IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Reliance Insurance Company (In Liquidation), Plaintiff v. Apple Computer, Inc., Defendant (Ancillary matter to IN RE: Reliance Insurance Company In Liquidation No. 1 REL 2001)	:	No. 3 REL 2007[1] Argued: June 21, 2010

BEFORE: **HONORABLE BONNIE BRIGANCE LEADBETTER,** President Judge
HONORABLE MARY HANNAH LEAVITT, Judge
HONORABLE JAMES R. KELLEY, Senior Judge

OPINION NOT REPORTED

MEMORANDUM OPINION BY
PRESIDENT JUDGE LEADBETTER[2] **FILED: June 23, 2011**

In the present action, the Insurance Commissioner, as statutory liquidator of Reliance Insurance Company,[3] seeks to recover from Apple, Inc.

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[1] This case was previously docketed at number 341 M.D. 2007.

[2] This opinion is filed in accordance with Section 256(b) of the Internal Operating Procedures of the Commonwealth Court, 210 Pa. Code § 67.29(b), which directs that where recusal of a commissioned judge results in a tie vote among the commissioned judges, the opinion shall be filed as circulated and shall not be published unless a majority of the participating judges vote to do so.

[3] Reliance entered rehabilitation on May 29, 2001, and entered liquidation on October 3, 2001.

$1,639,327.56 plus interest. While acknowledging the Liquidator's right to the money under an assignment agreement, Apple contends that it is entitled to retain the money as a setoff or recoupment against Reliance's liability to Apple on a separate claim. Before the court are the cross-motions for summary judgment.

Under a Trade Credit Insurance Policy, Reliance insured Apple for up to 90% of $15,000,000 in aggregate losses arising from qualifying defaults by Apple customers in specified Latin American countries. In 2000, after Pinacor, Inc. defaulted on its obligation to Apple, Reliance paid $1,639,327.56 pursuant to the Policy.[4] In exchange for payment from Reliance, Apple executed a Certifications and Release Agreement, assigning to Reliance Apple's claim against Pinacor and agreeing to act on Reliance's behalf in the Pinacor bankruptcy proceeding. Eventually, in 2005, Apple recovered from the Pinacor Estate the full amount of Pinacor's debt, which included the amount Reliance paid pursuant to the Policy. In an amended complaint,[5] the Liquidator asserts that Apple's failure to turn over the $1,639,327.56 is a violation of the Liquidation order (count I),[6] a breach of the

[4] This payment, made within the year prior to Reliance's liquidation, was the subject of an action by the Liquidator (671 M.D. 2003) to recover the payment as a voidable preference. Our court, in a single judge ruling, granted summary judgment in favor of Apple and our Supreme Court affirmed *sub nom. Ario v. Ingram Micro, Inc.*, 600 Pa. 305, 965 A.2d 1194 (2009).

[5] Apple filed preliminary objections to the original complaint, demurring on the grounds that the preference action was still pending, that laches or the statute of limitations barred the claim, and asserting defects in the form of the complaint. In December of 2008, this court overruled the demurrers based on pendency of the preference action and based on laches (noting that while laches should have been pled in new matter, the Liquidator had not objected to its assertion in preliminary objections), dismissed the objection based on the statute of limitations, noting that this must be pled in new matter, and sustained the objection to the form of the complaint, permitting amendment to plead separate causes of action in separate counts.

[6] The Liquidation order, in pertinent part, provides: "All . . . entities or other persons having in their possession assets which are, or may be, the property of Reliance, shall, unless otherwise instructed by the Liquidator, deliver the possession of the same immediately to the Liquidator …." *Koken v. Reliance Ins. Co.*, (269 M.D. 2001, Order filed October 3, 2001).

Certifications and Release Agreement (count II), and an obligation due under both a right of contractual subrogation (count III) and the principle of equitable subrogation (count IV). In answer to the complaint, Apple asserts in new matter that Reliance is obligated to pay $3,472,736.11 pursuant to the Trade Credit Insurance Policy for a default by Apple customer Datamac and that in failing to pay this obligation Reliance breached the Policy. Apple contends it is entitled to retain the Pinacor recovery as a partial set off or recoupment against the Datamac claim.[7] Apple further asserts, in new matter, that the Liquidator's claim is barred by the statute of limitations. The Liquidator replied to new matter, asserting that no right to setoff or recoupment can arise inasmuch as Apple's right to payment for the Datamac claim lacks the requisite mutuality with the Liquidator's right to subrogation in Apple's recovery of the Pinacor debt (as required for setoff) and the two claims do not arise from the same transaction (as required for recoupment). The Liquidator further asserts that the causes of action stated in counts II and III for breach of the Certifications and Release Agreement are not barred by the four year statute of limitations applicable to contract actions, as set forth at 42 Pa. C.S. § 5525, because this action, filed in 2007, comes approximately two years after Apple's recovery of the Pinacor debt in 2005.[8]

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[7] Apple filed a Proof of Claim (No. 593997) for the Datamac losses and the Liquidator issued a Notice of Determination (NOD) denying the claim as not covered under the Trade Credit Policy. Apple objected to the NOD; this court referred the matter to a referee, who recommended sustaining the objection, and, in June of 2009, our court approved the recommendation. An amended NOD assigns the claim a priority level (b) in the amount of $3,472,736.11.

[8] In its brief in support of summary judgment, Apple does not address the statute of limitations defense. We note that it is meritless.

Following the close of the pleadings, Apple moved for summary judgment contending that it is entitled to a setoff under Section 532 of the Insurance Department Act of 1921 (Act),[9] *as amended*, 40 P.S. § 221.32. Alternatively, Apple contends that its right to recoupment provides a complete defense to the Liquidator's action. Subsequently, the Liquidator cross-moved for partial judgment on the pleadings or, alternatively, partial summary judgment as to Apple's liability, leaving for later determination the quantification of damages, which is dependent on findings of fact regarding the costs Apple incurred in obtaining the recovery from the Pinacor estate and the amount of prejudgment interest.

Following the close of pleadings, judgment may be entered thereon if it is apparent that no dispute of material fact exists and a party is entitled to judgment as a matter of law. *See* Pa. R.C.P. No. 1034. Similarly, summary judgment is appropriate where, following the close of pleading and the completion of sufficient discovery, it is apparent from the record that there exists no material factual dispute or the burdened party lacks evidence necessary to establish a prima facie case. *See* Pa. R.C.P. No. 1035. Here, the parties agree that material facts are not disputed. Apple has a right, established through the statutory claims process, to its proportionate recovery on the Datamac claim, and the Liquidator has a subrogation interest in Apple's recovery from the Pinacor estate. The only question, whether Apple may retain its Pinacor recovery under theories of setoff or recoupment, is a pure question of law.

[9] Act of May 17, 1921, P.L. 789, added by Section 2 of the Act of December 14, 1977, P.L. 280.

SETOFFF

Section 532 of the Act provides for setoff, as follows:

> (a) Mutual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).
>
> (b) No setoff or counterclaim shall be allowed in favor of any person where:
> (1) the obligation of the insurer to the person would not at the date of the filing of a petition for liquidation entitle the person to share as a claimant in the assets of the insurer;
> (2) the obligation of the insurer to the person was purchased by or transferred to the person with a view to its being used as a setoff;
> (3) the obligation of the person is to pay an assessment levied against the members or subscribers of the insurer, or is to pay a balance upon a subscription to the capital stock of the insurer, or is in any way in the nature of a capital contribution; or
> (4) the obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

40 P.S. § 221.32. In order to prevail in the assertion of a right to setoff, there must exist mutuality between the respective debts. This requirement is strictly construed because setoff is an exception to the orderly procedures for discharging claims against an insolvent insurer. *See Koken v. Legion Ins. Co. (Bank of America II)*, 900 A.2d 418, 423 (Pa. Cmwlth. 2006) (single judge op.).

The mutuality requirement is satisfied only where it exists both as to time and capacity. Mutuality in time dictates that only preliquidation obligations can be setoff against other preliquidation obligations; post-liquidation obligations cannot be setoff against preliquidation obligations. *See Koken v. Legion Ins. Co.*

(Application of GE Frankona Reins. Co.), 865 A.2d 945, 955 (Pa. Cmwlth. 2005). Mutuality in capacity requires that debts exist between the same persons or entities acting in an equal capacity. For example, a fiduciary cannot offset claims held in his personal capacity against obligations that he assumes as a trustee. *Id.* at 954 n.21 (single judge op.), citing *Downey v. Humphreys,* 102 Cal.App.2d 323, 227 P.2d 484, 490 (1951). The parties disagree as to the presence of both aspects of mutuality.

