The Collateral Source Rule and Contract Damages

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The collateral source problem, that prickly game of three-cornered catch that occurs when an injured person has received compensation from a source independent of the injurer, remains one of the most troublesome in the modern law of damages. The focus of concern has been mainly the effect of the collateral source benefit on tort recovery, so much so that the collateral source problem is widely thought of as exclusively a tort problem. Indeed, in other areas it has led little more than a shadow existence. One of these other areas is contract claims, the subject of the present study. Largely neglected in the scholarly literature[1], the problem of the effect of collateral source payments on contract damages has evoked few responses that might give direction to a principled approach.

This Article begins with a brief explanation of the collateral source rule and its justifications, and argues that the difference in the policies underlying contract and tort does not by itself justify a different application of the collateral source rule in the two areas. In an attempt to develop some guiding principles for contract, the Article proceeds to analyze the existing case law, asking whether the outcome did turn or should have turned on (1) the type of breach, whether willful, negligent or innocent; (2) the type of damage, whether personal injury, property damage, or economic loss; and (3) the type of benefit and availability of subrogation.

What emerges from this investigation of the cases is that most often the choice before the court is not between conferring a windfall on either plaintiff or defendant but of determining which of two obli-

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1. Maxwell, *The Collateral Source Rule in the American Law of Damages*, 46 MINN. L. REV. 669 (1962), designed as a revision of C. MCCORMICK, CASES AND MATERIALS ON THE LAW OF DAMAGES (1935), affects to be comprehensive but offers no separate discussion of the contract problem beyond an approving reference to "the idea that the collateral source rule is a doctrine for tort cases." *Id.* at 675. His selection of contract cases is unsystematic and unrepresentative. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES (1973), makes the terse (and erroneous) statement that "the collateral source rule is not used at all in contract claims." *Id.* at 587. Dobbs notes, however, that "borderline cases, where the 'gist' of the action is regarded as in tort, may be different." *Id.* at 587 n.29.

gors (the defendant or the collateral source) should assume primary responsibility for compensating the loss. With few exceptions, repayment to the collateral source (by way of subrogation) has been the preferred solution. Even in the remaining situations, the collateral source rule has usually prevailed regardless of the type of breach, type of loss, or type of collateral benefit. This analysis thus confirms the original hypothesis against any principled distinction in the application of the collateral source rule between contract and tort.

I

THE COLLATERAL SOURCE RULE AND ITS JUSTIFICATIONS

An obvious source of inspiration and a starting point for an inquiry into the proper role of the collateral source rule in the law of contracts is the comparatively rich treatment of the problem in tort cases. As is well known, the so-called "collateral source rule" requires the tortfeasor to bear the full cost of the injury he has caused regardless of any benefit the victim may have received from an independent ("collateral") source.[2] Several justifications have been offered for this solution, which at first glance appears to overcompensate the plaintiff and runs counter to the general approach in many other countries.[3] Some of these justifications apply in general; others only to particular types of benefit— for example, to those financed by the plaintiff himself.

At the outset, we must distinguish the many situations where the plaintiff does not gain a "windfall" in any sense because he must reimburse the collateral source out of the damages he recovers from the tortfeasor. These situations include indemnity insurance, workers' compensation entitling the insurer to subrogation for benefits paid, contractual stipulations for repayment under certain prepaid medical plans, loans made to the victim on condition of repayment in case of a sucessful tort recovery, and other instances permitting the collateral source a direct claim for reimbursement from the tortfeasor. The common feature of all of these situations is that they are compatible with the widely favored ideal of assuring that the tortfeasor does not gain any advantage from the collateral benefit without at the same time

2. *See* RESTATEMENT (SECOND) OF TORTS § 920A(2) (1979). The literature, much of it critical, is voluminous. *See, e.g.*, 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 25.22-.23 (1956); Fleming, *The Collateral Source Rule and Loss Allocation in Tort Law,* 54 CALIF. L. REV. 1478 (1966); Note, *Unreason in the Low of Damages: The Collateral Source Rule,* 77 HARV. L. REV. 741 (1964).

Annotations of the relevant case law dealing with particular benefits are: 7 A.L.R.3d 516 (1966) (wages); 4 A.L.R.3d 535 (1965) (unemployment benefits); 84 A.L.R.2d 764 (1962) (social security); 75 A.L.R.2d 885 (1961) (pensions); 68 A.L.R.2d 876 (1959) (medical care).

3. *See* Fleming, *Collateral Benefits*, in 11 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW (TORTS) ch. 11 (A. Tunc ed. 1970).

overcompensating the plaintiff.[4] We will have occasion to see that a great many of the contract decisions involving the collateral source rule are in fact consistent with this ideal, whether expressly adverted to or not, and therefore—from this perspective—reached a perfectly unexceptionable result.[5]

Not reducing plaintiff's recovery by the amount of insurance benefits is also commonly defended on the ground that the defendant should not be allowed to take advantage of a fund created by the plaintiff himself. This argument has special force where the insurance carries no right of subrogation because public policy is indifferent to the insured's double recovery, as in the case of "sum" insurances like accident and life policies.[6] "Full" life, in contrast to "term," insurance contains of course a substantial investment feature and therefore represents a form of saving to which the defendant could no more fairly lay a claim than he could to the plaintiff's savings account.[7] "Fringe benefits" under employment contracts, such as disability pay, are generally treated no differently than if the plaintiff had paid for them independently and on his own initiative; functionally, these benefits are clearly part of the remuneration for his work. In contrast, benefits from a public source cannot be attributed either to the plaintiff's thrift or prescience and, in the absence of subrogation,[8] support a stronger claim by defendants for pro tanto reduction of their liability. Several no-fault plans[9] and the recent Model Uniform Product Liability Act[10] specifically sanction that result.

Traditionally, the principal general defense of the collateral source rule has been that for the sake of both deterrence and equity vis-a-vis his victim, a wrongdoer should not escape the full cost of the injury he has caused. The argument is now, however, widely discredited. Evocation of punishment for the defendant, who is pejoratively stigmatized

4. *See generally* Fleming, *supra* note 2 (examining various instances of reimbursement).

5. *See, e.g.,* text accompanying notes 105-09.

6. *See* Helfend v. Southern Cal. Rapid Transit Dist., 2 Cal. 3d 1, 9-11, 465 P.2d 61, 66-69, 84 Cal. Rptr. 173, 178-81 (1970). On the difference between "sum" and "indemnity" insurance as it affects subrogation, see Kimball & Davis, *The Extension of Insurance Subrogation*, 60 MICH. L. REV. 841 (1962).

7. The argument that accident and term life insurance (lacking investment features) should be credited to the tortfeasor has been made, but has fallen on empty ears. *E.g.*, 2 F. HARPER & F. JAMES, *supra* note 2, § 15.22; Fleming, *supra* note 2, at 1500.

8. In contrast to European practice, few of our relevant statutes provide for subrogation. A notable exception is the Federal Medical Care Recovery Act, 42 U.S.C. § 2651 (1976); *see* Bernzweig, *Public Law 87-693: An Analysis and Interpretation of the Federal Medical Care Recovery Act*, 64 COLUM. L. REV. 1257 (1964).

9. *E.g.* N.Y. INS. LAW § 671 (Consol. Supp. 1981-82); MICH. COMP. LAWS ANN. § 500.3109 (West Supp. 1982); UNIF. MOTOR VEHICLE ACCIDENT REPARATION ACT § 11, 14 U.L.A. 41 (1972).

10. MODEL UNIF. PROD. LIAB. ACT § 119, 44 Fed. Reg. 62,714, 62,747-48 (1979).

as "the wrongdoer," is incompatible with the exclusively compensatory purpose of tort damages,[11] and under modern conditions, the admonitory effect of an adverse judgment is usually deflected by liability insurance or other available conduits for distributing the loss. Acknowledging these truisms, the California Supreme Court in *Helfend v. Southern California Rapid Transit District*[12] explicitly disowned the punishment rationale and held that the collateral source rule could therefore be invoked against public entities just as well as against other tortfeasors.

The *Helfend* court considered that the collateral source rule, aside from expressing "a policy judgment in favor of encouraging citizens to purchase and maintain insurance for personal injuries and for other eventualities,"[13] also performed a "legitimate and even indispensable function"[14] by compensating for the plaintiff's attorney's share in the recovery.[15] That is to say, the plaintiff does not really receive a double recovery, because he must pay his own attorney a substantial percentage of the damages awarded. Abolition of the collateral source rule without a concomitant reform of the contingent fee system would therefore heavily prejudice the current position of successful plaintiffs by denying them, in effect, adequate compensation for their real loss.

The force of this argument is not, however, confined to the contingent fee system prevailing in torts but seems to apply equally to contract claims. Under the "American rule" which has been described as "deeply rooted in our history,"[16] the prevailing party is ordinarily responsible in either type of case for his own attorney's fees, the only difference being that in tort, unlike contract cases, the fees are usually fixed as a percentage of the award rather than at an hourly rate. One might conceivably argue that well-drawn contracts not infrequently entitle the aggrieved party to his legal expenses in vindicating his claim, and that the failure to insert such a provision could imply that the parties were prepared to absorb that risk without compensation. In either case the expense would therefore be bargained-for and inept to support

11. Indeed, it would violate statutory or common law restrictions on the award of punitive damages. Helfend v. Southern Cal. Rapid Transit Dist., 2 Cal. 3d 1, 13, 465 P.2d 61, 69, 84 Cal. Rptr. 173, 181 (1970).

12. 2 Cal. 3d 1, 465 P.2d 61, 84 Cal. Rptr. 173 (1970).

13. *Id.* at 10, 465 P.2d at 66, 84 Cal. Rptr. at 178.

14. *Id.* at 13, 465 P.2d at 69, 84 Cal. Rptr. at 181.

15. *Id.* at 12-13, 465 P.2d at 68-69, 84 Cal. Rptr. at 180-81.

16. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 270-71 (1974). This is not the place for considering the merits of that rule. The interested reader is referred to: Dawson, *Lawyers and Involuntary Clients: Attorney Fees from Funds*, 87 HARV. L. REV. 1597, 1598-601 (1974); Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CALIF. L. REV. 792 (1966); Goodhart, *Costs*, 38 YALE L.J. 849 (1929).

an argument of undercompensation.[17] In reality, however, the omission is more often attributable to quite different reasons: to neglect rather than design, to unequal bargaining power, to apprehension that it would favor one party more than the other[18] or that it would encourage litigation.

