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VENDOR-PURCHASER—THE DISPOSITION OF INSURANCE PROCEEDS—THE CHANGING LAW

For many years, a majority of American courts that faced the problem of the disposition of insurance proceeds, as between vendor and purchaser, after insured property that had been sold was destroyed, adopted and extended the law which had been created for vendor-purchaser relationships in areas other than insurance. The purpose of this note is to show the recent trend away from using the law of land transactions to answer insurance questions, and to indicate what result this trend could and probably should reach. Opinions representative of the trend are important because they discard legal fictions, and because they dispel some of the confusion which resulted from unwarranted extension of these fictions.

I. THE RULES AND THEIR REASONS

Parties to binding contracts for the conveyance of real property, and courts, have always been plagued with the problem of who must bear the loss if the property, or a part of it, is destroyed between the time of contracting and the time set for actual conveyance. A multitude of law review commentaries¹ and annotations² have explored, categorized, and criticized the reasoning of the decided cases, and it is unnecessary to make a complete historical summary; however, it is necessary to state generally what the past has provided for each of the three ways the basic problem can arise, viz., when the vendor had indemnity insurance and the purchaser had not, when the purchaser was the only insured, and when both the vendor and the purchaser had insured their respective interests.

When the vendor alone had insurance, the majority of American courts have held that the proceeds can be obtained by the purchaser,³ because the

1. *E.g.*, 22 ALBANY L. REV. 174 (1958); 33 HARV. L. REV. 813 (1919); Comment, 4 MO. L. REV. 290 (1939); 39 N.D.L. REV. 351 (1963); 4 SYRACUSE L. REV. 379 (1953); 40 TEX. L. REV. 902 (1962); 34 VA. L. REV. 965 (1948).

2. See Annot., 64 A.L.R.2d 1406 (1959).

3. See, *e.g.*, *Mattingly v. Springfield F. & M. Ins. Co.*, 120 Ky. 768, 83 S.W. 577 (1905); *Wm. Skinner & Sons' Ship-Building and Dry-Dock Co. v. Houghton*, 92 Md. 68, 48 Atl. 85 (1900); *Standard Oil Co. v. Dye*, 223 Mo. App. 926, 20 S.W.2d 946 (1929); *Manning v. North British & M. Ins. Co.*, 123 Mo. App. 456, 99 S.W. 1095 (1907); *State Mut. Fire Ins. Co. v. Updegraff*, 21 Pa. 513 (1853); *Gillingham v. Phelps*, 5 Wash. 2d 410, 105 P.2d 825 (1940). There are two important exceptions to this stated rule. The courts in Massachusetts have developed their own standards in determining the risk of loss question, *e.g.*, *Libman v. Levenson*, 236 Mass. 221, 128 N.E. 13 (1920). The other important exception is found in jurisdictions which have adopted

purchaser generally bears the risk of loss under the doctrine of equitable conversion. The rule could be stated to be that the insurance proceeds will inure to whichever party bears the risk of loss.⁴ An alternate statement would be that if the purchaser bears the risk of loss, the proceeds of the vendor's insurance are held in trust for the purchaser.⁵ The contrary view is based on the rule of insurance law that a contract of insurance is personal and can not be reached by one who is not a party or his privy.⁶ This rule leads to harsh results when the vendor is the only insured, and he is also entitled to the purchase price. In cases where the *purchaser* has insured his equitable interest in the buildings, courts have uniformly applied this rule because no unfairness arises from such a result.

American courts have relied on the reasoning of the majority opinion in one English case and the dissent in another. The first English case, *Paine v. Meller*,⁷ although not dealing with insurance, reasoned that under an executory contract the risk of loss was upon the purchaser because there had been an equitable conversion when the contract became enforceable. Equitable conversion is the principle that the purchaser of realty becomes the true owner once there is an enforceable contract, despite the fact that title has not yet been transferred to him.⁸ Equitable conversion is most commonly used in vendor-purchaser relationships to determine the devolution of the interest in property subject to a contract of sale if a party to the contract has died.⁹ It was extended to govern the question of which party must bear the risk of loss.¹⁰ The dominant requirement of equitable conversion is that of a specifically enforceable contract.¹¹ If the vendor is not able to give at least substantial performance,¹² the purchaser may elect to compel the vendor to convey what he does have and abate the purchase price, or the purchaser

the Uniform Vendor Purchaser Risk Act which makes possession of the property the determinative factor. California, Hawaii, Michigan, New York, South Dakota and Wisconsin are the states which have adopted this act.