As for mutuality in time, while the parties agree that the Datamac claim is a preliquidation debt,[10] they disagree as to whether Apple's Pinacor obligation is pre or post-liquidation debt. Apple contends that the Pinacor obligation arose at the inception of two preliquidation agreements, the Policy and the Certifications and Release Agreement. Apple's contention cannot prevail. Mutuality in time depends on when the obligation accrued, not on the date of entering the contract that created its mere possibility. In *Foster v. Mutual Fire, Marine and Inland Insurance Company*, 531 Pa. 598, 614 A.2d 1086 (1992), our Supreme Court ruled that reinsurers' case reserves and incurred but not reported (IBNR)[11] obligations to the insolvent insurer could not be setoff because those obligations had not matured as of the time insurer entered rehabilitation.[12] The Court stated: "[N]o right of setoff can be available against a note or other

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[10] Apple first submitted its Datamac claim to Reliance in November of 2000.

[11] "IBNR refers to amounts predicted to be paid in the future on account of events that have occurred but have not been reported as claims to the insurer." *Foster v. Mutual Fire*, 531 Pa. 598, 619 n.9, 614 A.2d 1086, 1097 n.9. "Case reserves are estimates of amounts required to cover future payments on account of known claims." *Id.*

[12] *Foster v. Mutual Fire* involved a plan of rehabilitation rather than liquidation; however, the Court concluded that provisions regarding setoffs under the liquidation section must also apply to actions proceeding under the statutory rehabilitation provisions. 531 Pa. 598, 617, 614 A.2d 1086, 1096.

obligation that does not mature until after a receiver for the insolvent debtor is appointed" and further explained:

> Case reserves and IBNR are at most calculations or estimates of future potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation. Their speculative and intangible nature at the time of the petition for rehabilitation does not warrant their being available for setoff against more due and owing or mature obligations.

531 Pa. at 620, 614 A.2d at 1097. Similarly, prior to the liquidation, Apple's recovery of Pinacor salvage existed only as a speculative and intangible possibility and not a due and owing obligation subject to setoff.

The case primarily relied upon by Apple, *United States v. Gerth*, 991 F.2d 1428 (8th Cir. 1993), does not dictate a different conclusion. The statement of the court in *Gerth* that "dependency on a postpetition event does not prevent a debt from arising prepetition," although somewhat overbroadly stated, is based on the court's conclusion that the parties' mutual promises to perform in the future gave rise to unconditional obligations at the time of contracting.[13] *Id.* at 1434.

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[13] The contract in *Gerth* was one under the Conservation Reserve Program between a farmer and the Department of Agriculture, wherein the farmer promised to withhold land from production and the Department promised regular payments of "rent." The court concluded these were mutual promises (farmer's performance was not a condition precedent to Department liability) so that the Department's payment obligation arose at formation of the contract. 991 F.2d 1428, 1434. *See also Stamp v. Ins. Co. of North America*, 908 F.2d 1375 (7th Cir. 1990), *aff'g O'Connor v. Ins. Co. of North America*, 622 F.Supp. 611 (N.D.Ill. 1985) (promises to pay losses contained in insurance and reinsurance policies gave rise to obligations at time of contracting; pre-insolvency claims created pre-insolvency debt regardless of post-insolvency court approval to make payments to certain claimants). *Accord Koken v. Legion Ins. Co.*, 865 A.2d 945, 955-56 (Pa. Cmwlth. 2004) (citing *O'Connor v. Ins. Co. of North America* in support of conclusion that preliquidation promises to pay losses created preliquidation debt regardless of postliquidation payment on claim and final accounting between insured and reinsurer).

Therefore, contract formation was the only transaction necessary for the mutual obligations to accrue, even if payments became due after the contract became effective. *Id*. at 1435. In the present case, the pre-insolvency contracts contained an executory promise by Apple to pursue a third party recovery and a promise to turn over any salvage, conditioned upon Apple's achieving some recovery. The obligation to turn over the salvage to the Liquidator arose only if funds were recovered, a very uncertain event dependent on Apple's prevailing on a claim against a third party, Pinacor, in bankruptcy.[14] Thus, the ruling in *Gerth* simply has no bearing on the conclusion that an obligation to turn over subrogable funds does not arise until those funds are realized. Inasmuch as Apple's obligation to the Liquidator did not arise until it received the Pinacor salvage, that obligation arose in 2005 and lacks the requisite mutuality in time to the preliquidation Datamac claim. On this basis alone, the absence of mutuality in time, Apple cannot prevail in its claim for set-off.

In addition, we note that mutuality in capacity is also lacking. Pursuant to the express terms of the Policy and the Certifications and Release Agreement,[15] executed by Apple when Reliance paid the Pinacor claim, Apple holds the Pinacor salvage funds in trust for Reliance and thus, does not stand, with

[14] *See Clark v. Cannon Steel Erection Co.*, 359 Ill. App. 3d 739, 835 N.E.2d 394, 402 (Ill.App.Ct. 2005) (where funds allegedly due from insolvent insurer were dependent on outcome of pending litigation, setoff not permitted).

[15] With regard to any salvage funds recovered on a debt for which Reliance paid under the Trade Credit Policy, the Policy states: "any salvage received by the Insured shall be considered held in trust for the Insurer . . . ." *See* Trade Credit Policy, (attached as Exhibit A to Amended Complaint, filed January 16, 2009) at 3, ¶ V.5. In the Certification and Release Agreement, Apple agreed to "assign and transfer to the Insurer, its successors and assigns, all right, title, interest in, and all sums of money now due, or to become due, to the Insured from the debtor, Pinacor, Inc. (Latin America)." *See* Certification and Release Agreement, (attached as Exhibit B to the Amended Complaint, filed January 16, 2009) at 2.

respect to the Pinacor salvage, in the capacity of a debtor. *See Pink v. American Surety Company of New York*, 283 N.Y. 290, 296, 28 N.E.2d 842, 844 (1940) ("The salvage was received for a specific purpose, by the terms of the contracts, to reimburse both the reinsured and the reinsurer proportionately for their losses. Out of its receipt, no relation of debtor and creditor was created.") There is no merit in Apple's contention that a trust, against which setoff must be precluded, is only one held for the benefit of a third party. It is enough that the salvage was received for a specific purpose, that of reimbursing the Reliance estate for losses on the payment of the Pinacor claim. *See Nat'l Garment Co. v. New York, Castle & St. Louis Railroad Co.*, 173 F.2d 32, 35 (8th Cir. 1949) (stating that where insured recovers funds to which the insurer has a right of subrogation, the recovery is "impressed with a trust for the insurer.").

RECOUPMENT

Recoupment is not mentioned in Article V of the Act. In *Legion (Bank of America II)*, the court noted that recoupment is also not mentioned in the Bankruptcy Code nor its predecessor, the Bankruptcy Act of 1898, from which Article V is derived. Nevertheless, recoupment has long been allowed in bankruptcy proceedings. 900 A.2d at 423. Ultimately, the court concluded only that "the use of recoupment as an affirmative defense is neither barred nor regulated by Article V." *Id.* at 429. In examining the general principles of recoupment, the *Legion (Bank of America II)* court observed that, in contrast to setoff, the doctrine of recoupment is not limited to debts existing only pre-insolvency. Further, recoupment is a defense, not a counterclaim, and the right

must arise from the same transaction ("unitary transaction test") as the plaintiff's cause of action and be invoked only to reduce the plaintiff's claim. *Id.* at 423.

Apple contends that the unitary transaction test is satisfied here because both debts arise from the Policy. The Liquidator points to the fact that two separate contracts underlie the present claims; the Policy pursuant to which the Liquidator must pay for the Datamac default and the Certifications and Release Agreement pursuant to which Apple must turn over Pinacor salvage to the Reliance estate. Further, even conceding that at root the events all began with obligations under the Policy, the Liquidator contends that Apple's Datamac claim under the Policy and the subrogation claim for the Pinacor salvage do not arise from the same transaction.