II
THE COLLATERAL SOURCE RULE AND THE POLICIES UNDERLYING CONTRACT AND TORT

The foregoing analysis of the tort and contract rationales for employing the collateral source rule to reimburse plaintiff's legal expenses leads to the more general question whether contract damages are not in truth dominated by different policies from those supporting the collateral source rule in tort cases. Aside altogether from the issue of contingent fees, the plaintiffs' bar persistently publicizes its claim that tort awards can never adequately compensate for personal injuries and that the collateral source rule, far from providing a windfall, only helps to minimize somewhat the enormity of the plaintiff's real loss. In this function indeed, the collateral source rule does not stand alone; most prominently the nontaxability of awards and the use of pretax earnings as a multiplicand are also commonly justified on the same ground.[19]

Contract damages are conventionally viewed in a very different light. Personal injury, which provides the dominant model for tort claims, plays a negligible role in contract damages, and nonpecuniary injury, such as emotional distress or sentimental loss, is ordinarily altogether excluded.[20] One of the principal arguments for indulgence in tort cases is therefore quite simply irrelevant in the contract context.

17. Indeed, an even more extreme argument is that the "American rule" alone is compatible with the fundamental policy of limiting contract damages to the expectation interest. A "loser pays all" rule would add a penalty and deter not only contract breaches but also contract bargaining. Hartzler, *The Business and Economic Functions of the Law of Contract Damages*, 6 AM. BUS. L.J. 387 (1968). Hartzler's thesis not only leans on a profound misunderstanding of the operation of the competing "English rule," but also it ignores its unfair differential effect on ordinary consumers as compared with professionals.

18. CAL. CIV. CODE § 1717 (West Supp. 1982) mandates reciprocity for contractual clauses entitling one of the parties to attorney's fees.

19. *See* McWeeney v. N.Y., N.H. & H.R.R., 282 F.2d 34, 38 (2d Cir. 1960).

20. *See* RESTATEMENT (SECOND) OF CONTRACTS § 353 (1981); *infra* note 31. English law is in accord. *See* Clarke, *Damages in Contract for Mental Distress*, 52 AUSTL. L.J. 626 (1978). This demonstrates also that, aside from attorney's fees, contract plaintiffs are frequently undercompensated in respect of non-provable, idiosyncratic losses. See Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977), which argues against the current bias against liquidated damage provisions. Undercompensation also results from the resistance to compensate the "consumer surplus" (i.e., subjective values above the utility associated with market price). *See* Harris, Ogus & Phillips, *Contract Remedies and the Consumer Surplus*, 95 LAW Q. REV. 581 (1979).

Beyond that, contract damages are administered in a penurious spirit in order to avoid unduly discouraging economic initiative and risk-taking. Even if punishment and deterrence have lost much of their credibility in tort theory, accident prevention is still recognized as a primary objective of legal policy that tort rules, including those of damage assessment, seek to promote. By contrast, according to a widely accredited viewpoint, contract obligations in a free market economy like ours[21] are obligations not necessarily to perform but rather to choose between performance and damages.[22] Not only are punitive damages ordinarily ruled out[23] and penalty clauses not enforced,[24] but specific performance is compelled only in exceptional circumstances where damages would not compensate the plaintiff for his loss.[25] There is some support even for the argument that the law is not merely indifferent toward actual performance of contracts, but even encourages (or at least *should* encourage) "efficient" breach.[26] By refusing to compel the promisor to perform and restricting the promisee's damages to the value of the promised performance, it permits the promisor to shift his resources to more profitable uses—a right move toward the grail of Pareto optimality.[27] In contrast to the wrongdoer sanctioned for unjust enrichment resulting from "unlawful" conduct (like crime or tort), the contract breaker is not accountable for his own increased profit. While one re-

21. In contrast to a free market society, the planned socialist economy emphasizes contractual discipline. In such an economy, because breach entails often irremediable shortfalls of the central plan, the primary remedy is specific performance, while damages serve less a compensatory than a deterrent purpose. Grossfeld, *Money Sanctions for Breach of Contract in a Communist Economy*, 72 YALE L.J. 1326, 1331-32 (1963).

22. This theorem stems from Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). *See generally* Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1145-47 (1970).

23. *E.g.*, CAL. CIV. CODE § 3294 (West Supp. 1982); RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981). However, the blanket proscription of punitive damages is weakening; exceptions are commonly allowed for fraudulent and "tortious" breaches of contract. *See* Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207 (1977); RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981) ("unless . . . also a tort").

24. RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981). But, as Professor Sweet demonstrates in *Liquidated Damages in California*, 60 CALIF. L. REV. 84 (1972), *reasonable* penalty clauses actually tend to be enforced.

25. Different views have been expressed on whether routine availability of specific performance would impair economic efficiency. Posner believes that it does. R. POSNER, ECONOMIC ANALYSIS OF LAW 88-89 (2d ed. 1977). Posner's view has been controverted recently by Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979).

26. *See* Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982) and literature cited *id.* at 947 n.4; RESTATEMENT (SECOND) OF CONTRACTS ch. 16, Introductory Note (1981); R. POSNER, *supra* note 25, at 55-59 (1st ed. 1973).

27. "The lower the level of compensation the greater the chance that one of the parties will find some alternative transaction which will result in a less than efficient use of resources." Harris, Ogus & Phillips, *supra* note 20, at 609 (advocating greater sensitivity to the "consumer surplus" in assessing damages in consumer contracts).

ceives the equivalent benefit of performance, the other comes off even better by not performing.

As we have seen, by denying the promisee his attorney's fees, the law does not shrink from deliberate undercompensation. Is it not arguable then that the collateral source rule would run counter to this basic contract orientation and that, instead, it would be more compatible to reduce the contract breaker's liability by the amount of the collateral benefit so long as the plaintiff is compensated for his actual net loss? Since a defendant can insist on the plaintiff mitigating his loss by his own reasonable efforts,[28] should he not be all the more entitled to the benefit of a third party's mitigation? Yet the hypothesis that rejection of the collateral source rule in contract would promote efficient breach is open to question, since the contract breaker would be taking advantage of an externality and thus distort the true cost of his reallocation of resources.[29] Insofar as the proposal is justified by an argument of efficiency, it therefore remains vulnerable. Moreover, for the would-be contract breaker, the possibility of a collateral benefit accruing to the promisee would rarely enter into his calculations; if it did not, to credit him with the benefit would give him a true windfall and serve no function as an incentive to more efficient allocation of resources. Besides, many a person of more robust turn of mind might wonder why the law should tamper with the parties' own allocation of the risks at the time they entered into a freely negotiated bargain and rescue one who had miscalculated. This thought is the more plausible where the collateral benefit, such as an insurance recovery, was created by the plaintiff as a back-up safeguard for himself rather than as a palliative for the defendant, let alone as an incentive for the latter's breach.

In summary, the policies underlying the law of contract do not dictate an application of the collateral source rule different from that in tort. For one thing, attorney's fees come out of both contract and tort awards; for another, even the controversial theory of efficient breach of contract would not justify minimizing the defendant's damages because to do so would give him the advantage of an externality and thus distort allocative efficiency.

This Article will now turn to the case law to inquire whether any guidelines for the application of the collateral source rule can be found in specific contract cases.

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28. *See infra* text accompanying notes 94-97. *See generally*, Farnsworth, *supra* note 22, at 1183-99; A. CORBIN, CORBIN ON CONTRACTS § 1039 (1964); RESTATEMENT (SECOND) OF CONTRACTS § 350 (1981). But the duty to mitigate has the different economic effect of avoiding waste rather than misallocating resources.

29. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 285 (1970).

III
THE CASE LAW

Unfortunately, the case law is singularly devoid of any speculations of principle and therefore rather deficient and uninspiring as a guide even to the solution of particular fact situations. Only a few opinions give us the benefit of a reasoned argument for their terse choice between the theory of mitigation and collateral benefit; others fail to come to grips with the fact that the real claimant is the collateral source rather than the contract obligee. While most of the cases reach defensible results on their specific facts, few opinions help to dispel the first impression of lack of orientation and irreconcilability. A more systematic analysis is therefore in order.

In a heuristic spirit, the cases in which the collateral source problem has arisen in the context of contractual claims have been classified in the following discussion according to a limited number of factors with some potential for fruitful analysis. These factors are (1) the type of breach, whether willful, negligent, or innocent; (2) the type of damage, whether personal injury, property damage, or economic loss; and (3) the type of benefit and the availability of subrogation.

A. Type of Breach

Whether the breach is intentional, merely negligent, or completely faultless may conceivably be relevant either because of the link between the collateral source rule and deterrence or because of the identification of intentional breach with "efficient" breach. Paradoxically, while the first perspective might favor applying the rule even in some contractual contexts, the latter perspective could point to the opposite conclusion.

1. Tortious Breach

The most explicit endorsement of the deterrence rationale stems from the Supreme Court of California in *City of Salinas v. Souza & McCue Construction Co.*[30] While recognizing that the collateral source rule was generally identified with tort cases, the court was prepared to concede that it had been applied in certain instances where the claim was "basically in contract, particularly where the breach has a tortious or wilful flavor."[31] Such was the situation in the *City of Salinas* case,

30. 66 Cal. 2d 217, 424 P.2d 921, 57 Cal. Rptr. 337 (1967).

31. *Id.* at 227, 424 P.2d at 926, 57 Cal. Rptr. at 342 (citations omitted). The California court has since become enamored of the notion of "tortious" breaches of contract as a means for venting its social opprobrium on certain "bad faith" breaches. The court has invoked tort sanctions, such as damages for emotional distress and punitive damages, in its campaign to reeducate the insurance industry. *See* Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13

where the city's misinformation to a building contractor about soil conditions sounded "in deceit, resulting in a fraudulent breach, and might, for some purposes, have been treated as an action for relief grounded on fraud."[32] However that might be, the rule was held inapplicable against a public entity because of its perceived punitive purpose; it would impose an unjust burden upon the innocent taxpayer without directly penalizing the wrongdoer.

Apart from the quoted statement being no more than dictum, the decision itself was undermined when, as already observed, the same court a few years later expressly repudiated the punitive rationale of the collateral source rule in *Helfend v. Southern Cal. Rapid Transit District*.[33] The actual holding in *City of Salinas*, however, was reaffirmed on the new ground that the plaintiff had "received payments from his subcontractor which, in the contractual setting of that case, did not constitute a truly independent source."[34] Thus, the court seemed to go a great deal further than it had on the prior occasion by assuming the collateral source rule to be prima facie applicable to contract claims without apparent reference to the nature of the breach involved. In the rare case of fraudulent breach, as in *City of Salinas*, the tort analogy for applying the collateral source rule is of course especially compelling. Without directly appealing to the theory of deterrence, it is sufficient to say that a contractor committing so egregious a breach hardly merits a more favorable treatment than a tortfeasor. It also argues with special persuasion for adopting an identical rule in contract as in tort, in order to avoid the outcome turning on a form of pleading or opening up the difficult question whether the plaintiff even has so much as an option to claim alternatively in tort.[35]

2. *Efficient Breach*

Standing the conventional wisdom on its head and pleading leniency precisely for what would generally be deemed breach "in bad faith" is, as already adumbrated, the argument that intentional breach

(1967); Neal v. Farmers Ins. Exch., 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978). These "tortious" breaches of contract are a category distinct from negligent injury in the performance of a contract between the parties, which raises the question of whether the plaintiff can sue in tort or contract. *See, e.g.*, Fuentes v. Perez, 66 Cal. App. 3d 163, 136 Cal. Rptr. 275 (1st Dist. 1977); Allen v. Jones, 104 Cal. App. 3d 207, 163 Cal. Rptr. 445 (4th Dist. 1980).