4. VANCE, INSURANCE § 131 (3d ed. 1951).

5. DE FUNIAK, HANDBOOK OF MODERN EQUITY § 93 (2d ed. 1956).

6. The minority American rule originated in the English decision of *Rayner v. Preston*, 18 Ch. D. 1 (1881). For American cases see, *e.g.*, *Birmingham Fire & Cas. Co. v. Lewis*, 133 So. 2d 876 (Ala. 1961); *Brownell v. Board of Educ.*, 239 N.Y. 369, 146 N.E. 630 (1925).

7. 31 Eng. Rep. 1088 (1801).

8. DE FUNIAK, *op. cit. supra* note 5, § 87. Or said another way, equity regards as done that which ought to be done. 2 POMEROY, EQUITY JURISPRUDENCE § 368, at 21 (5th ed. 1941).

9. See, *e.g.*, *Clapp v. Tower*, 11 N.D. 556, 93 N.W. 862 (1903).

10. See, *e.g.*, *Sewell v. Underhill*, 197 N.Y. 168, 90 N.E. 430 (1910).

11. DE FUNIAK, *op. cit. supra* note 5, § 87.

12. *Id.* at § 83.

may rescind the contract and recover his down payment.¹³ Subsequent destruction of the property does not alter the fact that there has been an equitable conversion.¹⁴

The second English case, *Rayner v. Preston*,¹⁵ dealt with insurance and the majority held that the proceeds could go only to a party to the insurance contract. The proceeds of the policy were paid to the vendor, but the insurer recovered them when the vendor was allowed to extract the purchase price from the purchaser.¹⁶ This case served as the foundation for the American minority rule. However, the dissent reasoned that because, in equity, the purchaser was the true owner, the relationship of trustee-beneficiary was created, and the vendor should hold not only the legal title in trust for the purchaser, but he should also hold the insurance proceeds in trust. To bolster this reasoning, American courts have usually indicated that it would be unjust to allow the vendor to enforce the contract of sale and also be enriched by the proceeds of his insurance policy. While the reasoning of the courts has been fairly consistent since this problem was first considered, in the past few years changes in reasoning have become apparent; it may be that these changes indicate a trend. Before looking at these cases, studying a few examples of the majority view might help to show the reasoning used, and the results sometimes obtained.

In the Missouri case of *Standard Oil v. Dye*,¹⁷ the purchaser had accepted an option to purchase, but before the vendors had executed a deed of conveyance a building on the land was destroyed. The purchaser paid the purchase price but reserved its right to claim the insurance proceeds which had already been collected by the vendor. The court applied the majority reasoning and reached the normal result that the purchaser could recover the vendor's insurance proceeds. However, the court felt an additional explanation was necessary and stated, "All must agree that after a valid contract of sale all appreciation of the property is the purchaser's and so, also, necessarily, all depreciation."¹⁸

In a more recent case, *Vogel v. Northern Assurance Co.*,¹⁹ similar reasoning was used to reach a more debatable result. The purchaser sued his own insurance company for the policy limit of \$9,000 and the vendor's insurance company for the vendor's policy limit of \$6,000; the loss of buildings under executory contract of sale was only \$12,000. The court allowed recovery in

13. *Ibid.*

14. 4 POMEROY, EQUITY JURISPRUDENCE § 1161a, at 482 (5th ed. 1941).

15. 18 Ch. D. 1 (1881).

16. See also *Castellain v. Preston*, 11 Q.B.D. 380 (1883).

17. 223 Mo. App. 926, 20 S.W.2d 946 (1929).

18. *Id.* at 932, 20 S.W.2d at 949.

19. 219 F.2d 409 (3d Cir. 1955). The federal court applied Pennsylvania law.

full (\$15,000) against both insurers stating that the purchaser's insurance proceeds are a matter of contract right to him, and that it has been settled law in Pennsylvania since 1853²⁰ the vendor's insurance money belongs to the purchaser. The court's use of reasoning based on equitable conversion led to a faulty result because the court first determined the party who must bear the risk of loss and directed the proceeds of the vendor's insurance to be paid to the purchaser without looking further.

In the 1960 Missouri case of *Ingram v. Kiewit*²¹ there had been a partial destruction by tornado of buildings on land that was subject to an executory contract of sale. A portion of the vendor's insurance proceeds was used by the vendor to restore the damage, and the purchaser was allowed to recover the excess of the proceeds. The proceeds of the policy were \$7,500, the repairs had a value of \$5,700, and thus the purchasers received a windfall of \$1,800. The court of appeals drew an analogy to the rule in mortgagor-mortgagee relations, where the proceeds of insurance must be applied to the extinguishment of the mortgage debt.²² The analogy added nothing to the solution of the question before the court.