What will suffice to constitute a unified transaction has been interpreted differently by different courts. The United States Bankruptcy Court in Maryland has noted that there are "at least two doctrines" applied in "determining whether events constitute the same transaction." *Powell v. FELFRA*, 284 B.R. 573, 576 (Bankr. D. Md. 2002). The court in *Powell* described these two approaches, as follows:

> First, under the logical relationship test, the creditor and debtor's contractual relationship is determinate. This means "a transaction" may include a "series of many occurrences, depending not so much upon immediateness of their connection as upon their logical relationship." *TLC Hospitals v. U.S Dept. of Health and Human Servs.*, 224 F.3d 1008, 1012 (9th Cir. 2000). In *TLC Hospitals*, the court held that pre-petition Medicare overpayments to the debtor, a nursing facility, in one fiscal year and Medicare underpayments for post-petition services in a subsequent fiscal year were part of one transaction. *Id*. The court reasoned that the protracted billing procedures on which the relationship was based

> indicated that the payments were logically related. It stated "while this exchange of funds may stretch over an extended period of time, it remains part of a continuous balancing process between the parties." *Id.*. Under a logical relationship analysis, the word "transaction" is given a liberal and flexible construction. *Aetna U.S. Healthcare, Inc. v. Madigan*, 270 B.R. 749, 755 (9th Cir. BAP 2001).
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> Second, some courts find that a logical relationship alone is insufficient. *University Medical Ctr. v. Sullivan,* 973 F.2d 1065, 1081 (3rd Cir. 1992). . . . Rather, these courts subscribe to a narrow or circumscribed interpretation as to what defines the same transaction for the purposes of bankruptcy. *Malinowski v. New York State Dept. of Labor*, 156 F.3d 131, 133 (2nd Cir. 1998); *University Medical Ctr. v. Sullivan*, 973 F.2d 1065, 1081 (3rd Cir. 1992). The Third Circuit stated in *University Medical Center*:
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> > For purposes of recoupment, a mere logical relationship is not enough: the fact that the same two parties are involved and that a similar subject matter gave rise to both claims, . . . does not mean that the two arose from the "same transaction." Rather, both debts must arise out of a single integrated transaction so that it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations.
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> *Id*. at 1081 [(ruling that equitable recoupment was not justified in a case with very similar facts as those in *TLC Hospitals*)].

Id. at 576-77. "Under either standard, however, courts evaluate the equities of the case, the main difference between them being the degree of interconnectedness required with respect to the relevant obligations." *Id.* at 577 (quoting *Madigan*, 270 B.R. at 756).

It cannot be denied that a logical relationship exists between Apple's obligation to turn over the Pinacor salvage and the Liquidator's obligation to pay the Datamac claim. However, recent Pennsylvania case law indicates that this

Commonwealth has not adopted the logical relationship test. In *Cohen v. Goldberg*, 554 Pa. 201, 720 A.2d 1028 (1998), our Supreme Court, citing the proscription in *University Medical Center v. Sullivan,* 973 F.2d 1065, 1081 (3rd Cir. 1992) that "a mere logical relationship is not enough," ruled that the wife in an action for equitable distribution of marital assets could not recoup amounts she loaned to husband during the marriage to bolster his failing business. The court in *Cohen* stated:

> [The] finding that the parties' marriage was a "common element giving rise to both debts, and without which neither would exist," is insufficient to render the marriage a single transaction for purposes of recoupment. "A set of common facts differs substantially from a single transaction or a single series of transactions that gives rise to both a debtor's and a creditor's claims against each other." *Reading Company [v. Philadelphia]*, 155 B.R. 890, 912 (E.D. Pa. 1993)].

Id. at 206, 720 A.2d at 1031.

Apple maintains that by virtue of the parties' contractual relationship recoupment is appropriate and in support points to the remark in *Cohen* that recoupment is commonly applied where "both the creditor and debtor have claims arising from a single contract." *Id*. We do not agree. In *Lee v. Schweiker*, 739 F.2d 870, 875-76 (3d Cir. 1984), the court noted that most recoupment cases involve single contracts that provide for advance payments based on estimates of what ultimately would be due, subject to later correction. That is not the case here. Moreover, the presence of a contract between the parties is not a litmus test for recoupment. In *University Medical Center*, a case decided after *Lee*, the Third Circuit, applying the narrow construction of "single transaction," refused to allow recoupment even under circumstances that fit the scenario described in *Lee*. *See*

973 F.2d at 1081 (stating that, "a typical situation in which equitable recoupment can be invoked involves a credit and debt arising out of a transaction for the same goods and services.").

In *University Medical Center,* the court concluded that the Department of Health and Human Services (HHS) was not entitled to equitable recoupment for overpayments in 1985 through 1987 against amounts due to the bankrupt medical center in 1988 under a Medicare provider agreement. The court recognized that the Medicare program operated on a net balance accounting system where HHS paid the medical center based on estimates of future expenditures and then, following an annual audit to determine actual costs, adjusted subsequent payments to account for prior over or underpayments. 973 F.2d at 1070. The court further stated that while recoupment has been applied where relevant claims arise from a single contract, the fact that a contract exists between the debtor and creditor does not automatically enable the creditor to effect a recoupment. *Id.* at 1080. The court concluded that the provider agreement, which it characterized as a "unique type of contract" that did not "provide for a defined transaction or even a series of transactions" and had not been assumed by the medical center post-bankruptcy, merely established a "relationship between the parties." *Id.* at 1081. This relationship was "not sufficient to support the conclusion that Medicare overpayments made to UMC in 1985 arise from the same transaction, for the purposes of equitable recoupment, as Medicare payments due UMC for services provided in 1988." *Id.* "Recovery of the 1985 overpayment therefore, is the final act of the transaction that began in 1985. UMC's 1988 post-petition services were the beginning of transactions that would stretch into the future, but they were not part of the 1985 transactions." *Id.* at 1082.

As in *University Medical Center*, the parties in the present case formed a contractual relationship under the Policy but this relationship is not alone enough to make their every interaction related to the Policy an integrated transaction for purpose of recoupment. In fact, the circumstances here dictate even more strongly against recoupment, in that Apple's obligation to turn over the Pinacor salvage arises not only as a matter of equitable subrogation based on Reliance's payment on the Pinacor claim but also a contractual obligation arising from a contract separate from the Policy, the Certification and Release, in which Apple promised to turn over any later recovery it realized from Pinacor. Thus, we cannot conclude that the contractual relationship established by the Policy mandates that the Liquidator's obligation on the Datamac claim and Apple's obligation to turn over the Pinacor salvage arise from the same transaction.

Further, even recognizing that equitable principles may not be violated by netting the Pinacor and Datamac obligations, this recognition is not enough to justify recoupment. The determination of rights in equity is a matter of sound discretion. The exercise of that discretion should not rest solely on a determination that equity is not offended by the requested recoupment but should also consider relevant policy concerns. As our Supreme Court ruled in *Cohen v. Goldberg*, it is error to neglect consideration of overarching policy concerns in favor of general equitable concerns and thus stretch the single transaction requirement beyond its accepted meaning. *Id.* at 206-7, 720 A.2d at 1031. *See also Lee*, 739 F.2d at 876 (considering that the purpose of social security payments is to provide income to qualifying persons, the court concluded that once a bankruptcy petition is filed the income provided by those benefits should be protected by the automatic stay, and in spite of statutory or contractual provisions for

"recoupment," the right of the social security administration to recover pre-petition debts stemming from overpayments should be subject to the limitations on setoff).

In assessing the degree of interconnectedness required here with respect to the parties' obligations, we consider the policy at the core of the insolvency process, that of protecting the interests of the insureds, some of whom have little or no ability to easily withstand the loss of the full benefit of their insurance coverage, and the policy of avoiding preferential treatment of one claimant over another. A narrow application of the single transaction test is especially appropriate in light of these policies because it does not permit too easily either a reduction in the assets marshaled for the benefit of all claimants or the preferential treatment that results from an unwarranted recoupment.[16] Considering the equities, including the impact on claimants other than Apple, and applying a narrow construction of the unified transaction test, we conclude that the obligations at issue here do not arise from a unified transaction that would justify a recoupment by Apple.