32. Failure to make a full disclosure by one who is bound to disclose is treated as fraud under CAL. CIV. CODE § 1710 (West 1982). In that sense, the defendants' conduct constituted a fraudulent breach of contract, which is perhaps alternatively actionable in tort.

33. 2 Cal. 3d 1, 14, 465 P.2d 61, 69, 84 Cal. Rptr. 173, 181 (1970).

34. *Helfend*, 2 Cal. 3d at 9, 465 P.2d at 66, 84 Cal. Rptr. at 178. In truth, the *Salinas* court had specifically declined to express a view on that question. *See City of Salinas*, 66 Cal. 2d at 227, 424 P.2d at 926, 57 Cal. Rptr. at 342.

35. *See supra* note 31.

should not be discouraged because, far from being reprehensible, it promotes a more efficient reallocation of resources. Negligent breach, on the other hand, cannot be so justified since it causes only dislocation and diminution of wealth. That this line of reasoning would have less appeal to lawyers than it might to theoretical economists is not altogether surprising. In the first place, as already pointed out, the assumption that the collateral source rule would impede an efficient reallocation of resources is controvertible on the ground that it would create an externality and thus result in a distortion of the true cost of breach. Thus, even if courts were to heed the new school of economic analysis rather than follow the conventional hunch that failure to perform, particularly if deliberate, is "just plainly wrong," the argument is internally flawed. A second objection is the practical one that, in contrast to civil law systems, our law generally pays scant attention to whether a contract breach is willful, merely negligent or innocent, the obligation to perform being strict.[36] Moreover, conformable to the suggested rationale, a distinction would be called for between cases where the breach was intended to promote greater efficiency of resources and others which, though calculated, were the result of erroneous contract interpretation or judgment.[37] In sum, the proposed economic theorem would impose an unfamiliar and vexing burden of characterization. No decision or even dictum in its support has been discovered.

3. Negligent Breach

As indicated in the preceding discussion, there is indeed some scattered support for excluding the collateral source rule from less reprehensible breaches of contract. But because that support is based exclusively on the punitive theory of the rule, its precedential weight especially in California is rather dubious. In any event, the cases can be explained on other grounds or merely contain dicta. We have seen that the only California Supreme Court decision in favor of excluding the collateral source rule from less reprehensible contract breaches was later assigned to a different ground,[38] and a sole intervening decision of

36. This is not to say that our law does not provide some ameliorating possibilities, such as the doctrine of commercial frustration, mistake, etc. But Continental law's major premise is that contractual liability is based on fault, subject to a number of important exceptions. *See* Lawson, *Fault and Contract—A Few Comparisons*, 49 TUL. L. REV. 295 (1975); 2 K. ZWEIGERT & H. KOTZ, AN INTRODUCTION TO COMPARATIVE LAW 174-77 (T. Weir trans. 1977).

37. Examples of the latter kind were United Protective Workers of Am., Local No. 2 v. Ford Motor Co., 223 F.2d 49 (7th Cir. 1955) and Dehnart v. Waukesha Brewing Co., 21 Wis. 2d. 583, 124 N.W.2d 664 (1963), involving employers' breach of collective bargaining agreements due to bona fide misinterpretation. Yet it was precisely because these breaches were deemed untainted by "bad faith or misconduct" that the defendants' liability was reduced by the collateral benefit (social security and retirement benefits). *See also infra* text accompanying note 117.

38. *See supra* text accompanying notes 30-35.

the court of appeal is now tarnished in consequence.[39] This leaves only a federal decision crediting social security and retirement benefits against an employer's liability for wrongfully dismissing the plaintiff in breach of a collective bargaining agreement on the ground that the defendant was not a "wrongdoer in the tort sense [and there was] no justification for an award with even the flavor of punitive damages."[40] That decision has been followed at least once on similar facts,[41] but runs against the general trend even among cases dealing with this particular kind of benefit.[42]

More consistent is a line of cases *refusing* to credit negligent defendants with a collateral benefit received by the plaintiff.[43] These usually involve negligent performance rather than failure to perform, such as fire damage caused by tenants or leaky roofs by building contractors. Obviously such liability is more akin to tort, often indeed supporting alternative claims in tort and contract.[44] Moreover, the injury complained of is often property damage or personal injury,[45] reinforcing the analogy of tort.

Finally, as might be expected, the source of the collateral benefit is frequently the plaintiff's insurer, who can be subrogated to the claim against the defendant or is the real party in interest. Reimbursement, however, is favored not only in the insurance cases, where subrogation is the familiar consequence, but also in less conventional situations. In one case, for example, an auditor had negligently failed to uncover an embezzlement, but his liability was not reduced by a tax refund his client had received on that account because the government, like an

39. Patent Scaffolding Co. v. William Simpson Constr. Co., 256 Cal. App. 2d 506, 64 Cal. Rptr. 187 (2d Dist. 1967). *See infra* text accompanying note 66.

40. United Protective Workers, Local No. 2 v. Ford Motor Co., 223 F.2d 49, 54 (7th Cir. 1955).

41. *Dehnart*, 21 Wis. 2d 583, 124 N.W.2d 664 (1963).

42. *See infra* text accompanying note 43.

43. Great Lakes Gas Transmission Co. v. Grayco Constructors Inc., 506 F.2d 498, 503-04 (6th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975); Staten Island Rapid Transit Ry. v. S.T.G. Constr. Co., 421 F.2d 53 (2d Cir.), *cert. denied*, 398 U.S. 951 (1970); Western Fire Ins. Co. v. Milner Hotels, 232 F.2d 779 (8th Cir. 1956); The Dimitrios Chandris, 43 F. Supp. 829 (E.D. Pa. 1942), *aff'd sub nom.* Ring v. The Dimitrios Chandris, 133 F.2d 124 (3d Cir. 1943); Manila School Dist. No. 15 v. Sanders, 226 Ark. 270, 289 S.W.2d 529 (1956); Freeman v. Rubin, 318 So. 2d 540 (Fla. Dist. Ct. App. 1975); Executive Dev. Properties, Inc. v. Andrews Plumbing Co., 134 Ga. App. 618, 215 S.E. 2d 318 (1975); Cereal Byproducts Co. v. Hall, 16 Ill. App. 2d 79, 147 N.E.2d 383 (1958).

44. The judicial opinions rarely reveal whether they purport to deal with contract or tort liability. (An exception is Maloney Tank Mfg. Co. v. Mid-Continent Petroleum Corp., 49 F.2d 146 (10th Cir. 1931), where the contract claim sidestepped complications over vicarious liability.) The justification for citing them in the present context is that damage was caused by negligence in the performance of a contract between the parties. In some cases, though, the negligence is even unrelated to the performance of the contract. *See* Daeschner v. Gibson, 103 Kan. 555, 175 P. 681 (1918).

45. *See* cases cited *infra* note 90.

insurer, had an "interest in recovery."[46] In another case, where the federal government partly funded a construction contract, including the extra cost caused by the negligent performance of the contractor, the latter was denied a setoff because it was preferable to repay the government than relieve the contractor.[47] In yet a third case, it was unsuccessfully argued that the plaintiff public utility could capitalize the loss caused by the negligent contractor and pass it on as an extra charge to its customers.[48] Clearly, there was no reason why in the first two cases the general taxpayer and in the last case the consumer public should subsidize the defendant and assume such an unmerited externality. These cases emphasize the tripolar tension of the collateral source problem and the challenge to allocate primary responsibility for the loss between the collateral source and the defendant on the basis of individual equities.

4. Innocent Breach

"Innocent breach," though not a familiar category in our law, conceivably comprises all situations where the promisor's failure to perform, though without legal justification, was neither willful nor negligent in the usual sense of lacking reasonable care. This may range from well-intentioned miscalculation in planning performance to vicarious responsibility for misperformance by agents or servants and to dealers' warranty liability for defective merchandise. No case law dealing with the collateral source rule in any of those situations has been discovered, but its richer treatment in the following group of cases lends little support to opponents of the collateral source rule.[49]

The purest form of "innocent breach" is one where the obligor is not even causally responsible for the occurrence of the loss for which he has assumed legal responsibility. Here the very term "breach" strikes a false note: it merely signifies the maturing of a risk assumed by contract. Examples are the liability of a bailee[50] or of a purchaser or conditional vendee for a loss after the risk has passed to him.[51] If the obligee's loss is partially or wholly made good from another source, typically from insurance, will this benefit *pro tanto* reduce the obligor's

46. *Cereal Byproducts*, 16 Ill. App. 2d 79, 82, 147 N.E.2d 383, 384 (1958).

47. Staten Island Rapid Transit Ry. v. S.T.G. Constructors Inc. Co., 421 F.2d 53 (2d Cir.), *cert. denied*, 398 U.S. 951 (1970).

48. Great Lakes Gas Transmission Co. v. Grayco Constructors Inc., 506 F.2d 498 (6th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975).

49. In that group, even among the minority rejecting the collateral source rule, some stress the fact that unlike in the above-mentioned instances, the obligor's responsibility for the loss is non-causal. *See, e.g.*, Patent Scaffolding Co. v. William Simpson Constr. Co., 256 Cal. App. 2d 506, 512, 64 Cal. Rptr. 187, 192 (2d Dist. 1967).

50. *See infra* text accompanying note 71.

51. *See infra* text accompanying notes 74-75.

liability? It will be noticed that here both sources of compensation are contractual and triggered by an event that does not connote fault, not even causal responsibility, by either of them. In this situation, the tripolar nature of the problem of allocating the loss is thrown into special relief whenever claims against the contract obligor are being asserted both by the obligee and the obligee's insurer as subrogee.[52] Various solutions to this type of innocent breach problem are possible.[53] Perhaps the most equitable would be for both sources to share the loss. Such equitable contribution is of course familiar as between two or more insurers of the same loss where neither is designated as "primary" or "excess."[54] In the instant situation, however, it can be—and has been—plausibly argued in favor of the primacy of the insurer that the sole purpose of his undertaking was to assume responsibility for the loss, unlike the other contractor, for whom that responsibility was merely collateral or subsidiary to another purpose, such as storing or transporting the property, and who received no distinct consideration for assuming the risk.[55] The same argument has also been made in favor of a contractor whose breach consisted merely in failure to procure insurance for the obligee, who had however the foresight to procure insurance on his own.[56] The proposal to share has received some guarded support in academic writing, but not from the courts.[57]

Another possible solution, allocating primacy to the insurer, is effected by denying him subrogation to the insured's so-called "collateral rights" (other than tort claims) against the contract obligor. One way of distributing that benefit is to confer it on the contract obligor by reducing his liability to the obligee. The conventional objection, that this in effect foists an insured on the insurer without the latter's consent, is purely formal since the risk of the loss was voluntarily assumed and rarely increased by the substitution.[58] The wide appeal of this so-

52. See especially Judge Goodman's opinion in *In re* Future Mfg. Coop., 165 F. Supp. 111 (N.D. Cal. 1958), discussed *infra* in text accompanying note 65, which for that reason alone has become "leading." Many cases dealing with the problem of this section are incomplete, however, ruling only against reduction of the defendant's damages without passing on whether the plaintiff must eventually reimburse the collateral source.