II. THE TREND AND ITS REASONS

A change in judicial thinking has been expressed in three recent cases which might well represent a trend away from the use of reasoning designed for the solution of land transaction problems and toward a recognition that the problem is, instead, one of insurance.

Although New York was a strong member of the American minority, the 1957 New York case of *Raplee v. Piper*²³ allowed the purchaser to benefit from the proceeds of the vendor's policy because the contract of sale called for the purchaser to pay the premiums on the insurance policy. Because of this one fact, the court refused to follow the earlier precedent case of *Brownell v. Board of Education*²⁴ which had firmly agreed with the reasoning and result of the English case of *Rayner v. Preston*. The majority in the *Raplee* case reasoned that "the simple analysis of the situation is that the insurance

20. The precedent case referred to was *State Mut. Fire Ins. Co. v. Updegraff*, 21 Pa. 513 (1853).

21. 331 S.W.2d 681 (Mo. Ct. App. 1960).

22. The court stated the rule concerning mortgages to be, "where the mortgagee, under an agreement with the mortgagor, insures the mortgaged property at the charge of the mortgagor, the insurance proceeds, in the event of loss, must be applied by the mortgagee toward the extinguishment of the debt or the restoration of the property . . ." *Id.* at 684. The court went on to recognize that a true mortgagor-mortgagee relationship did not exist.

23. 3 N.Y.2d 179, 143 N.E.2d 919 (1957).

24. 239 N.Y. 369, 146 N.E. 630 (1925).

was taken out at the cost of the vendee in the name of the vendor for the protection of the contract and of both parties to the contract,"²⁵ and thus the purchaser should recover.

The fallacy of this reasoning is that neither a tangible object such as a building, nor an intangible object such as a contract can be insured; what is protected or insured is a person's interest in the subject or object said to be insured.²⁶ The three most common ways that a person's interest can be protected by an insurance contract are to name him either the insured, the beneficiary, or the person designated in the "loss payable" clause.²⁷ It is immaterial who pays the premium of the indemnity insurance; the insurance is to protect the interest of the person designated in the policy.²⁸ This does not mean that the contract of sale cannot specify what the disposition of the insurance proceeds will be as between the parties, but the contract in the *Raplee* case did not so specify. The dissent advocated following the doctrine of the *Brownell* case and stated the distinction raised by the majority was immaterial. The majority's premise that the contract itself was insured was technically incorrect.

In the 1962 Texas case of *Paramount Fire Ins. Co. v. Aetna Cas. & Sur. Co.*,²⁹ there was an executory contract of sale on buildings that were destroyed; both parties had indemnity insurance. The court recognized the general rule that if the purchaser has no insurance, the proceeds of the vendor's insurance policy constitute a trust fund in favor of the purchaser. The court held, "We believe that there is nothing in the present case, however, which would require such an exception to the principle that an insurance policy is basically a personal indemnity contract."³⁰ The deciding factor was that the purchaser as well as the vendor had insured his interest. Therefore it was no longer necessary to use rules of equity to avoid the harshness of calling insurance a purely personal contract. The case stands for an exception to the majority rule that insurance follows the risk of loss, viz., when both vendor and purchaser are insured, the court will apply the minority rule that insurance proceeds are personal. It can be assumed that if the purchaser had not adequately protected his interest, the court would have required the vendor's insurer to pay the purchaser. Such a result

25. It should be noted that both parties to the contract were not insured by the terms of the policy. 3 N.Y.2d at 182, 143 N.E.2d at 920.

26. VANCE, INSURANCE § 13, at 97-98 (3d ed. 1951).

27. *Id.* § 28. Professor Vance refers to the beneficiary or the one named in the "loss payable" clause of the contract as "assureds" and he makes distinctions between indemnity and life insurance which are not material to the broad principle stated.

28. *Id.* § 19, at 117-18.

29. 163 Tex. 250, 353 S.W.2d 841 (1962).

30. *Id.* at 256, 353 S.W.2d at 845.

would have been exactly opposite to that of the *Vogel* case which required payment to the purchaser by both his insurer and the vendor's insurer, even though such combined payment exceeded the actual loss.

Thus the court did realize that the issue was one of the disposition of insurance proceeds; however, it is suggested that a new rule should have been laid down. The door was left open for the Texas court to return to deciding cases such as these by using the law of land transactions rather than principles of insurance law.

