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David vs. Goliath: I.R.S. Tax Lien vs. Med Pay Subro Lien

By [Gary Wickert](#) | April 4, 2013

In 1 Samuel 17, the Bible tells one of the most poignant and motivating stories of all time. The Philistine army had gathered for war against Israel. The two armies faced each other, camped for battle on opposite sides of a steep valley. Goliath, a Philistine giant measuring over seven feet tall and wearing full armor, came out each day for 40 days, mocking and challenging the Israelites to a fight. A young teenager named David was sent to the front lines, and even though he was only a messenger, he volunteered to fight Goliath. Dressed in his simple tunic, carrying his shepherd's staff, slingshot and a pouch full of stones, David shouted to Goliath, "You come against me with sword and spear and javelin, but I come against you in the name of the Lord Almighty." As Goliath moved in for the kill, David reached into his bag and slung one of his stones at Goliath's head. Finding a hole in the armor, the stone sank into the giant's forehead and he fell face down on the ground.

On March 14, 2013, this classic tale of the underdog prevailing against great odds was recently replayed in a subrogation context in federal district court in Iowa.

In *Simmons Perrine Moyer Bergman, PLC v. Coleman*, 2013 WL 1080666 (N.D. Iowa 2013), Joe Coleman was injured in an auto accident, recovered \$1.9 million

but owed \$1.5 million in back federal and state taxes. Coleman's attorney (\$633k in fees), the I.R.S. (\$1.5 M), the State of Iowa (\$453k), and State Farm (\$69k med pay lien) all claimed priority to the \$1.9 million. Coleman's attorney was allowed to take \$700k in fees/costs and the rest (\$1.2 million) was held with the Clerk of the Court to divide among all the parties. The stage was set for a David v. Goliath showdown between the federal government's mighty I.R.S. tax lien and State Farm's lowly med pay subrogation lien.

The Court began by noting that federal law permits the establishment of a lien in favor of the United States upon all property or rights to property held by persons owing unpaid taxes. The United States was entitled to all of the \$1.2 million because of its lien, subject only to the possible claims of the other claimants.

State Farm paid medical expenses on Coleman's behalf, totaling \$69,095.69. The State Farm policy stated that it was subrogated to the extent Coleman was entitled to recover against any third party for his injuries. The policy also provided that proceeds from a settlement were to be held "in trust" and must be reimbursed.

The I.R.S. tax lien extended to all property "belonging" to the delinquent taxpayer. State Farm argued that the portion of the settlement proceeds representing its subrogation interest never "belonged" to the Colemans because it was being held "in trust" and, therefore, the federal tax liens never attached to that amount.

The Colemans settled the underlying personal injury action, however, without notifying State Farm. The defendants in the personal injury action issued checks to the Colemans and their attorneys. The release signed by the Colemans stated that the Colemans "will negotiate and pay from the proceeds of this settlement" any medical bills or subrogation interests. In the release signed with the other underlying tortfeasor, the Colemans agreed to satisfy subrogation claims from any "net proceeds" after satisfying the federal tax lien.

The Court also noted that when the Colemans signed the settlement agreements they had a clearly-defined state law right to the settlement proceeds. Accordingly, the tax lien attached to the settlement proceeds at that time. The United States acknowledged that State Farm also had a valid claim on the settlement proceeds. The I.R.S. claimed that its pre-existing lien must be satisfied before State Farm was entitled to recover. The Court noted that lien priority is established by the familiar rule of "first in time, first in right." *United States v. City of New Britain, Conn.*, 347 U.S. 81, 85 (1954). State Farm argued, however, that its claim was mischaracterized as a "lien" on the Colemans' property. That is, State Farm asserted that the dispute is not one of priority between competing liens. Rather, State Farm argued that the

portion of the settlement proceeds representing medical bills was held by the Colemans “in trust” for State Farm’s benefit and, therefore, never actually became the Colemans’ “property.” That is, as mere trustees, the property did not “belong” to the Colemans. Therefore, according to the argument, the United States’ tax lien never attached to that portion of the settlement.

The issue; therefore, was whether the Colemans had a “property interest” in that portion of the settlement proceeds representing medical bills paid by State Farm.

If all of the settlement proceeds “belonged” to the Colemans, subject only to State Farm’s claim for reimbursement, then the United States’ tax lien attached and has priority over any claim by State Farm.

On the other hand, if an amount was being held “in trust” and did not “belong” to the Colemans—i.e., they had no property interest in that amount, then the United States’ tax lien would not attach to those funds. In answering this question, the Court turned to Iowa state law. *Aquilino v. United States*, 363 U.S. 509, 513 (1960) (“state law controls in determining the nature of the legal interest which the taxpayer had in the property”).

The question then became: if an insured settles a claim for injuries sustained in a motor vehicle accident, and his insurance policy provides that the person “shall hold in trust” the settlement proceeds and reimburse medical expenses paid by the insurer, is the amount being held “in trust” property “belonging” to the insured? The Court determined that this question must be answered in terms of a constructive trust. Under Iowa law, a constructive trust is an equitable remedy courts apply to provide restitution and prevent unjust enrichment. *Berger v. Cas’ Feed Store, Inc.*, 577 N.W.2d 631, 632 (Iowa 1998).

The Court noted that subrogation is an equitable doctrine that is intended to give relief to an entity “that pays a legal obligation that should have, in good conscience, been satisfied by another.” *Allied Mut. Ins. Co. v. Heiken*, 675 N.W.2d 820, 824 (Iowa 2004).

Subrogation plays a “vital role in insurance law” by permitting an insurer to recover against persons responsible for the insured’s loss. The insurer’s claim is against the tortfeasor, not the insured. These principles reveal that the insurer’s claim for subrogation is against the tortfeasor responsible for the loss to the insured. The insurer has no right of subrogation against the insured. Therefore, the Court stated that State Farm’s claim was against the underlying tortfeasors, not against the Colemans.

As spelled out in the policy, amounts paid by the underlying tortfeasors, representing medical bills paid by State Farm, were paid to the Colemans to “hold in trust” for State Farm. The clear policy language subrogated State Farm to the extent of its medical payments and further provided the Colemans “shall hold in trust” the settlement proceeds and reimburse State Farm to the extent of its payment.

Therefore, the Court ruled that, to the extent a portion of the settlement proceeds represented medical expenses paid by State Farm, the money was being held in trust for State Farm’s benefit, was not the property of the Colemans, and was not subject to the I.R.S. tax lien. Goliath lost, and State Farm was entitled to recover their med pay subrogation interest.

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