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[16] As the Liquidator points out, if Apple retains the Pinacor salvage as a recoupment against the Datamac claim, Apple receives 100 cents on the dollar for nearly one-half (47.2%) of the Datamac claim at a time when other class (b) claimants are receiving interim distributions of less. Further, if Apple later receives a partial interim distribution on the outstanding balance of the Datamac claim, its total recovery on that claim will almost certainly far exceed that provided to other claimants.

Accordingly, Apple's motion for summary judgment on its recoupment defense is denied and the Liquidator's cross-motion for partial summary judgment on the claim for payment of the Pinacor recovered funds is granted.

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BONNIE BRIGANCE LEADBETTER,
President Judge

Judge Pellegrini did not participate in the decision in this case.

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Reliance Insurance Company (In Liquidation), Plaintiff	:	
v.	:	No. 3 REL 2007
Apple Computer, Inc., Defendant	:	
(Ancillary matter to IN RE: Reliance Insurance Company In Liquidation No. 1 REL 2001)	:	

O R D E R

AND NOW, this 23rd day of June, 2011, the Motion for Summary Judgment filed by Apple Computer, Inc. is hereby DENIED and the Cross-Motion for Partial Summary Judgment filed by the Liquidator is hereby GRANTED.

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BONNIE BRIGANCE LEADBETTER,
President Judge

IN THE COMMONWEALTH COURT OF PENNSYLVANIA

Reliance Insurance Company (In Liquidation), Plaintiff	:	
v.	:	No. 3 REL 2007 Argued: June 21, 2010
Apple Computer, Inc., Defendant	:	
(Ancillary matter to IN RE: Reliance Insurance Company In Liquidation No. 1 REL 2001)	:	

BEFORE: HONORABLE BONNIE BRIGANCE LEADBETTER, President Judge
HONORABLE MARY HANNAH LEAVITT, Judge
HONORABLE JAMES R. KELLEY, Senior Judge

<u>OPINION NOT REPORTED</u>

DISSENTING OPINION
BY JUDGE LEAVITT FILED: June 23, 2011

Respectfully, I dissent. Article V of The Insurance Department Act of 1921[1] does not support the Liquidator's demand that a Reliance policyholder, Apple Computer, Inc., pay the Reliance Insurance Company estate $1.6 million in cash when Reliance owes Apple in excess of $3 million on an unpaid insurance policy claim. Under the doctrines of setoff and recoupment, Apple is entitled to discharge its obligation to remit subrogated monies by reducing its $3 million policy claim against the Reliance estate, a claim unpaid since 2000. To conclude otherwise, the majority has construed a subrogation clause in the policy using precedent that construed reinsurance treaties. However, there is a world of difference between a

[1] Act of May 17, 1921, P.L. 789, *as amended*, 40 P.S. §§221.1-221.63.

reinsurance treaty and an insurance policy.[2] The better line of cases is that which pertains to release and trust agreements that policyholders execute to secure their insurer's subrogation rights. That precedent establishes that a policyholder is not a trustee of subrogated monies it holds, notwithstanding the use of the word "trust" in the subrogation clause. For this and other reasons, Apple has made the technical case for setoff and recoupment and is, therefore, entitled to summary judgment.

Background

This matter arises from a single trade credit insurance policy (Policy) issued by Reliance to Apple on November 29, 1999, to protect Apple against the risk that its customers would default on their debts to Apple.[3] In 2000, Apple submitted two claims covered by the Policy. The first claim was for $3,472,736.11 to cover Datamac's default to Apple, and the second was in the amount of $1,639,327.56 to cover Pinacor's default. Reliance denied coverage on the Datamac claim, and it was still unpaid when Reliance was placed into liquidation in October of 2001. However, Reliance paid the Pinacor claim. As a condition of the Pinacor claim payment, Apple executed a Certifications and Release Agreement (Release), by which Reliance assigned its right to conduct the subrogation litigation to Apple. Accordingly, Apple pursued Pinacor in bankruptcy for all its losses, some of which had been covered by Reliance's claim payment. After Reliance was liquidated, this Court determined that Reliance owed Apple $3,472,736.11 on the Datamac claim. The Court accepted the

[2] *See In re: Liquidators of Reserve Insurance Company*, 122 Ill. 2d 555, 562, 524 N.E.2d 538, 541 (Ill. 1988) (holding that "the interest involved in a reinsurance agreement is different from that involved in a direct insurance agreement.")

[3] The Policy provided Apple with coverage for 90% of losses arising from credit defaults by Apple customers located in Latin America, up to an aggregate maximum of $15,000,000.

Referee's conclusion that the Liquidator's stated reasons for denying the Datamac claim lacked merit, in breach of the Policy.

The contractual obligations of the parties under the Policy were established before Reliance was placed into liquidation in October of 2001. Reliance was obligated to pay both the Datamac and Pinacor claims, but Reliance also had a subrogation right to recover its payment on the Pinacor claim. Neither party has yet performed. The question is whether the doctrine of setoff or recoupment, or both, provide Apple with a defense to the Liquidator's breach of contract action against Apple for nonpayment of the Reliance share of Apple's Pinacor recovery. I believe they do.

Setoff

The only amount owed by a creditor to an insolvent insurer is the net amount over the setoff rights of the creditor. This treatment is consistent with the longstanding recognition in bankruptcy and insurer insolvency proceedings of the "fundamental fairness of setoff and the 'absurdity of making A pay when B owes A.'" WILLIAM J. BRANUM, *Setoffs, Recoupments, and Voidable Preferences - In the Insolvency Process*, in AMERICAN BAR ASSOCIATION, LAW AND PRACTICE OF INSURANCE COMPANY INSOLVENCY REVISITED 907, 911 (F.L. Semaya ed., 1989) (footnotes omitted) (hereinafter BRANUM). Setoff has been afforded constitutional protection under the Fifth and Fourteenth Amendments to the United States Constitution. *Id.* Funds subject to setoff are not part of the general assets of the insolvent insurer and, thus, the exercise of a setoff by a creditor of the estate does not work a preference against other creditors. *Id.*

Setoff refers to the reduction of mutual debts and credits to a net balance. Here, the net balance is the difference between the $3,472,736.11 Reliance

owes Apple and the $1,639,327.56 Apple owes Reliance. Mutuality requires satisfaction of two factors: capacity and time. In insurance insolvency proceedings, setoff issues arise, almost exclusively, from reinsurance arrangements, which can involve numerous treaties over a long period of time.[4] It is in the context of unscrambling multiple contracts that the rules of mutuality were devised.

Mutuality in time means, as noted by the majority, that pre-liquidation obligations can be set off only against other pre-liquidation obligations, and post-liquidation obligations can be set off only against other post-liquidation obligations. The reason has been explained as follows:

> Without this mutuality of time requirement, *a person who owed money to the insolvent* before the insolvency could *purchase claims against the estate* thereafter at a reduced rate and use those claims as setoff against the more expensive preliquidation claim.

BRANUM at 914 (footnote omitted) (emphasis added). The only purpose of the mutuality in time requirement is to prevent debtors from purchasing another creditor's claims. No other purpose has been identified in bankruptcy or insurance insolvency case law, treatise or other authority. Apple is a creditor solely by virtue of the Policy it purchased from Reliance pre-liquidation.

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[4] For example, Insurer A may cede risk to Insurer B in one treaty but accept risk from Insurer B in another treaty. Insurer B may retrocede part of the risk it accepted from Insurer A back to Insurer A. The two insurers may engage in multiple reinsurance treaties, covering different time periods in which the roles of cedant and reinsurer reverse several times. In any given accounting period, whether monthly or quarterly, claim obligations and premium obligations under all the reinsurance agreements are netted out to determine whether insurer A owes insurer B, or vice versa. *See, e.g., Koken v. Legion Insurance Co. (GE Frankona Reinsurance Co.)*, 865 A.2d 945 (Pa. Cmwlth. 2004).

A debt to an insolvent insurer will be found to be a pre-liquidation debt if the amount of the debt is provable pre-liquidation. The due date of the debt is not dispositive. As treatise authority points out,

> [t]o determine whether a claim existed at the time of the order, it is important to understand certain concepts: (1) contingent v. absolute claims; (2) immature v. mature claims; and (3) unliquidated v. liquidated claims.