In March of 1963 the Missouri Supreme Court in *Skelly Oil Co. v. Ashmore*³¹ refuted the reasoning of previous Missouri cases siding with the American majority.³² A building subject to an executory contract of sale was destroyed prior to conveyance of legal title; only the vendor carried indemnity insurance. The purchaser sued for and got specific performance with an abatement of the purchase price in the amount of insurance proceeds the vendor had collected.³³ The result on the facts is that which would have been reached by any of the majority view courts; however, the reasoning of the court greatly extended the trend of the changing law.

The court reasoned that the doctrine of equitable conversion cannot logically be used to cast the loss on the purchaser, and it concluded that the equity court may award insurance proceeds based on their interpretation of what is fair and just.

Thus the court went farther in accepting insurance as the basis of the litigation than the other two "trend" decisions. The court said "the *non sequitur* involved in the proposition that performance may be had because of the equitable ownership of the land by the vendee, which in turn depends upon the right of performance, is evident."³⁴ What the court apparently means is that since equitable conversion depends upon the right to performance of the contract, when performance is no longer possible there should be no conversion. This is a misinterpretation of the doctrine of equitable conversion, because as was mentioned earlier, the conversion occurs at the time the contract first becomes specifically enforceable, and the subsequent destruction of the property does not alter the fact of the conversion. The court seems to have overlooked the distinction between "equity" which is guided by rules and maxims and "equity" as a concept of fairness. There-

31. *Skelly Oil Co. v. Ashmore*, 365 S.W.2d 582 (Mo. 1963).

32. *Id.* at 587.

33. The trial court found in favor of the plaintiff purchaser. An appeal was taken and argument first made to Division No. 2 of the Missouri Supreme Court. It was transferred to the court *en banc* where it was reargued. The judgment for the plaintiff purchaser was affirmed, but a rehearing was granted and the case was reargued before the court *en banc*. The judgment for the plaintiff purchaser was again affirmed.

34. 365 S.W.2d at 588.

fore, it is suggested that while the court properly discarded the doctrine of equitable conversion as controlling in insurance cases, the grounds for doing so were faulty. By eliminating it, the Missouri court struck the heart out of the reasoning of the American majority. Equitable conversion was often unexpressed in the reasoning of the courts, but it was the basis for finding that the risk of loss fell upon the purchaser. The dissent in *Skelly*³⁵ agreed that the doctrine of equitable conversion should be discarded in a case such as this, and the only real point of contention was what was just and equitable as between the two parties.

This, however, was only the first of the three areas of reasoning used. The court went on to say that "instead we believe the Massachusetts rule is the proper rule."³⁶ The Massachusetts rule would place the loss upon the vendor because of an implied condition in the contract that it will no longer be binding if the buildings are destroyed.³⁷ But the court allowed the purchaser to compel specific performance although, under the rule it had just stated, the contract was no longer binding on either party. The result finally reached was that it will award insurance proceeds according to what it considers to be just and fair. The court said, "the short of the matter is that defendants will get all they bargained for; but without the building or its value plaintiff will not."³⁸ The obvious problem created by this holding is that every question concerning the disposition of insurance proceeds in a case such as this will have to be submitted to a court of equity for its determination of what is just and equitable as between the parties. But at least the court has withdrawn from deciding such cases according to rules of law established to govern land transactions.

At first glance these three cases appear quite dissimilar, and in many respects they are. In the *Raplee* case, the court paid homage to the minority rule as expressed previously by that court,³⁹ but allowed the purchaser to benefit from the vendor's policy because the purchaser had paid the premiums. In the *Paramount* case the court paid homage to the majority view, but made a distinction because the purchaser's own interest had been insured.⁴⁰ In the *Skelly* case the court flatly rejected the majority rule, but

35. *Id.* at 585.

36. *Id.* at 589.

37. The most frequently used example of the Massachusetts rule is *Libman v. Levenson*, 236 Mass. 221, 128 N.E. 13 (1920), which the court in *Skelly* cited and quoted.

38. 365 S.W.2d at 589-90.

39. "If . . . the vendor at his own cost, for his own protection and not because of any agreement, has taken out fire insurance, then such contract is personal to him and he need not credit to proceeds against the price (*Brownell v. Board of Educ.*, 239 N.Y. 369, 146 N.E. 630, 37 A.L.R. 1319)." 143 N.E.2d at 920.