53. See especially McCoid, *Allocation of Loss and Property Insurance*, 39 IND. L.J. 647 (1964); J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 201-05 (2d ed. 1980).

54. *See* J. APPLEMAN & J. APPLEMAN, INSURANCE LAW & PRACTICE §§ 5-8 to -10 (1981); 16 G. COUCH, ENCYCLOPEDIA OF INSURANCE LAW § 62:147 (2d ed. 1966).

55. Patent Scaffolding Co. v. William Simpson Constr. Co., 256 Cal. App. 2d 506, 516, 64 Cal. Rptr. 187, 194-95 (2d Dist. 1967).

56. *Id.*

57. King, *Subrogation under Contracts Insuring Property*, 30 TEX. L. REV. 62 (1951); Langmaid, *Some Recent Subrogation Problems in the Law of Suretyship and Insurance*, 47 HARV. L. REV. 976 (1934). *Cf. Patent Scaffolding*, 256 Cal. App. 2d at 517, 64 Cal. Rptr. at 195.

58. *See infra* note 77.

lution may be gauged from its adoption as standard for the purchaser of land,[59] for banks that innocently negotiate checks forged by a drawer's employee who is covered by a fidelity bond,[60] and occasionally even for a buyer[61] or conditional vendee of chattels[62] or a contractor who had failed to procure insurance.[63] Indeed, some courts quite generally deny subrogation to "collateral rights" in the absence of an express subrogation clause.[64]

The leading opinion is Judge Goodman's in *In re Future Manufacturing Cooperative*,[65] a case of a conditional vendee. It deserves this accolade because, unlike most other opinions which content themselves merely with a search for precedent, it recognizes the problem as posing a policy choice and carefully evaluates the alternatives. Holding that the conditional vendee was liable only for the difference between the purchase price and the proceeds of the vendor's insurance, the judge preferred to place the ultimate burden of the loss on the insurer, who had been compensated, rather than on the vendee, who did not cause the loss. While this decision admittedly ran counter to the normal concept of insurance as a personal contract between the insurer and the insured and might even increase the moral hazard assumed by the insurer, these considerations were outweighed by the equitable considerations favoring the vendee and the fact that the insurer could have protected himself by declining to issue the policy or including an express subrogation clause.

Judge Goodman's analysis certainly compares favorably with the

59. *See In re* Future Mfg. Coop., 165 F. Supp. at 114, with citation to case annotations and law reviews in note 9. Contrary to Judge Goodman's thinking, the British rule is in reality less sympathetic to the purchaser. A *pessimum exemplum* is Ziel Nominees v. V.A.C.C. Ins. Co., 7 Austl. L.R. 667 (Austl. 1975), where it was held that neither vendor nor purchaser could collect under the vendor's fire policy.

60. *See infra* note 67.

61. Gard v. Razanskas, 248 Iowa 1333, 85 N.W.2d 612 (1957) (buyer, who exercised option to purchase property, held to be covered by seller's insurance when it was discovered that the property was damaged); U.C.C. § 2-510(2), (3).

62. *In re* Future Mfg. Coop., 165 F. Supp. at 114-16 (concluding that the cases were "about equally divided"). McCoid, *supra* note 53, at 657 concluded, however, that the "prevailing result" favored subrogation by analogy to mortgages of realty.

63. Patent Scaffolding Co. v. William Simpson Constr. Co., 256 Cal. App. 2d 506, 64 Cal. Rptr. 187 (2d Dist. 1967).

64. *See* R. SPEIDEL, R. SUMMERS & J. WHITE, TEACHING MATERIALS ON COMMERCIAL AND CONSUMER LAW 870 (2d ed. 1974). *See* Fields v. Western Millers Mut. Fire Ins. Co., 290 N.Y. 209, 48 N.E.2d 489 (1943) and *In re* Future Mfg. Coop., 165 F. Supp. 111 (N.D. Cal. 1958) for refusal to construe general subrogation clauses as including "collateral rights."

65. 165 F. Supp. at 113-16. Though he found none of the three alternatives free from objection and precedent no clearcut guide, he eventually preferred the instant solution, partly because a majority of the combined decisions dealing with mortgagees of realty and conditional vendees of personalty favored it, and partly because an unwilling insurer could protect himself by suitable exclusion of cover.

clumsier approach of the California Court of Appeal in *Patent Scaffolding Co. v. William Simpson Construction Co.*,[66] which dealt with the liability of a general contractor for rented scaffolding equipment damaged in a fire. Claims were made both by the supplier of the scaffolding, based on the contractor's failure to insure in accordance with their contract, and by the supplier's insurers as subrogees. The court wrestled with this problem in two stages. First, it rejected the supplier's claim on the ground that its loss had already been compensated by the insurers and that the collateral source rule was inapplicable to breaches of contract without tortious or willful flavor. Second, it denied subrogation rights to the insurers because "their losses [were] not causally related to a breach of duty for which the party to be charged may be liable to the insured for a loss compensated by the insurers."[67]

The *Patent Scaffolding* approach put the cart before the horse: it reversed the proper sequence of the two issues because it failed to understand their interrelation. By first taking up the collateral source rule and deciding against it, the court left nothing to which the insurer could be subrogated. In other words, the insurer's claim had in reality been preempted, and the court could have saved itself the trouble of considering whether subrogation would have been equitable under the circumstances. Instead, the court should have faced the subrogation claim first. If the court had allowed subrogation, it would have *necessarily* followed that the contractor was liable for the full damages—in other words, that the collateral source rule applied. If the court rejected the subrogation claim—as indeed it did—the court should only *thereafter* have considered the collateral source rule in order to determine whether to prefer "double recovery" for the contract obligee or confer the collateral benefit on the obligor by reducing his damages.[68]

66. 256 Cal. App. 2d 506, 64 Cal. Rptr. 187 (2d Dist. 1967).

67. *Id.* at 512, 64 Cal. Rptr. at 192 (asserting that the California cases, with one exception, conformed to that rule). Its main base was a line of decisions which hold that "where a wrongdoer causes loss both to a surety by reason of its bond and to a third person, the surety's normal right of recovery through subrogation against the third person is limited to situations in which the surety's equity is superior to that of the third person," e.g., where the latter was negligent in relation to the "primary cause" of the loss. Continental Ins. Co. v. Morgan, Olmstead, Kennedy & Gardner, Inc., 83 Cal. App. 3d 593, 602-05, 148 Cal. Rptr. 57, 62-64 (2d Dist. 1978); Meyers v. Bank of America, 11 Cal. 2d 92, 102-03, 77 P.2d 1084, 1089 (1938); Annot., 137 A.L.R. 700 (1942). Farnsworth, *Insurance Against Check Forgery*, 60 COLUM. L. REV. 284, 316-24 (1960) is critical of the denial of subrogation.

68. At first blush there appears to be a logical impasse. On the one hand, subrogation presupposes that there is a claim to which the would-be subrogor can be subrogated, because what does not exist cannot be passed on. On the other hand, if subrogation is available, the loss can be allocated to the contract obligor without overcompensating the contract obligee. The second issue must be given priority in this instance because on it depends whether the obligee would gain a "benefit" by not reducing the obligor's liability. If there is no "benefit," we do not even reach the problem of collateral benefit.

The third solution to the collateral source problem in the innocent breach situation is to reimburse the collateral source by making the contract breaker's liability "primary" and the insurer's liability "secondary."[69] From a technical point of view, as already emphasized, this result necessarily involves application of the collateral source rule in order to assure a fund of unreduced damages to which the insurer can be subrogated. This solution has been consistently applied against mortgagors of realty,[70] carriers,[71] consignees,[72] lessees,[73] and also, though less uniformly, against conditional vendees of chattels.[74] The resulting difference in treatment from that of the outright purchaser[75] may perhaps be explained on the ground that the longer prospective duration of the mortgage relationship provides the parties with ampler opportunity for protecting their interests than the brief interregnum between a cash sale and the transfer of possession.[76] Moreover, the policy of minimizing the risk works in opposite directions in the two situations. The mortgagor and conditional vendee are assigned the legal risk of loss because, being in possession, they are in a better position to avoid the hazard: to transfer to them the benefit of the other party's policy might tend to reduce their incentive to safeguard the property, and thereby to increase the insurer's risk.[77] In contrast, the transfer of risk to the purchaser prior to his taking possession, a product of sheer conceptualism, runs counter to the policy of identifying risk with control. This defect would of course be best overcome by reforming the

69. Royal Zenith Corp. v. Citizens Publications, Inc., 179 N.W.2d 340 (Iowa 1970), argues that at least a specific contractual obligation assumed by the defendant to insure reveals an intent to make him primarily liable for the loss.

70. *See In re* Future Mfg. Corp., 165 F. Supp. at 113. This is conceded to be "the prevailing rule" in *id.* at 113 n.5, citing King, *supra* note 57, at 72; Langmaid, *supra* note 57, at 992; Campbell, *Non-Consensual Suretyship*, 45 YALE L.J. 69, 69-76 (1935). A recent illustration is Mann v. Glens Falls Ins. Co., 541 F.2d 819 (9th Cir. 1976) (purchaser-mortgagor).

71. *In re* Future Mfg. Coop., 165 F. Supp. at 113 (citing King, *supra* note 57, at 78; Campbell, *supra* note 70, at 79). This solution is a fortiori where the bailee caused the loss, as in Gusikoff v. Republic Storage Co., 241 A.D. 889, 272 N.Y.S. 77 (1934) (per curiam) (loss by bonded warehouse.)

72. United States Fidelity & Guar. Co. v. Slifkin, 200 F. Supp. 563 (N.D. Ala. 1961); National Fire Ins. Co. v. Mogan, 186 Or. 285, 206 P.2d 963 (1949).

73. *See In re* Future Mfg. Coop., 165 F. Supp. at 113, and cases cited *id.* at 113 n.7; Commercial Union Fire Ins. Co. v. Kelly, 389 P.2d 641 (Okla. 1964).

74. *In re* Future Mfg. Coop., 165 F. Supp. at 114-16.

75. *Id.* at 113-16. Authority is actually divided. Allowing subrogation is American Equitable Assurance Co. v. Newman, 132 Mont. 63, 313 P.2d 1023 (1957).