MILTON S. WOLKE, JR., *Voidable Preferences, Fraudulent Conveyances, Offsets and Recoupment*, in AMERICAN BAR ASSOCIATION, LAW AND PRACTICE OF INSURANCE COMPANY INSOLVENCY, 349, 364 (D.M. Spector ed., 1986) (footnote omitted) (hereinafter WOLKE). The above-listed factors identified by Wolke are based upon bankruptcy precepts that are relevant inasmuch as Article V is based upon the Bankruptcy Act of 1898. *Koken v. Legion Insurance Co. (GE Frankona)*, 865 A.2d at 954 (citations omitted). A debt may be "absolutely owing but not presently due" at the time of petition and nevertheless be considered a pre-petition debt. 4 COLLIER ON BANKRUPTCY (14th ed.), ¶68.10 at 896 (COLLIER). In considering the timing of a debt, one must consider whether the debt in question arose "out of any act of the liquidator" or arose "from the acts of the insolvent insurer prior to liquidation." WOLKE at 365 (footnote omitted). A debt created by act of the insolvent insurer is a pre-liquidation debt, and one created by the liquidator is a post-liquidation debt.

In *O'Connor v. Insurance Company of North America*, 622 F.Supp. 611 (N.D. Ill. 1985), the U.S. District Court reduced the debt of a group of reinsurers to an insolvent insurer estate by the amount the estate owed the reinsurers, who were participants in a reinsurance pool. The parties agreed that the debt of the insolvent insurer, Reserve Insurance Company, to the reinsurers was a pre-liquidation debt. They disagreed on the timing of the reinsurers' debt to the Reserve estate. The

liquidator claimed it was post-liquidation because the monies were not owed when Reserve was placed into receivership. However, the District Court found in favor of the reinsurers. Relying on Collier and 1898 Bankruptcy Act case law, the court explained that "provable debts" are those that were fixed in amount at the time of liquidation. *Id.* at 619. Because the reinsurance claim payments and unearned premiums owed to the insolvent insurer by the reinsurers were "provable debts" pre-liquidation, they were pre-liquidation debts. That the debts were not due to be paid at the time of liquidation was held to be of no moment.

The majority treats Apple's debt to Reliance on the Pinacor recovery, which was not owed until after receivership, as a post-liquidation debt. It analogizes Apple's debt to an insurer's incurred but not reported claim reserves, which were held to be post-liquidation debts in *Foster v. Mutual Fire, Marine and Inland Insurance Company*, 531 Pa. 598, 614 A.2d 1086 (1992). However, Apple's debt is quite dissimilar.

An incurred but not reported claim reserve is an actuarial estimate of an insurer's liability. The particulars of any "claim" in that reserve is unknown. First, the claim may never be reported by the insured because the insured may simply decide not to seek available insurance coverage on the loss. Second, the amount of the claim cannot be known until it is actually adjudicated in accordance with the terms of the policy. As explained by treatise authority, "the insurer's debt for a loss under a policy is incurred when it can be calculated." WOLKE at 356. A policy "claim" represented in an actuarial reserve cannot be calculated; it is no more than an estimate. In short, an insurer's liability for an incurred but not reported claim is too inchoate to be a "provable debt."

By contrast, the amount of Apple's debt to Reliance and the circumstances under which it would be paid were fixed pre-liquidation in the August 2000 Release. There was no act of the Liquidator involved in creating Apple's debt; it was fixed entirely by Reliance prior to liquidation. *See also In re Communication Dynamics, Inc.,* 382 B.R. 219, 233-34 (Bankr. D. Del. 2008) (citing bankruptcy cases that establish that conditional right to payment established pre-petition is a pre-petition debt even though the conditions to payment are satisfied post-petition). The fact that the condition for Apple's payment arose post-liquidation did not make it a post-liquidation debt.

In sum, both debts at issue were pre-liquidation obligations that arose from two claims that Apple submitted to Reliance in 2000 for payment under the Policy.[5] The parties agree that the Datamac claim is a pre-liquidation debt. Apple's debt to Pinacor is likewise pre-liquidation because the amount of that debt was provable and the conditions for its payment were established as of the date Reliance was ordered to be liquidated.

The majority next found that the two debts were not mutual debts arising out of a debtor-creditor relationship, *i.e.,* that the parties did not stand in the same capacity to each other. Specifically, the majority reasoned that Apple is a trustee of the funds it owes to Reliance, which altered the nature of the relationship, at least with respect to the Pinacor recovery.

[5] Alternatively, the Datamac claim could be considered a post-petition debt because the Liquidator valued the claim at $0.00, asserting it was covered under the Policy. The Referee reversed, holding that the claim was covered under the Policy. This Court affirmed the Referee, and the claim has been valued at $3,472,736.11. Because the validity of Apple's claim was established post-liquidation, it could be considered a post-liquidation debt. In any case, Apple did not purchase the Datamac claim to reduce its Pinacor obligation. BRANUM at 914.

The majority reached this conclusion on the basis of Section 5 of Article V of the Policy, which states:

> 5. **Assignment and Subrogation**.
> As a condition to any claim payment, the Insured shall assign to the Insurer all right, title and interest with respect to all Qualifying Defaults which are the subject of the claim and all related security interests and claims against third parties. Should the Insurer so request, the Insured shall retain legal title to any interests or rights to which the Insurer is entitled. Any salvage received by the Insured shall be considered held in trust for the Insurer and transferred to the Insurer for apportionment in accordance with section 6 of Article V.

Policy, art. V, §5. The majority believes that the sentence stating that any "salvage received by the Insured shall be considered held in trust for the Insurer" transformed Apple's status from that of a debtor to that of a trustee. In reaching this conclusion, the majority relies principally upon *Pink v. American Surety Company of New York*, 28 N.E.2d 842 (N.Y. 1940).[6]

Pink arose out of reinsurance agreements between an insolvent insurer, Guardian Casualty Company, and its reinsured, American Surety Company of New York. The contracts gave Guardian Casualty the right to a proportional share of any salvage collected by the reinsured, American Surety. The Court of Appeals stated that

> *[o]ut of its receipt [of salvage], no relation of debtor and creditor was created.* In relation to any salvage collected to

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[6] The majority also relies on *obiter dicta* in *National Garment Co. v. New York, Castle & St. Louis Railroad Co.,* 173 F.2d 32, 35 (8th Cir. 1949). *National Garment* concerned whether a shipper, whose garments were damaged by the railroad, could sue the railroad after receiving partial payment from the shipper's insurer. The court held that it could pursue the railroad for the whole loss, noting that if successful, the shipper's insurer may be able to recover its payment from the shipper. The court cited to Moore's Federal Practice for this aside. The real issue in *National Garment* concerned the construction of a bill of lading under federal law.

> recoup losses on specific risks under the reinsurance contracts *the reinsured was a trustee for the reinsurer as to moneys in its hands* belonging to the latter or to be applied to a specific purpose.

Pink, 28 N.E.2d at 844 (emphasis added). The court based this conclusion on the fact that the reinsurer lacked any authority to adjust policy claims or pursue subrogation. The court explained that

> *[s]ole control and direction of any claims and suits were thus in the hands of the reinsured*, and its action and determination thereon, in the absence of fraud or bad faith, were conclusive on the reinsurer.
>
> ***
>
> [U]nder the terms of the contract the reinsurer was entitled to its proportion of the salvage recovered by [the reinsured]. Nevertheless, *only [the reinsured] was permitted to secure it in the first instance. The [reinsurer] could not question any decision made or action taken by [the reinsured]* in connection therewith. Nevertheless, [the reinsured] was bound to act in good faith. By the express terms of the contracts the agreements were "regarded by the *parties hereto as an honorable engagement rather than as a mere legal obligation*."

Id. (emphasis added). Treatise authority confirms that the theoretical underpinning to the holding in *Pink* was the reinsurer's inability to pursue salvage on its own and its complete dependency upon the reinsured's claims department. 1A COUCH ON INSURANCE 3d, §9:20 (2010) (COUCH).