40. 353 S.W.2d at 845.

allowed the purchaser to benefit from the proceeds of the vendor's insurance.⁴¹ The three decisions have an important common denominator: while they recognized that disposition of insurance was the real issue, they did not simply turn to the minority view that has always recognized the issue to be one of insurance rather than an interest in property. Prior to these cases, most majority courts allowed the purchaser to recover but did so without acknowledging that insurance was a separate and distinct issue to be solved.⁴² They, of course, knew that the result was to be the disposition of insurance proceeds, but their reasoning was the same as it would have been if insurance had not been involved. As was stated by a law review commentary on a majority view case, "*incidental* to the question of risk of loss, is the problem of who, as between the vendor and purchaser, is entitled to the proceeds of a policy of insurance taken out by the vendor, which insures him against damage to or destruction of the property which is the subject of the contract of sale. . . ."⁴³

III. THE TREND AND ITS DESTINATION

These "trend" cases are an important beginning to a solution of the problem, but they are only the beginning. The courts which follow the minority view that insurance proceeds are personal to the one whose interest was protected recognized the fact that insurance is the key factor, but the results of such decisions are harsh and distasteful to the equity courts which are called on to enforce the contracts of sale.

The answer may be, as it was in England, to establish a rule by legislation. An English statute,⁴⁴ enacted in 1925, reads as follows:

(1) Where after the date of any contract for sale or exchange of property, money becomes payable under any policy of insurance maintained by the vendor in respect of any damage to or destruction of property included in the contract, the money shall, on completion of the contract, be held or receivable by the vendor on behalf of the purchaser and paid by the vendor to the purchaser on completion of the sale or exchange, or so soon thereafter as the same shall be received by the vendor.

Uniform statutes such as the one above would settle the matter and would grant a result that would probably live up to what the public in general expects the law to be. However, because of the improbability of the passage of a uniform law on the subject or even legislation by the states individually,

41. 365 S.W.2d at 587, 590.

42. See, *e.g.*, the reasoning of *Standard Oil Co. v. Dye*, 223 Mo. App. 926, 932, 20 S.W.2d 946, 948 (1929).

43. Comment, 4 Mo. L. REV. 290, 294 (1939). (Emphasis added.)

44. Law of Property Act, 1925, 15 Geo. 5, c. 20, § 47.

the answer must be sought elsewhere. It may be that the issues will have to be settled by the parties by stipulating in the contract what the disposition of the insurance proceeds will be.⁴⁵ However, in the past parties to the contract have been reluctant to see the necessity of such a provision, and this attitude will probably continue. The answer seemingly will have to come through judicial rather than through personal or legislative means. It is suggested, therefore, that (1) courts follow the trend of the New York, Texas, and Missouri courts and recognize that the problem is one of disposition of insurance proceeds and that they look to insurance law rather than the law of land transactions for their answer; (2) that they accept the rule that insurance contracts are personal, and that the proceeds are personal to the ones whose interests are insured; and (3) that courts develop a judicial exception to this rule of insurance law that if the purchase money of the executory contract for the sale of the insured buildings is paid, the purchaser is subrogated⁴⁶ to the vendor's proceeds or right to the proceeds to the extent that the purchaser has been or will be damaged by the loss. This last condition is necessary because in jurisdiction with valued-policy laws⁴⁷ the insurance proceeds may exceed the value of the buildings destroyed, or the purchaser may be insured; and it is not desirable to allow the purchaser a windfall upon his choice to require specific performance. If these rules are accepted, then the courts could first turn to their property law and contract law to determine whether the contract is specifically enforceable and then they could turn to a rule of insurance law, and its exception, to determine the disposition of the insurance proceeds.

45. 22 ALBANY L. REV. 174, 179 (1958).

46. This theory of subrogation seems to have been recognized by Professor Patterson. He states,

[A]lthough in many states a purchaser of real property under contract is bound to go through with the deal and pay the full purchase price despite intervening destruction of the building by fire or other unavoidable casualty, the insurer, on paying the vendor, is not subrogated to the vendor's claim against the purchaser. While there is a strong dictum in New York that the English decisions would be followed there, the majority of American courts take the view that the vendee is entitled to claim the insurance money collected by the vendor; *in short, the subrogation works the other way.* (Emphasis added.)

PATTERSON, ESSENTIALS OF INSURANCE LAW § 33 (2d ed. 1957).

47. See, e.g., MO. REV. STAT. § 379.160 (1959), which states,

[P]rovided further, that in all suits brought upon policies of insurance against loss or damage by fire hereafter issued or renewed, the defendant [insurer] shall not be permitted to deny that the property insured thereby was worth at the time of the issuing of the policy the full amount insured therein on said property covering both real and personal property

Professor Patterson lists the states having valued-policy laws to be Arkansas, California, Delaware, Florida, Iowa, Kansas, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, North Dakota, Ohio, South Carolina, South Dakota, Texas, West Virginia and Wisconsin. PATTERSON, ESSENTIALS OF INSURANCE LAW § 32, n.126 (2d ed. 1957).