76. *See* King, *supra* note 57, at 78; Langmaid, *supra* note 57, at 983.

77. In many cases the risk of increased hazard is perhaps more apparent than real, as when the conditional vendor or mortgagee procured the insurance specifically to cover the property in the other's possession. In other cases, it is also arguable that, by not excluding the risk, the insurer was content to assume it regardless of whether the named insured was in possession. *See supra* text accompanying note 65.

risk rule, as under the Uniform Vendor and Purchaser Risk Act,[78] and—only as a last resort[79]—conferring the benefit of the seller's insurance on the purchaser.

Condoning double recovery by the plaintiff appears to have the least appeal as a solution to the present puzzle. In the first place, double recovery would in some of the preceding situations expose the insured to a moral hazard insofar as he is in a position to control the risk. Moreover, the collateral source is almost always an indemnity insurance which offers an opportunity, if not a compelling reason,[80] for reimbursement of the benefit. This has more appeal than "overcompensating" the plaintiff, especially at the cost of an "innocent" obligor without causal responsibility for the loss.

The preceding survey of the problem of the "innocent" contract obligor reveals a judicial response at once more sensitive and firmer than that in the culpable breach situations. Partly this may just be the harvest of considerably greater experience with stock situations of relatively frequent occurrence. Another contributing factor is that the collateral source, usually an insurer, is alert in vindicating its own position and thereby injects a three-dimensionality into the contest. This not only adds other options but invites a consideration of policies more meaningful than the dogmatic *ipse dixits* found elsewhere.

5. Summary

The foregoing analysis suggests that while the type of breach involved cannot be the sole basis for deciding whether to apply the collateral source rule, the type of breach could be a factor. More specifically, a court's solution to the tripolar tension that these cases pose may ultimately depend on an allocation of primary responsibility between the defendant and the collateral source on the basis of individual equities, including perhaps the type of breach involved.

We now turn to criteria, other than the obligor's culpability, that might affect the allocation of collateral benefits in breach of contract cases.

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78. CAL. CIV. CODE § 1662 (West 1973).

79. The argument for preferring the first to the second method is that the risk rule should once and for all allocate the desirable risk distribution rather than that a court should reallocate the risk on so-called equitable grounds. The latter method, adopted by U.C.C. § 2-510 (1979), is administratively inefficient, haphazard in result because dependent on the fortuity of insurance cover, and bad for insurance planning. *See* McCoid, *supra* note 53, at 664-74.

80. Indemnity insurance traditionally entails subrogation precisely in order to prevent double recovery by the insured because of the policy against wagers and because of the moral hazard of tempting him to bring about the loss.

B. Type of Loss

It is at least conceivable that different types of loss might elicit different responses to the problem of mitigation from a collateral source. For example, the tendency toward greater restraint in assessing damages for breach of contract than for tort may in fact reflect a difference in attitude toward economic losses, especially loss of business profits, compared with personal injury. Personal injury evokes intense sympathy, coupled with a feeling that damages will especially not fully compensate graver injuries. Compensation for loss of profit, on the other hand, is the most that the promisee can fairly ask for and should arguably be restricted to the net loss, especially so as not to burden the contract breaker unnecessarily. Thus, we shall examine three different types of loss—personal injury, property damage, and pure economic loss—to ascertain whether the type of loss has, or should have, an effect on the application of the collateral source rule.

1. Personal Injury

Under the preceding point of view, personal injury claims for breach of contract are obviously, indistinguishable from claims in tort. Moreover, plaintiffs in these cases almost invariably enjoy the option of claiming either in tort or contract, if they are not relegated exclusively to tort under the "gravamen theory."[81] Accordingly, warranty claims prior to the emergence of modern tort liability for defective products should illustrate the hypothesis of identical application of the collateral source rule. The remarkable scarcity of case law probably demonstrates more clearly than anything else that here the tort model is really too compelling for argument and that the collateral source rule is applied as a matter of course. In one of the few cases on record, *Tinnerholm v. Parke Davis & Co.*,[82] the plaintiff's infant son contracted polio as a result of a defective vaccine. Claims were made both for negligence and breach of implied warranty,[83] but the court dealt with the question of what allowance to make for medical assistance received from the state without distinguishing between contract and tort.[84] The

81. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS 618 (4th ed. 1971); Prosser, *The Borderland of Tort and Contract*, in SELECTED TOPICS ON THE LAW OF TORTS 380 (1954).

82. 411 F.2d 48, 54 (2d Cir. 1969).

83. At the time, the prevailing doctrine in New York still adhered to the contract theory of warranty. *See, e.g.*, Mendel v. Pittsburgh Plate Glass Co., 25 N.Y.2d 340, 253 N.E.2d 207, 305 N.Y.S.2d 490 (1969) (overruled in Victorson v. Bock Laundry Mach. Co., 37 N.Y.2d 395, 335 N.E.2d 275, 373 N.Y.S.2d 39 (1975)).

84. Neither at trial nor on appeal did the defendant attack the collateral source rule as such but argued merely (unsuccessfully) that it did not apply, under the rule in *Drinkwater v. Dinsmore*, 80 N.Y. 390 (1980), to gratuitous benefits. Decisive was the fact that the plaintiff was under obligation to reimburse the state.

warranty claim was of course at least quasi-tortious,[85] but in any event the coupled negligence claim points to the absurdity of applying different rules for the same injury in these cases.

An explicit application of the collateral source rule to a personal injury claim for negligent breach of contract occurred in *Goddell v. I.T.T. Federal Support Services*.[86] The plaintiff, a welder who had sustained electrical shocks, alleged negligence and sued as third-party beneficiary of a contract for maintenance and inspection between his employer's assignor and the defendant. The court ruled specifically that damages would not be reduced by state and private insurance benefits received by the plaintiff, citing two tort cases in support of the collateral source rule.

In yet another group of cases, the purchaser of warranted goods, in an action for breach of warranty, consistently recovered from his seller the amounts he was required to pay as damages for personal injury to a third party[87] or as workers' compensation to an employee.[88] Typically, the real party in interest as subrogee was the purchaser's liability or workers' compensation insurer,[89] no suggestion being found that the defendant's liability be instead mitigated by the insurance proceeds.

Thus, while case law involving the application of the collateral source rule to contract claims for personal injury is scarce, the cases on record clearly indicate that the collateral source rule should apply as it does in tort. This result is of course correct, for it would be unreasonable and inconsistent to apply different rules to the same injury depending merely on the form of pleading. Moreover, as previously mentioned, the scarcity of case law is perhaps the most definitive evidence of the tort model's acceptance in this area of contract.

2. *Property Damage*

Cases of property damage also generally follow the tort model.[90]

85. In Donohue v. Acme Heating, Sheet Metal & Roofing Co., 214 Minn. 424, 425-26, 8 N.W.2d 618, 619 (1943), a case of property damage resulting from breach of an implied warranty on the sale of an oil-heating unit, the court curtly ruled that "insurance coverage of the plaintiff has no effect on the liability of a defendant for a *tort*" (emphasis added).

86. 15 Wash. App. 639, 550 P.2d 1171 (1976).

87. London Guarantee & Accident Co. v. Strait Scale Co., 322 Mo. 502, 15 S.W.2d 766 (1929); John Wanamaker, N.Y., Inc. v. Otis Elevator Co., 228 N.Y. 192, 126 N.E. 718 (1920); Boston Woven Hose & Rubber Co. v. Kendall, 178 Mass. 232, 59 N.E. 657 (1901).

88. General Analine & Film Corp. v. Schrader & Son, Inc., 12 N.Y.2d 366, 190 N.E.2d 232, 239 N.Y.S.2d 868 (1963). A single deviant, based on the local history of workers' compensation legislation, is United States Casualty Co. v. Hercules Powder Co., 4 N.J. 157, 72 A.2d 190 (1950). *See also* 2 A. LARSON, WORKMEN'S COMPENSATION FOR OCCUPATIONAL INJURIES AND DEATH § 77.20 (1982).

89. In London Guarantee & Accident Co. v. Otis Elevator Co., 86 Ind. App. 150, 155 N.E. 182 (1927), the insurer was actually the nominal plaintiff.

90. *See, e.g.*, Executive Dev. Properties, Inc. v. Andrews Plumbing Co., 134 Ga. App. 618,

For example, in *New Foundation Baptist Church v. Davis*,[91] the defendant had negligently constructed an addition to the plaintiff's sanctuary, which resulted in the floor collapsing during a funeral service. The repairs were carried out by a contractor who, as trustee of the church, merely charged for his expenses and contributed his time, waiving all profit. The court held that the trustee's generosity should not inure to the benefit of the defendant and, invoking the collateral source rule, awarded full damages for the value of the repairs.

3. Economic Loss

In cases of pure economic loss, especially where damages are claimed for loss to the plaintiff's expectation interest rather than to his reliance interest,[92] the tort analogy is obviously weakest. Shades of deterrence and punishment fade in the absence of any compelling reason for leaving the plaintiff better off after breach than if he had realized the expected benefit of his bargain from performance. Certain distinctions, however, must be observed.

First, the gain may be the result of an action taken by the plaintiff himself, either before or after the breach. In general, actions taken before the breach that result in minimizing his loss are viewed as collateral. Aside from the case of insurance, already considered, this attitude is illustrated by the tendency to disregard advantageous subcontracts in assessing the loss. Thus, if a seller delivers defective goods or delivers late, the buyer is generally held entitled to the conventional measure of contract damages even though a sub-buyer paid the full contract price, either because the sub-buyer waived objections or because the breach did not affect the subcontract.[93]

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215 S.E.2d 318 (1975); Commercial Union Fire Ins. Co. v. Kelly, 389 P.2d 641 (Okla. 1964); Manila School Dist. No. 15 v. Sanders, 226 Ark. 270, 289 S.W.2d 529 (1956); Donohue v. Acme Heating, Sheet Metal & Roofing Co., 214 Minn. 424, 8 N.W.2d 618 (1943); Maloney Tank Mfg. Co. v. Mid-Continent Petroleum Corp., 49 F.2d 146 (10th Cir. 1931).

91. 257 S.C. 443, 186 S.E.2d 247 (1972).

92. *See* Fuller & Perdue, *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936).