The majority has overlooked *Pink's* stated rationale for its holding, *i.e.,* the reinsurer's dependence upon the reinsured. *Pink*, 28 N.E.2d at 844; 1A COUCH §9:20. It simply extended *Pink*, a holding construing a reinsurance treaty, to an

insurance policy. However, a reinsurance treaty and an insurance policy are quite different, as Apple correctly notes.[7]

Reliance was not dependent on Apple to pursue salvage. The Policy expressly reserved in Reliance the right to pursue salvage. Section 5 of Article V of the Policy states that "the Insured shall assign to the Insurer all right, title, and interest with respect to all Qualifying Defaults …." Policy, art. V, §5. Section 6 of Article V presumes that Reliance is the party that will pursue salvage or subrogation; accordingly, it states that

> [a]ny amounts of salvage … shall be applied first to reimburse the Insurer for its out-of-pocket expenses in pursuing salvage with respect to the Approved Debtor involved and shall then be divided between the parties according to the Recovery Ratio.

Policy, art. V, §6. Here, in spite of Reliance's contract right to control the subrogation litigation, it chose instead to authorize Apple

> to act on its behalf in connection with the Bankruptcy Proceedings (but only as respects that claim filed against Pinacor, Inc. (Latin America)).

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[7] Admittedly, there are similarities between reinsurance and insurance. These similarities have prompted reinsureds to argue that their claims against an insolvent insurer should be treated as policyholder claims. *See, e.g., Foremost Life Insurance Co. v. Department of Insurance*, 409 N.E.2d 1092 (Ind. 1980). Such claims always fail, and reinsurer claims are assigned a lower priority, that of a general creditor. In so holding, courts explain that there is "both a technical and an actual difference between the ordinary or usual contract of insurance and a contract of re-insurance …." *Aetna Casualty & Surety Co. v. International Re-insurance Corp.*, 175 A. 114, 121 (N.J. Ch. 1934). The purpose of the insolvency statute is to protect "the ordinary citizens who bought 'policies….'" *Id.* Apple is not an "ordinary citizen;" however, Article V does not distinguish between sophisticated commercial policyholders, such as Apple, and other, less sophisticated policyholders.

Certifications and Release Agreement at 2. In sum, Reliance was not solely dependent upon Apple with respect to subrogation, and this fact alone makes *Pink* inapplicable to our construction of the subrogation clause in the Policy.

In any case, the Court need not look to reinsurance contract precedent. There is ample precedent that has construed policy language stating that the insured holds salvage, or subrogation monies, "in trust" for the insurer. This precedent has consistently held that this "in trust" language does not make the insured a trustee but, rather, creates no more than a "mere legal obligation." Further, the insured's debt obligation is subordinate to the most important provision in an insurance policy: the insurer's promise to pay for losses covered under the policy.

The Release signed by Apple is a type of release and trust agreement,[8] which are executed by insureds as a condition of claim payment. Such agreements are routinely construed in favor of the insured and strictly construed against the insurer. *See, e.g.*, *Midland Bank and Trust Company v. Fidelity and Deposit Company of Maryland*, 442 F.Supp. 960, 969 (D.N.J. 1977). Further, notwithstanding the fact that release and trust agreements typically require the insured to hold any money it may recover "in trust" for the insurer, courts do not construe that term to give the insurer a priority over the insured to the funds. Rather, the "[subrogation] clause must be subordinated to the basic insurance promise and that the insurer should not recover sums received by the insured from the tort source until the insured has been fully indemnified." *Oss v. United Services Automobile Association*, 807 F.2d 457, 460 (5th Cir. 1987) (quotation and citation omitted). The "basic insurance promise" is to pay losses arising from insured perils, or "insuring agreement," which is the centerpiece of

[8] Notably, however, the Release at issue here does not contain the word "trust" in its title or in its text.

any insurance contract. GEORGE E. REJDA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 77 (6th ed. 1998).

The primacy of the insured's interest has led to the development of the "made whole" doctrine, which forbids the insurer to demand subrogated monies held "in trust" by the insured until the insured has been fully compensated for his losses. *See* ROGER M. BARON, *Subrogation: A Pandora's Box Awaiting Closure*, 41 S.D. L. REV. 237, 249-255 (1996) (hereinafter BARON). The "made whole" doctrine has been adopted by a majority of states, including Pennsylvania. *Id.* at 250; *see also Nationwide Mutual Insurance Company v. DiTomo*, 478 A.2d 1381 (Pa. Super. 1984); *Watson v. Allstate Insurance Co.,* 28 F.Supp. 2d 942 (M.D. Pa. 1998). The doctrine gives the insured, not the insurer, a priority over those funds.

The rationale for the doctrine has several components. An insured pays a premium to transfer a risk of loss to the insurer, and the insurer is contractually obligated to cover the loss, up to the amounts stated in the policy. This is the most fundamental provision in the policy and the reason the parties have come together in the first place. REJDA at 77. When the insurer recovers its claim payment from a third party by subrogation, it enjoys a windfall. BARON at 243-244; *Frost v. Porter Leasing Corp.*, 436 N.E.2d 387, 389 (Mass. 1982). Subrogation is considered a harsh doctrine precisely because it deprives the insured of the benefit of its bargain. As has been explained:

> *The principal purpose of an insurance contract is to protect the insured from loss*, thereby placing the risk of loss on the insurer…. The insurer has accepted payments from the insured to assume this risk of loss. Therefore, if "either the insurer or the insured must to some extent go unpaid, the loss should be borne by the insurer …." *This basic principle cannot be summarily overcome by a boiler-plate provision in an insurance contract that purports to entitle the insurer to subrogation out of the first monies* received by the insured.

Esparza v. Scott and White Health Plan, 909 S.W.2d 548, 551-552 (Tex. Ct. App. 1995) (citations omitted) (emphasis added). The subrogation clause in an insurance policy, which gives the insurer a right to subrogated monies, or "salvage," held by an insured "in trust," is secondary to the contract provision that requires the insurer to cover a loss. The "in trust" language creates the insurer's right to subrogation but does not make the insured a trustee.[9]

In Pennsylvania, no state court has directly addressed a release and trust agreement. However, the United States District Court for the Middle District of Pennsylvania has done so. In *Watson*, the release and trust agreement Allstate required its insured to sign provided that

> any monies recovered by the [Plaintiffs] as the result of judgment, settlement, or otherwise, *will be held in trust by the [Plaintiffs] and paid to [Allstate]*, provided, however, any sum recovered in excess of the total amount paid by [Allstate] to the [Plaintiffs] under the terms of the above-mentioned policy, shall be retained by the [Plaintiffs] for [their] own use and benefit.

Watson, 28 F.Supp. 2d at 944 (emphasis added). In determining whether this language nullified the "made whole" doctrine, the court held that:

> Language to the effect that the insurer has a right of subrogation, and that the *insured has a duty to hold the proceeds of a settlement or judgment in trust*, is insufficient to alter the "made whole" principle.

[9] The Liquidator asserts that the "in trust" phrase in the Policy required Apple to make its payment one way: in cash. The "trust" language, the Liquidator asserts, bars Apple from remitting the "trust" monies by means of setoff, *i.e.*, by reducing Reliance's debt to Apple. Stated otherwise, the Liquidator construes the "trust" to give the insurer a priority over the insured, but case law instructs otherwise.

Id. at 946 (emphasis added). The court held that contract language, *i.e.*, holding "proceeds in trust," did not mean, literally, that those funds could not be used by the insured for the insured's benefit. To deprive the insured of the use of those funds, the District Court held that more explicit language was needed, such as an express statement that the insured's right to the funds was secondary to that of the insurer. It had to recite that the insured must pay the insurer the subrogated monies "immediately" upon receipt. *Id.*

In reaching this conclusion, the U.S. District Court looked at cases from other jurisdictions, in particular *Wine v. Globe American Casualty Co.*, 917 S.W.2d 558 (Ky. 1996). The language of the release and trust agreement at issue in *Wine* stated that

> if … the person to and for whom payment is made recovers damages from another, *that person shall hold in trust for [the insurer]* the proceeds of the recovery and shall reimburse [the insurer] to the extent of our payment.

