoped that this manuscript has enlivened and empowered your analysis of the law's allocation of risk.

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not define a single payment in that context as subject to subrogation because that would create rather than prevent unjust enrichment. *Crawford State Bank v. McEwen*, 132 Neb. 399, 272 N.W. 226 (1937).

[58] *Neumann v. American Family Ins.*, 5 Neb.App. 704, 563 N.W.2d 791, review sustained (2000).

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