93. American law: *see* D. DOBBS, *supra* note 1, at 184-5; S. WILLISTON, THE LAW GOVERNING SALES OF GOODS AT COMMON LAW AND UNDER THE UNIFORM SALES ACT § 613 (rev. ed. 1948); U.C.C. § 2-714 (1978). *But see* McInnis & Co. v. Western Tractor & Equip. Co., 67 Wash. 2d 965, 410 P.2d 908 (1966). English law: Slater v. Hoyle & Smith, Ltd., [1920] 2 K.B. 11 (C.A.) (no reduction in recovery for price received on resale of defective goods); Joyner v. Weeks [1891] 2 Q.B. 31 (C.A.) (no reduction in recovery for failure to repair when no loss was suffered due to subsequent leasing of premises). *Contra* Wertheim v. Chicoutimi Pulp Co., [1911] A.C. 301 (P.C. 1910) (amount by which resale price exceeded market price at time of delivery deducted from recovery for delayed delivery); H. MCGREGOR, MCGREGOR ON DAMAGES §§ 252-253 (13th ed. 1972). The principle of "abstract loss" assessment is also dominant in continental jurisprudence. See the comparative analysis by Steindorff, *Abstrakte und Konkrete Schadensberechnung*, 158 ARCHIV FUR DIE CIVILISTISCHE PRAXIS 431 (1959-1960). *Cf.* Ruddach v. Don Johnston Ford, Inc., 97 Wash. 2d 277, 644 P.2d 671 (1982). In *Ruddach*, the question was whether the tenant's liability for repairs would be reduced to $5,000 after the landlord had agreed with a purchaser that

As regards action taken after the breach, the plaintiff is of course under a duty to take reasonable steps in mitigation. Whether he does so or not, avoided or avoidable loss reduces the defendant's liability.[94] Problematic only is the situation where the gain results from action the plaintiff was not required to take. Here the rule appears to be that he must give credit for gains arising out of the act of mitigation itself.[95] For example, in the leading case of *United States v. Ebinger*,[96] where a welding contractor had negligently destroyed a valuable cooling tower, maintenance costs that the plaintiff would save over the life of a new tower were held deductible from the defendant's damages. Similarly, in the English counterpart case of *British Westinghouse Co. v. Underground Railways Co.*,[97] defective turbines supplied to the railway company had to be prematurely replaced, but the substitutes were more powerful and economical. It was held that the consequent gain in profits must be set off against the cost of the substitutes. Conversely, however, in another case a sulphur producer, which on closing its Mexican operations cancelled its charter of the plaintiff's carrier vessel, could not set off the higher prices the plaintiff's own sulphur fetched as the result of the defendant's shutdown. The court reasoned that the gain did not result from a saving on the cost of performance.[98]

Second, another distinction in the economic loss situation is that any partial or complete satisfaction of the plaintiff's loss by one liable therefor extinguishes *pro tanto* the liability of any other person liable for the same loss. That recovery from one tortfeasor, whether pursuant to a successful action or settlement, satisfies *pro tanto* the liability of co-tortfeasors is a universally recognized exception to the collateral source rule even in the tort context.[99] In other words, such payments are not considered "collateral." But that principle applies regardless of the nature of the plaintiff's cause of action against the several defendants. As Justice Traynor once enunciated:

> Since the rule against double recovery is aimed at preventing unjust

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he would not be liable for more than that sum on account of repairs. The court did "not find it necessary to extend the collateral source rule to the contract area to resolve this matter" because it construed the sales agreement as requiring the seller to pursue his rights against the tenant for the benefit of the purchaser. The court below split on the issue of the collateral source rule. Ruddach v. Don Johnston Ford, Inc., 27 Wash. App. 654, 621 P.2d 742 (1980).

94. RESTATEMENT (SECOND) OF CONTRACTS § 350 (1981).

95. *See, e.g.*, H. MCGREGOR, *supra* note 93, §§ 238, 246-251.

96. 386 F.2d 557 (2d Cir. 1967).

97. [1912] A.C. 673.

98. Louisiana Sulphur Carriers, Inc. v. Gulf Resources & Chem. Corp., 53 F.R.D. 458, 462 (D. Del. 1971).

99. *See* W. PROSSER, *supra* note 81, at 304-05; RESTATEMENT (SECOND) OF TORTS § 885(3) (1977); UNIF. CONTRIBUTION AMONG TORTFEASORS ACT § 4, 12 U.L.A. 98 (1975); CAL. CIV. PROC. CODE § 877 (West 1980); Waite v. Godfrey, 106 Cal. App. 3d 760, 768-69, 163 Cal. Rptr. 881, 886-87 (4th Dist. 1980) (applied to uninsured motorist insurance).

> enrichment, it is not only immaterial whether plaintiff has one or several causes of action against tort feasors, but whether one of his causes of action is based on contract and the other on tort, whether the one requires proof of negligence and the other does not. The decisive consideration in barring an action seeking double recovery is that plaintiff shall not recover twice for his loss by taking advantage of the fortuitous circumstance that more than one person is responsible to him for that loss.[100]

An illustration already noted stems from the controversial California case of *City of Salinas v. Souza & McCue Construction Co.*, where the plaintiff was required to give credit for payments received from his own subcontractor "which, in the contractual setting of that case, did not constitute a truly independent source."[101] So also in *New York Bank Note Co. v. Kidder Press Manufacturing Co.*,[102] where an action was brought against the seller of a printing press for breach of an agreement not to sell similar presses to any of the plaintiff's competitors. Because the plaintiff had already settled a claim against one of the competitors, the settlement amount was held deductible from the damages against the defendant. In yet another case[103] a buyer of land who had already recovered from the seller for breach of warranty sued his own lawyer for malpractice, but was allowed to recover only for attorney's fees incurred in his claim against the seller, and not for the diminished value of the land which was not at issue.[104]

Third, another distinction is that the source of the collateral benefit may be the plaintiff's insurer or some third party who can be subrogated to the plaintiff's claim. In this situation, the collateral source rule is usually invoked against the defendant in order to preserve the latter's

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100. Anheuser-Busch, Inc. v. Starley, 28 Cal. 2d 347, 353, 170 P.2d 448, 452 (1946) (Traynor, J., dissenting). That this statement stems from a dissenting opinion does not detract from its validity. For not only was the majority opinion, authored by Justice Carter, severely flawed by internal inconsistency, but—most significant for the present context—it itself rejected a certain argument on the very ground that it "would permit double recovery for the shipper which is not favored." *Id.* at 351. *But cf.* Greenberg v. Hastie, 202 Cal. App. 2d 159, 178, 20 Cal. Rptr. 747, 759 (1st Dist. 1962) where a buyer of land sued the seller on the contract for termite damage and the termite company in tort for negligence. The court intimated that damages against the latter would not be reduced by recovery from the former, citing *Anheuser-Busch*.

101. *See supra* note 34 and accompanying text.

102. 192 Mass. 391, 78 N.E. 463 (1906).

103. Hiss v. Friedberg, 201 Va. 572, 112 S.E.2d 871 (1960).

104. *See* Long Leaf Lumber, Inc. v. Svolos, 258 So. 2d 121 (La. Ct. App. 1972). In *Long Leaf Lumber*, the supplier of lumber sued a homeowner on a bond for the price of material delivered. The court ruled the supplier must set off what he had recovered out of the contactor's bankruptcy. If the homeowner had first paid in full, he would presumably have been subrogated against the bankrupt estate. *See also* Lanahan v. Heaver, 79 Md. 413, 29 A. 1036 (1894) (contractor's claim against developer reduced by his own share of condemnation award from city); Daeschner v. Gibson, 103 Kan. 555, 175 P. 681 (1918) (payment by the city which considered itself responsible reduces negligent contractor's liability).

right of subrogation. A strong illustration comes from *Waumbec Mills, Inc. v. Bahnson Service Co.*,[105] where the defendant had failed to procure liability insurance for the plaintiff contractor as required by their contract. When the plaintiff negligently injured two of the defendant's employees, he was indemnified by his own insurer but held entitled, despite his own negligence, to recover the full amount from the defendant so as to be able to repay the insurer.[106] A not uncommon illustration already noted[107] from outside the insurance field is provided by *Staten Island Rapid Transit Railway Co. v. S.T.G. Construction Co.*,[108] where a contractor failed to complete his job and was sued for the excess cost of completion. It was held that the fact that the U.S. Government had borne five-sixths of the additional cost did not require that the award be reduced, because the plaintiff would clearly have to repay that sum.[109]

Thus, with respect to contractual claims for economic loss, unlike contract claims for personal injury or property damage, application of the collateral source rule will depend upon the particular facts at hand. This differential application of the collateral source rule is largely due to the fact that the tort analogy is no longer as strong.

In sum, there are three inquiries that must be made when analyzing the applicability of the collateral source rule to contract claims for economic loss. First, did the plaintiff gain by reason of action taken by himself either before or after the breach? This is important because gains incurred by reason of the former are viewed as collateral benefits, whereas gains incurred by reason of the latter generally are not, perhaps because the plaintiff was under a duty to take reasonable steps in mitigation. Somewhat similar is the second distinction concerning whether the plaintiff received compensation from a source that shared liability with the defendant. In this situation, as in tort, the collateral source rule does not apply because the source was not collateral. Finally, it is important to ask whether the collateral source is the plaintiff's insurer or some other party who can be subrogated to the plaintiff's claim. If so, the collateral source rule is generally applicable so that the collateral source's subrogation claim can be preserved and, moreover, avoids the Hobson's choice between granting a windfall to the plaintiff or to the defendant.

The analysis will now turn to the final factor which may affect the

105. 103 N.H. 461, 174 A.2d 839 (1961). *Accord* Christy v. Menasha Corp., 297 Minn. 334, 211 N.W.2d 773 (1973).

106. The insurer was held rightly joined as a real party in interest.

107. *See supra* note 47 and accompanying text.

108. 421 F.2d 53 (2nd Cir.), *cert. denied*, 398 U.S. 951 (1970).

109. *Id.* at 57-58; *cf.* Mason-Rust v. Laborers' Int'l Union, Local 42, 435 F.2d 939 (8th Cir. 1970), for similar reasoning in a claim against a union for a jurisdictional strike, analogized to tort.

collateral source rule's application to contract claims, the purpose of the collateral benefit.

C. *Purpose of Collateral Benefit*

The Second Restatement of Contracts suggests rather coyly that the collateral source rule "is less compelling in the case of a breach of contract than in the case of a tort . . . . [F]or example, the effect of the receipt of unemployment benefits by a discharged employee will turn on legislative policy rather than on the [general rule limiting damages to his actual loss in the value of the expected bargain]."[110] This "legislative purpose" doctrine unfortunately reveals itself in most situations as more a will 'o the wisp than a guide, for the obvious reason that the contingency of a tort or contract recovery by the recipient would usually be outside the contemplation of the collateral benefactor in the absence of a specific provision for subrogation or repayment. Thus if reimbursement of the collateral source is excluded from consideration, the only remaining alternatives are either double recovery for the plaintiff or reduced liability for the defendant. Yet it is easier to postulate that the collateral benefit was not intended to inure to the advantage of a contract breaker (any more than a tortfeasor) than to infer that it was to be kept by the recipient regardless of the availability of other compensation.

The relevance of the purpose or nature of the specific benefit on the collateral source rule may be usefully tested in connection with two types of benefit, unemployment and insurance payments.