Wine, 917 S.W.2d. at 563-564 (emphasis added). The Supreme Court of Kentucky held that this language merely expressed the insurer's *right* of subrogation, but it did not give the insurer a *priority* over the insured. *Id.* at 564 (emphasis in original). This was consistent, the Court noted, with the principle that a construction of the insurance policy "most favorable to the insured must be adopted." *Id.* (quotation omitted). *See also Farmers Insurance Exchange v. Zerin*, 61 Cal. Rptr. 2d 707, 711 (Cal. Ct. App. 1997) (holding that insured's obligation under a release and trust agreement to hold third party recoveries "in trust" was no more than a "bare promise to reimburse" the insurer and did not give the insurer an equitable lien upon the funds).

Likewise, here, the boilerplate "in trust" language in the Policy subrogation clause, identical to that considered in *Watson* and in *Wine,* lacks the specificity needed to require Apple to remit the monies it received from Pinacor in cash and in advance of receiving any payment from Reliance on its Datamac claim. The Policy subrogation clause did not alter the debtor-creditor relationship of Apple and Reliance. In vain, therefore, will one search for a court in any jurisdiction applying the reasoning of *Pink* to a policy subrogation clause.[10]

Apple has been made whole on the Pinacor loss, but it has not received anything at all from Reliance on the Datamac claim. The "made whole" doctrine usually applies where the insurer has at least honored its contractual obligation. The case for the "made whole" doctrine is even stronger where, as here, the insurer has not fulfilled its central contractual obligation to pay claims. In any event, the "in trust" language in the Policy subrogation clause created no more than a legal obligation, not a fiduciary obligation, in the insured.[11] It did not create a common law trust or give Reliance a lien upon the Pinacor monies. *Farmers*, 61 Cal. Rptr. 2d at 712.

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[10] There is no such thing as subrogation between a reinsured and a reinsurer as there is in an insurance contract. The reinsurer's obligation is one of pure indemnity. *Fidelity & Deposit Co. of Maryland v. Pink*, 302 U.S. 224 (1937) (holding that because the reinsurance agreement is one of indemnity, not liability, the reinsurer had no contract obligation to participate in an insolvent insurer's claims obligation until the insurer actually paid claims). The reinsurer takes a percentage of the reinsured's loss in exchange for receiving a percentage of the reinsured's premium. If the reinsured's "loss" is reduced by salvage, then so must the reinsurer's "loss" be reduced. If not, then the reinsurer has paid in excess of what the contract requires, and the reinsured would enjoy an extra-contractual benefit.

[11] Subrogation prevents an insured from recovering twice on the same loss: once from the insurer and once from the tortfeasor. Apple will not receive double payment. Rather, it will remit the subrogated monies by reducing the amount of its Datamac claim against Reliance.

There are other problems with the majority's conclusion that the subrogation clause changed the status of the parties to the Policy.

First, Reliance, as the insurer, has a fiduciary responsibility to its policyholder, Apple. *See Ridgeway ex rel. Estate of Ridgeway v. U.S. Life Credit Ins. Co.,* 793 A.2d 972, 977 (Pa. Super. 2002) (holding that the duty to act in good faith stems from the insurer's fiduciary status created by the insurance policy). The Liquidator has not offered any authority to support the notion that Apple had a fiduciary responsibility to Reliance. However, if so, then arguably both parties stand in the same capacity: as a fiduciary to the other.

Second, in the context of the insurer-insured relationship, setoff is exercised by the insurer. Automobile insurance policies, for example, allow the insurer to reduce the policyholder's benefit payment by the salvage value of a totally destroyed vehicle. 12 COUCH §177:4. Here, it is Reliance that should be exercising setoff to reduce the amount of the policy benefit it owes to Apple on the Datamac claim by the amount of the Pinacor recovery. Insurers routinely use setoff to reduce a claim payment by the policyholder's deductible, salvage or premium due. *Id.*

In sum, more than a description of the salvage recovery as held "in trust" was needed to effect an alteration in Apple's capacity from that of a debtor to a fiduciary. Insurers bear a fiduciary obligation to their policyholders, not the reverse. Indeed, the Liquidator did not sue Apple for breach of fiduciary duty but only for breach of contract. Apple's obligation to remit the Pinacor recovery to Reliance did not alter the essential debtor-creditor relationship between Reliance and Apple that was created by the Policy.[12] *Wine*, 917 S.W.2d at 563-64. Reliance and Apple are

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[12] In *Koken (GE Frankona),* this Court cited *Downey v. Humphreys*, 227 P.2d 484, 490 (Cal. Dist. Ct. App. 1951), for the general proposition that funds held in trust are not subject to setoff. More
(Footnote continued on the next page . . .)

each a debtor and creditor of the other. Their debts and credits are mutual in time. Accordingly, Apple may remit the subrogated funds owed to the Reliance estate in the form of offset, *i.e.,* by reduction of the estate's liability for Apple's Datamac claim.

Recoupment

However, even if Apple were not entitled to setoff, I believe that it has made the case for recoupment, which provides similar relief to debtors who are also creditors, such as Apple. Recoupment is strictly defensive in nature and will not support an affirmative recovery. BRANUM at 940. It is an equitable remedy that, as a matter of fundamental fairness, allows a defendant to show he is not liable for the full amount of the plaintiff's claim because of the defendant's claim against plaintiff. *Id.* at 940-941. Unlike setoff, mutuality is not required. The sole technical requirement in recoupment is that defendant's reduction claim arise from the same transaction. *Id.* Our Supreme Court explained in *Cohen v. Goldberg*, 554 Pa. 201, 206, 720 A.2d 1028, 1030-31 (1998), "[t]he most common application of the doctrine of recoupment is where … both the creditor and the debtor have *claims arising from a single contract.*" (citation omitted) (emphasis added).[13] *See also In re Graves,* 234 B.R. 149,

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precisely, the California District Court of Appeal stated that "a fiduciary cannot set off claims owed by him in his personal capacity against obligations that he assumes as a trustee." *Id.* However, the court found that insurance agents, which collected insurance premium for its principal, the insurer, did not hold them in trust. The court explained that if a person receives monies to which he has unrestricted use, even though he owes them to a third party, a debt is created. At issue in *Downey* was whether insurance premium received by an agent to its principal, the insurance company, made the agent a trustee of that premium. The court held that it did not because the funds were co-mingled with the knowledge of the insurer.

Likewise, here, Apple was permitted to co-mingle the funds it owed Reliance with its other funds. Its use of the recovered funds was unrestricted, upon receipt.

[13] *Cohen* involved multiple contracts between a husband and wife, each of whom conducted a separate medical specialty practice. As the husband's medical practice declined, the wife made a
(Footnote continued on the next page . . .)

150 (Bankr. M.D. Fla. 1999) (holding series of claim payments under a single policy constituted a single transaction and, thus, insurer could recoup pre-bankruptcy claim payments from bankrupt policyholder by reducing its post-bankruptcy claim payments); *In re: Delta Air Lines*, 359 B.R. 454, 465 (Bankr. S.D. NY 2006) (explaining "right of recoupment arises only in the context of a single contract or a series of transactions constituting a single, integrated transaction or contract").

The claims of Reliance and Apple arise from a single contract, which is the Policy. Reliance's claim against the Pinacor salvage derives from Article V, Sections 5 and 6 of the Policy, and Apple's right to payment for the Datamac claim derives from the coverage for "Qualifying Defaults" provided in Article I of the Policy. The majority holds that the Certifications and Release Agreement is a separate agreement from the Policy, but this does not survive close scrutiny.

The Policy required Apple to execute the Release as a condition of Reliance's payment of the Pinacor claim. Amended Complaint ¶14. As explained, policyholders commonly execute trust and release agreements as a condition of payment of a claim. *See also* 15 COUCH §216:1.[14] The Release cannot stand alone; it

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series of separate loans to her husband's practice over a four-year period of time. Some loans were documented in writing, and others were not. In addition, prior to their marriage, the parties executed an antenuptial agreement. With respect to her husband's unpaid loans, the wife filed proofs of claim in her husband's bankruptcy. She did not receive any payment from the bankruptcy estate. When the two divorced, the wife attempted to recoup the amount of her unpaid loans in the division of the marital estate, which was governed by the antenuptial agreement. The Supreme Court held that the multiple loans and the antenuptial agreement did not constitute an "integrated transaction" for purposes of recoupment. Nor did it accept the notion that the marriage itself was a "transaction."

In contrast to the multiple contracts governing different transactions presented in *Cohen*, here the two claims arise from a single contract, *i.e.*, the Policy, and a single policy year.