1. Unemployment Benefits

The opacity of the legislative purpose test is revealed by the two cases that the Restatement cites supposedly as illustrations of divergent legislative intent. Both cases[111] involved actions for wrongful dismissal. In one a California court refused to reduce the defendant's damages by unemployment benefits, while in the other the Seventh Circuit came to the opposite conclusion with respect to social security and retirement benefits. Yet neither opinion contained the slightest hint of being influenced by a specific legislative purpose, *which could explain the divergent outcomes*. Indeed the latter opinion appears to contain an express disclaimer by stating that "[t]he status of social security and annuity payments is not material to the decision here. The question . . . concerns only the proper damages for breach of contract."[112]

110. RESTATEMENT (SECOND) OF CONTRACTS § 347 comment e (1979); *id.* illustration 14.

111. Billetter v. Posell, 94 Cal. App. 2d 858, 211 P.2d 621, (2d Dist. 1949); United Protective Workers Local 2 v. Ford Motor Co., 223 F.2d 49 (7th Cir. 1955).

112. United Protective Workers Local 2 v. Ford Motor Co., 223 F.2d at 53.

Thus, the cases dealing with the effect of unemployment benefits on damages for wrongful dismissal turn not on legislative purpose but either on the culpability of the defendant's breach or on the court's *general* attitude toward the dilemma of either tolerating double recovery or letting a wrongdoer off.[113] In fact, all but two of the numerous cases[114] give the plaintiff the benefit of the collateral source rule, with the rhetorical flourish (which is a conclusion rather than a reason) that the purpose of unemployment benefits is to alleviate distress, not to relieve a wrongdoer;[115] also that otherwise it would make it less expensive for an employer, and thus give him an incentive, to breach his contracts.[116] The two deviant decisions,[117] both based on a refusal to apply tort rules to innocent breaches of contract, are invariably explained by the difference between "good faith" breaches resulting from misinterpretation of collective bargaining agreements and "wrongful" dismissals in violation of fair labor standards and the like, sometimes

113. *See* Note, *Mitigation of Damages by Social Welfare Benefits*, 48 B.U.L. REV. 271 (1968), which analyzes the case law, including the contract cases of unlawful dismissal, in terms of various approaches: economic; cause of action; funded v. unfunded; and legislative policy.

114. NLRB v. Marshall Field & Co., 129 F.2d 169 (7th Cir. 1942); Billetter v. Posell, 94 Cal. App. 2d 858, 211 P.2d 621 (1949); Bang v. International Sisal Co., 212 Minn. 135, 4 N.W.2d 113 (1942); Burens v. Wolfe Wear-U-Well Corp., 236 Mo. App. 892, 158 S.W.2d 175 (Mo. Ct. App. 1942); Sporn v. Celebrity, Inc., 129 N.J. Super. 449, 324 A.2d 71 (1974); Century Papers, Inc. v. Perrino, 551 S.W.2d 507 (Tex. Civ. App. 1977). The Canadian case law is in accord. *E.g.*, Dewitt v. A. & B. Sound Ltd., 85 D.L.R.3d 604, 606 (1978) ("Perhaps provision should be made (in legislation) for a refund to the unemployment insurance fund . . . ."); Jack Cewe Ltd. v. Jorgenson, 111 D.L.R.3d 577 (1980). But not inconsistently, mitigation was enforced in Raabe v. Florida East Coast Ry. Co., 259 F. Supp. 351 (M.D. Fla. 1966), where the *employer* had to refund the benefits, since he would otherwise have been liable twice.

The somewhat related question, whether arbitration awards of "compensation for time lost" should be mitigated by unemployment benefits has received diverse answers. Marshall Field & Co. v. NLRB, 318 U.S. 253 (1943), *aff'g*, 129 F.2d 169 (7th Cir. 1942) and NLRB v. Gullett Gin Co., 340 U.S. 361 (1951), upheld the NLRB's power to award back pay without reduction for unemployment benefits. But some state decisions have required mitigation: Meyers v. Director of the Div. of Employment Sec., 341 Mass. 79, 82, 167 N.E.2d 160, 162-63 (1960) ("award of back pay . . . was not a fine, penalty *or damages*") (emphasis added); Metal Products Workers Union Local No. 1645 v. Torrington Co., 19 Conn. Supp. 408, 116 A.2d 449 (1955). *Cf.* Hubbard Broadcasting, Inc. v. Loescher, 291 N.W.2d 216 (Minn. 1980) (no setoff against liability on injunction bond for lost wages on account of loans made by new employer because recovery would be credited to the latter; otherwise applicability of collateral source rule left open).

115. The court in Dehnart v. Waukesha Brewing Co., 21 Wis. 2d 583, 597, 124 N.W.2d 664, 671 (1963), rightly exposed the fallacy that the purpose of unemployment benefits justified the conclusion that benefits were therefore not deductible.

116. *See* NRLB v. Gullett Gin Co., 340 U.S. 361 (1951). Supplementary arguments also occasionally voiced are: (1) that unemployment benefits are no less collateral, being paid by the state, for being financed out of contributions from the employer; (2) that reduction would be the more inequitable where the employee has to pay separate contributions in addition to the employer's; (3) if double recovery gives undue concern, it can be corrected by legislation authorizing subrogation.

117. United Protective Workers Local No. 2 v. Ford Motor Co., 223 F.2d 49 (7th Cir. 1955); Dehnart v. Waukesha Brewing Co., 21 Wis. 2d 583, 124 N.W.2d 664 (1963). See *supra* note 37 for the background of these cases.

reinforced by an award of punitive damages.[118] What emerges is a strong consensus in favor of the tort analogy for situations which evoke intense disapproval of the contract breaker and sympathy for the aggrieved plaintiff.[119] Wrongful dismissal is simply not a breach of contract which courts will view with the detachment advocated by apologists of the "efficient" breach; its potentially devastating effect on the employee is attested by the pejorative use of the term "wrongful" from the tort vocabulary; and the collateral source rule is justified both by the need for deterrence and by the feeling that mere indemnity for his net economic loss does not compensate the employee for all his injury, emotional as well as pecuniary.

2. Insurance: Subrogation

Although the judicial treatment of unemployment benefits lends scant support to the Restatement illustration of the legislative purpose doctrine, it is nonetheless true that the nature of the particular benefit may sometimes influence the application of the collateral source rule in contract no less than it does in tort cases. Especially with insurance benefits, the issues of who paid the premiums and whether the insurer has a right of subrogation assume importance.

In the tort context, it has been consistently considered decisive that if the plaintiff himself procured insurance through his own initiative and at his own cost, the defendant is not entitled to benefit from the insurance by a reduction of damages. As it is commonly put, the plaintiff is free to "bargain for double recovery" even when—as in the case of non-indemnity insurance—the insurer is not entitled to reimbursement. While the attendant risk of malingering and overuse has received recognition in the formulation of social security and no-fault plans,[120] it has not affected the traditional treatment of private insurance. Nor would one expect greater deference to this argument in cases of contract breach where the pressure for risk avoidance is usually sufficiently exerted by self-interest and the legal requirement of mitigation.

In cases of unemployment insurance, the employer has occasionally claimed set-off on the ground that it was he who paid the premiums and that the benefit was therefore not "collateral."[121] This

118. *See* Burens v. Wolfe Wear-U-Well Corp., 236 Mo. App. 892, 158 S.W.2d 175 (Mo. Ct. App. 1942).

119. Discharge of an employee in contravention of a public policy, for example for joining a union, is in fact treated as a tort by some courts. *E.g.*, Tameny v. Atlantic Richfield Co., 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980) (allowing punitive damages).

120. *See* S. REA, DISABILITY INSURANCE AND PUBLIC POLICY ch. 4 (1981).

121. *E.g.*, Sporn v. Celebrity, Inc., 129 N.J. Super. 449, 324 A.2d 71 (1974); Dehnart v. Waukesha Brewing Co., 21 Wis. 2d 583, 124 N.W.2d 664 (1963).

In clear cases where the defendant paid the premium, as did the bonded warehouseman in

argument, however, has been generally discounted on the plausible view that regardless of who formally pays the premiums, they are in reality attributable to the employee's earnings and should thus be credited to him rather than to the employer.[122]

Where the plaintiff himself has paid the insurance premiums, the collateral source rule will usually defeat the defendant, especially if the insurer has a right of subrogation. This may be an occasion for reemphasizing that subrogation is widely considered the optimal solution for the whole problem of collateral benefits on the ground that it prevents both the defendant from taking an undeserved advantage of the benefit and the plaintiff from being overcompensated. This is the function, if not the purpose, of subrogation in the case of indemnity insurance, and is widely emulated in modern social legislation, especially abroad.[123] But there are two reservations. First, equitable considerations to the contrary have, as already noted, met with some success in situations where the defendant bears no causal responsibility for the plaintiff's loss, as when he merely carries the risk of loss as purchaser prior to taking possession.[124] In these situations, double recovery by the plaintiff is ruled out, the insurance being indemnitory, since on grounds of public policy the insured must be denied every incentive to bring about, and profit from, the loss. This leaves the insurer and the defendant as the only plausible contestants, and it is arguable that the balance is tilted against the insurer at least where he has underwritten the specific risk while the defendant was merely caught unaware in the brief interval between contract and transfer of possession and, as such, was in no position to minimize the risk.

Secondly, some critics (including the author) have drawn attention to the high transaction costs of subrogation recoveries.[125] It would be more cost-efficient and not unfair to credit the defendant with the benefit, at least in situations in which the cost reduction would in the long run enure for the benefit of the plaintiff's class as it obviously does in

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Publix Theatres Corp. v. Powell, 71 S.W.2d 237 (Tex. Civ. App. 1934), the insurance is of course not "collateral" and therefore mitigates his damages.

122. *See* Sporn v. Celebrity, Inc., 129 N.J. Super. 449, 455, 324 A.2d 71, 74 (1974). The case is a fortiori where, as in *Sporn*, the employee actually paid half the premiums under New Jersey law.

123. The most prominent example from our statute book is, of course, the workers' compensation act which almost universally invests the employer or his insurer with a right of subrogation or indemnity against third-party tortfeasors. Otherwise however, American statutes rarely advert to the problem; a notable exception being the Federal Medical Recovery Act, 42 U.S.C. § 2651 (1976). The European legislation, with the exception of Scandinavia and Britain, strongly favors subrogation. German courts, indeed, have gone so far as even to imply an automatic assignment. *See* Fleming, *supra* note 3, ch. 11; W. VON MARSCHALL, REFLEXSCHADEN UND REGRESSRECHTE (1967).

124. *See supra* text accompanying notes 51-52.

125. F. HARPER & F. JAMES, *supra* note 2; Fleming, *supra* note 2.

the case of collision insurance for automobiles.[126] But this reasoning is not confined to the torts area and has on a few occasions, in the following cases, carried the day also in the context of contract claims.

Perhaps the most plausible exception to the subrogation rule concerned a claim by a property owner against a water company for a fire loss caused by inadequate pressure in its hydrants. Most such claims have been rejected by denying any "duty" in tort and by refusing to treat the property owner as a third-party beneficiary of the contract between the water company and the city.[127] But though the court in *William Burford & Co. v. Glasgow Water Co.*[128] was exceptionally prepared to countenance the claimant as a third-party beneficiary, it considered that subrogation would "work a manifest injustice" because the insurer, unlike the water company, had been paid to assume the fire risk and because property owners would in the end have to pay higher water rates without reduction in fire insurance premiums. In sum, what makes subrogation "inequitable" in the water company cases, as also in cases of municipal liability for riot damage,[129] is that the cheapest and most efficient way of compensating the loss, from the point of view of the victim class which has eventually to foot the bill, is via first-party insurance without the additional expense of further redistribution.

Rather more questionable was the relief of the defendant in another third-party beneficiary case. In *Anderson v. Rexroad*[130] a contractor had in his contract for street repair with the city assumed liability "for all losses or damages arising from the nature of the work to be done." His bulldozer driver ruptured a gas line, destroying the plaintiff's home. The latter sued as third-party beneficiary of the contract,

126. Thus several no-fault plans abrogate all tort claims for damage to automobiles and make first party insurance optional. *E.g.*, UNIF. MOTOR VEHICLE ACCIDENT REPARATIONS ACT § 5(a)(4), 14 U.L.A. 63-64 (1980). Florida held this provision unconstitutional for denying substantive due process. Kluger v. White, 281 So. 2d 1 (Fla. 1973).

127. The best known is Justice Cardozo's opinion, in H.R. Moch Co. v. Rensselaer Water Co., 247 N.Y. 160, 159 N.E. 896 (1928). The literature starts with Corbin, *Liability of Water Companies for Losses by Fire*, 19 YALE L.J. 425 (1909). *See also* Seavey, *The Waterworks Cases and Stare Decisis*, 66 HARV. L. REV. 84 (1952); Gregory, *Gratuitous Undertakings and the Duty of Care*, 1 DE PAUL L. REV. 30, 55-67 (1951); W. PROSSER, *supra* note 81, at 625-26.

128. 223 Ky. 54, 2 S.W.2d 1027 (1928).

129. Interstate Fire & Casualty Co. v. Milwaukee, 45 Wis. 2d 331, 173 N.W.2d 187 (1970). Again as in the water company cases, an alternative though cruder solution is to abolish municipal liability for riot damage altogether because the risk can be spread through standard insurance policies; *e.g.*, Tort Claims Act, ch. 1681, § 17, 1963 Cal. Stat. 3266, 3286.

See also the line of New England statutes which transfers plaintiffs' fire insurance to—even negligent—railroads, *e.g.*, N.H. REV. STAT. ANN. § 380:3 (1966), *cited in* Waumbec Mills v. Bahnson Serv. Co., 103 N.H. 461, 464, 174 A.2d 839, 842 (1961); *see also* Farren v. Maine Cent. R.R., 112 Me. 81, 90 A. 497 (1914); Lyons v. Boston & L.R.R., 181 Mass. 551, 64 N.E. 404 (1902). In Canada, the federal Railway Act, CAN. REV. STAT. ch. R-2, § 338(3) (1970), credits non-negligent railways (strictly liable) with the plaintiff's insurance.

130. 180 Kan. 505, 306 P.2d 137 (1957).

but the court applied the plaintiff's fire insurance in reduction of the defendant's damages, holding briefly that the tort analogy was inapplicable to contract actions.

Quite aside from the cavalier treatment of the subrogation issue by the Kansas court, the result is open to criticism. As a commentator has rightly pointed out, "[t]he contractor's agreement here is essentially a limited insurance agreement, the subject matter of which is, to some extent at least, under the control of the insurer."[131] In the more typical situations involving a plaintiff's insurance company and the third party there is, as mentioned earlier,[132] some force in the argument that the former, unlike the latter, has been paid to assume the risk as the principal purpose of its undertaking and should therefore carry ultimate responsibility. Occasionally, however, as here, the roles are reversed in that the third party expressly assumed the unusual risks incident to the work he undertook, while the plaintiff's insurer had not focused on such risks. In substance, therefore, this situation reflects the familiar distinction between "blanket" and "specific" insurance, where primacy is allotted to the latter.[133] Moreover, the fact that the third party also controlled the hazard, perhaps culpably caused the loss,[134] only goes to reinforce the argument.

It is even debatable whether *Rexroad* is otherwise on all fours with the water company cases. Since the defendant happened to contract with the city, both situations share the common feature that the burden of imposing liability on the third party might ultimately be passed on to the very taxpayers who already paid for fire insurance. On the other hand, the defendant might well have undertaken the work for a private developer, in which case the "pool of distribution" would have been quite different from that of the threatened property owners. Thus while the outcome in *Rexroad* might in this respect be defensible on its own peculiar facts, it could not serve as a paradigm for construction contracts in general.[135]

131. Maxwell, *supra* note 1, at 676.

132. *See supra* text accompanying note 124.

133. *See* United States Fidelity & Guar. Co. v. Slifkin, 200 F. Supp. at 577; 6 J. APPLEMAN, INSURANCE LAW & PRACTICE § 3912 (1972).

134. The defendant employed the bulldozer driver, but the plaintiff pleaded in contract to avoid the proximate cause issue posed by the utility's alleged failure to identify the gas line. This appears more clearly from the report of earlier proceedings in Anderson v. Rexroad, 178 Kan. 227, 228-29, 284 P.2d 1077, 1079 (1955).

135. The same problem has been the subject of lively debate over the unique art. 51 of the Swiss Code of Obligations which prescribes the following order of precedence among obligors from different "causes": first liable is he who is responsible for the loss in tort (fault), and last he who is liable by law in the absence of fault and contractual obligation. In the missing category, priority among obligors liable alike in contract, the prominent case is that of the insurer and the contract breaker, for which various views have been advocated in the absence of any clear commitment by the Federal Court. One of these, reflecting the unmistakable fault bias of art. 51,

The legislative purpose doctrine is thus much less than a guiding light for the application of the collateral source rule to contract claims. The major problem is that if there is no subrogation, the contingency of contract recovery by the plaintiff is generally outside the contemplation of the collateral benefactor, which leaves the often unattractive choice of allowing double recovery to the plaintiff or a windfall to the defendant.

While subrogation is often the optimal solution to this dilemma, in some situations it is nevertheless preferable to deny the rule's application. If the defendant has innocently breached and the insurer has underwritten the specific risk, it may be preferable to have the insurer assume primary liability for the plaintiff's loss. Moreover, given the high transaction costs involved in subrogation recoveries, in those situations where the cost reductions from disallowing subrogation would benefit the plaintiff's class it may also be a sound decision to disallow subrogation and to deny the rule's application.

CONCLUSION

The collateral source rule has received almost exclusive attention in the field of torts, primarily no doubt because of the prevalence of collateral benefits received by victims of personal injury. Long dominating that field, the rule has in recent years fallen under increasing criticism and disfavor.[136] This trend, if it be such, would be auspicious for opposing its extension to the neighboring field of contract damages.

There is indeed a fairly widespread, if superficial, belief that the collateral source rule is confined to tort or tort-like claims. Evidently

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would allow subrogation against a negligent but not against an innocent breacher. A variant which echoes a familiar American theme, favors subrogation except against one who did not participate at all in causing the loss and can claim the same causal innocence as the insurer. A third school, however, would deny subrogation against all but the most inexcusable breaches of contract on the ground that the notion underlying subrogation of punishing a contract breacher or tortfeasor has become obsolete, whereas the insurer assumes the risk as his very business in contrast to the other whose responsibility for the loss is only subsidiary to his principal undertaking.

The various views are summarized by R. KARRER, DER REGRESS DES VERSICHERERS GEGEN DRITTHAFTPFLICHTIGE 28-32 (1965); the most thorough analysis, advocating the third view, is by Yung, *Le recour de l'assureur contre le tiers responsable du dommage en vertu d'un contrat*, in RECUEIL DE TRAVAUX SOCIETE SUISSE DES JURISTES 215 (1952).

136. Aside from the scholarly criticism noted *supra* note 1 and the opposition of the defense lobby, *see* DEFENSE RESEARCH INSTITUTE INC., RESPONSIBLE REFORM: A PROGRAM TO IMPROVE THE LIABILITY REPARATION SYSTEM 21-22 (No. 8, 1969), recent legislative efforts to reduce the burden of tort liability in particular sectors have included provisions making evidence of certain collateral benefits admissible: medical liability—*e.g.*, CAL. CIV. CODE § 3333.1 (West 1970), Arizona Medical Malpractice Act, ARIZ. REV. STAT. ANN. § 12-565 (1982); products liability—UNIF. PRODUCTS LIABILITY ACT § 119, 44 Fed. Reg. 62,714, 62,747 (1979) (requiring reduction by any compensation from a public source); the trend being most pronounced in automobile no-fault statutes—*see supra* note 9.

based on a punitive rationale for the rule, this hypothesis has rarely been seriously probed either in judicial opinions or scholarly writing. There are few decisions to back it up, and the dicta in bootstrap fashion cite each other.

A comprehensive survey of the case law, like that in the present Article, actually reveals a much more diversified and sophisticated treatment of the problem. For one thing, just as in the torts context, it is oversimplistic to view the problem as posing a choice merely between the two equally unattractive alternatives of either overcompensating the plaintiff or conferring a windfall on the defendant. In fact, the problem is three-, not two-dimensional: the collateral source not only provides an opportunity for reimbursement but it, rather than the contract obligee, in reality often contests the defendant's plea for mitigation. This at once moves into the forefront of inquiry the more challenging question: which of the two obligors should assume primary responsibility for compensating the loss. Not surprisingly, save in a few exceptional and justifiable situations, repayment via subrogation has almost uniformly been judged preferable to crediting the defendant with the collateral benefit. Even in the residue of cases where reimbursement was not in the cards, the collateral source rule has mostly prevailed regardless of the type of breach, type of loss or type of collateral benefit. In sum, notwithstanding the above-mentioned myth, the judicial record actually discourages any facile distinction merely between tort and contract.[137] As suggested in the introductory pages, a difference in treatment of the collateral source rule under that focus would be difficult to justify either by reference to the rationale of that rule or the respective policies behind contractual and tort damages. Seekers of the wider generalization may well detect here additional proof of the insidious convergence between tort and contract, which Grant Gilmore a few years ago brought to wider public attention in his prophetical monograph *The Death of Contract*.[138]

137. As a matter of interest rather than as a reinforcing argument, it may be noted that Continental literature treats *compensatio lucri cum damno* or *Vorteilsausgleichung* as relating to the meaning of "compensation" generally, without distinguishing between contract and tort claims. The rich German literature unreservedly intermingles illustrations from both areas. *E.g.*, Lange, *Die Vorteilsausgleichung*, 18 JURISTISCHE SCHULUNG 649 (1978) and literature cited at 649.

138. G. GILMORE, THE DEATH OF CONTRACT (1974).