[14] In the insurance field, releases are used to extinguish policy obligations. 15 COUCH §216:1. They are executed by insureds, to extinguish their claim against their insurer; by insurers to release their
(Footnote continued on the next page . . .)

has no meaning except with reference to the Policy. Notably, the majority relies upon the subrogation clause in the Policy to find that the Release imposed a "trust" upon the Pinacor proceeds. This is because the Release itself says nothing about a trust and does not even refer to the subrogation clause in the Policy.[15] If the Release is to be treated as a stand-alone contract, then it did not impose any "trust" obligations on Apple, which makes setoff available to Apple. The Policy and Release cannot be read together for purposes of the setoff analysis but then separated for purposes of the recoupment analysis. The Release is inextricably connected to the Policy.

To find recoupment unavailable to Apple, the majority relies upon *In re University Medical Center*, 973 F.2d 1065 (3d. Cir. 1992), a readily distinguishable case. *University Medical Center* concerned two debts that arose three years apart under an ongoing contractual relationship between a hospital and the federal government relating to Medicare services. The federal government invoked the doctrine of recoupment to deny the hospital's claim for payment. The Third Circuit

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claims against other insurers or third parties; and by third parties to release their claims against insureds or their insurers. *Id.* Releases prepared for the insurer's benefit will be construed against the insurer. *Id.* at §216:8; *Continental Insurance Co. v. Dunne*, 226 F.2d 471 (9th Cir. 1955). Here, the Release, crafted by Reliance, states:

> [T]he Insured does assign and transfer to the Insurer, its successors and assigns, all right, title, and interest in, and all sums of money now due … to the Insured from the Debtor, Pinacor, Inc.

Certifications and Release Agreement at 2. All doubts about the meaning of the Release must be construed against Reliance; notably, the Release does not state that it survives the Insurer's insolvency.

[15] The Release states:

> If requested by the Insurer, the Insured will cooperate to cause any checks to be issued by the Trustee in the Bankruptcy proceeding in payment of the Qualifying Default (but only those checks issued on account of the claim against Pinacor, Inc. (Latin America)) to be payable to both the Insured and the Insurer.

Release, at 2.

held that the regulatory framework imposed on the parties' contractual relationship "indicate[s] that reimbursement payments made for any one year arise from transactions wholly distinct from reimbursement payments made for subsequent years." *Id.* at 1080. Stated otherwise, each year of the ongoing contractual relationship was a new "transaction" for purposes of recoupment. Accordingly, the Third Circuit correctly held that the federal government could not use recoupment to refuse to pay the hospital for services it rendered to Medicare patients. *Id.* at 1082.

Here, by contrast, the two debts arise from a single Policy and a single year. There is no regulatory scheme that treats each policy claim as a separate transaction. To the contrary, *In re Graves*, 234 B.R. 149, held that multiple claims arising from a single insurance policy constitute a single integrated transaction.

The Policy transferred Apple's risk of loss to Reliance with respect to a discrete list of Latin American risks, including Pinacor and Datamac. The test for recoupment is whether the two separate debts arose out of a series of transactions constituting an "integrated transaction," such that "it would be inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations." *Cohen*, 554 Pa. at 205, 720 A.2d at 1030 (citation omitted). "[T]he predominate consideration, given the equitable nature of the recoupment doctrine, is whether it would be fair for the debtor to enjoy the benefits of the transaction without also meeting its obligations." *In re Reeves*, 265 B.R. 766, 771 (Bankr. N.D. Ohio 2001).

The majority does not explain why it is fair to make Apple pay in full, when Reliance has not done so and will not. It simply holds that the Datamac and Pinacor claims do not constitute an "integrated transaction." To the extent the majority considers the equities, it adverts to the other creditors of Reliance. Apparently, the majority believes that recoupment effects a preference, but it does not.

BRANUM at 911. Further, in recoupment, the equities analysis is applied to the conduct of the parties to the contract, *i.e.*, Apple and Reliance, not to what recoupment means for other creditors.

In any subrogation case, as already noted, the equities favor the insured because the insurer's recovery of subrogated funds deprives the insured of the insurer's contract performance. Further, it is inequitable for Reliance to demand Apple's contract performance when Reliance itself has been in breach of its fiduciary and contractual obligation to pay Apple's Datamac claim since 2000.[16] Had the Datamac claim been paid timely in accordance with the Policy, there would be no dispute today. Reliance's refusal to pay the Datamac claim constitutes a breach of contract, and a material breach of contract excuses the non-breaching party from its performance obligation under the same contract. *See, e.g., Widmer Engineering, Inc. v. Dufalla*, 837 A.2d 459, 467 (Pa. Super. 2003) (noting "settled principle of contract law: a material breach by one party to a contract entitles the non-breaching party to

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[16] The estate would benefit from Apple's recoupment and setoff because the estate's total liability to the class of policyholder creditors would be reduced. Accordingly, the pro-rata share of each policyholder payment would be increased. If Apple is not allowed to invoke setoff or recoupment, the Pinacor payment will go first to administrative expenses.

In footnote 14, the majority accepts the Liquidator's assertion that recoupment places Apple in a better position than other policyholder claimants. There are several problems with the Liquidator's assertion. First, funds subject to setoff or recoupment can never work a preference because the funds are not assets of the estate. BRANUM at 911. Second, the Liquidator's model compares apples to oranges. Some Reliance policyholders will receive 100% on the first $300,000 of their loss, and others will receive 100% on the first $100,000 of the loss from guaranty funds. Other policyholders will not receive anything from guaranty funds because they are not eligible. The Liquidator argues from a faulty premise: that all Reliance policyholders will be treated exactly the same. Third, the Liquidator will make Apple contribute to the payment of its own Datamac claim by disallowing setoff or recoupment. It is fundamentally unfair and absurd to make "A pay when B owes A." *Id.*

In any case, as noted, in applying recoupment, the equities examine the conduct of Apple and Reliance, not the impact upon other creditors.

suspend performance"). Accordingly, Apple is properly excused from its contract performance, even assuming the subrogation clause in the Policy required Apple to remit the Pinacor recovery in the form of cash, not setoff.

In sum, the technical requirements of the doctrine of recoupment have been satisfied by Apple, and the equities favor Apple. It is fundamentally unfair to make Apply pay over subrogated monies in cash, which will give Reliance a windfall, when Reliance has been in breach of contract since 2000 on its debt to Apple. Simply, Reliance's obligation to pay the Datamac claim takes precedence over Apple's obligation with respect to the subrogated Pinacor funds.

Conclusion

The Liquidator has been dogged in its pursuit of Apple. As the majority observes, the Liquidator first tried to recover $1.6 million from Apple on the theory that the pre-liquidation payment effected a preference, having been made too close in time to Reliance's receivership. When that failed, the Liquidator valued the Datamac claim at $0.00, which, if successful, would have left Apple without a Reliance debt against which it could assert setoff or recoupment. However, the Datamac payment was found to be owing in full. These litigation strategies signal the Liquidator's own discomfort about the strength of the position that Apple must pay in excess of $1.6 million under the Policy when Reliance owes Apple in excess of $3.0 million under that same Policy.

Normally, a policyholder's debts to the insurer, whether for premium or deductible or salvage, are offset from the insurer's claim obligation. 17 COUCH §244.64. The Liquidator offers no reason for abandoning this approach, other than to seize on *Pink.* However, Wolke points out that even in a reinsurance contract, where *Pink* governs, the reinsurer can "reduce reinsurance proceeds it owes to an insolvent

insurer by salvage proceeds held by the insurer and due to the reinsurer even if the salvage proceeds are held as trust funds." WOLKE, at 367. The Liquidator should use the Pinacor salvage funds, even if held in trust, to reduce the amount it owes Apple on the Datamac claim.

It is fundamentally unfair to make a policyholder, even a leviathan such as Apple, pay its insurer $1.6 million when that insurer owes Apple in excess of $3 million under the same Policy. The Liquidator may reduce its claim payment to Apple by the amount of Apple's debt to it, which has the immediate effect of reducing the Reliance estate liability to policyholders by $1.6 million. By reducing that liability, all policyholders benefit.

On the basis of setoff and the doctrine of recoupment, I would grant summary judgment to Apple.

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MARY HANNAH LEAVITT, Judge