Changing places

Subrogation is often the last decision made when settling an insurance claim. But it is a very important one.

The damage has been repaired. The loss adjusters have issued their final report. The claim has been settled. So, what do you, the insurer, do next?

The natural response is to try and recoup your loss. And the doctrine of subrogation has been developed to enable insurers to do just that.

Doctrine of subrogation

Subrogation is the name given to the right of an insurer, who has indemnified its policyholder, to take the place of that policyholder and try to recover the money paid out from any potentially liable third party. It is a quasi-automatic right that becomes available as soon as the insurer pays out on a claim.

In effect, it is the mirror image of the indemnity principle: once an insurer has paid the policyholder for a loss covered under the terms of the policy, it can step into the policyholder's shoes and seek to recoup that loss up to the extent of the indemnity. This prevents a possible double recovery by a policyholder – firstly from its insurers and then, secondly, from any liable third party it might choose to sue.

Obstacles to subrogation

There are, however, obstacles. An insurer's rights can never be better than its policyholder's. This is a particularly important point for insurers as they may find that, despite the apparent merits of a policyholder's case, they cannot, in fact, pursue the third party because of the policyholder's position. For instance:

- the intended defendant is a co-insured – for example, under a JCT contract. An insurer cannot step into the shoes of one policyholder to sue another;
- the policyholder may have waived any rights of subrogation – for instance, a contractor policyholder may have waived any claim against its subcontractor and if the policyholder cannot sue its subcontractor, then neither can the insurer;
- an insurer will be bound by any contractual terms preventing recovery or limiting the amount that can be recovered;
- the policyholder may have already settled any claim with the third party, in which case the insurer will almost certainly be bound by the terms of the settlement;
- it may be that the policyholder's rights vest with a subsidiary or sister company or that the policyholder has been acquired by somebody else. In the absence of any transfer of such rights, the insurer may find that any claim has been lost; and
- a subrogated recovery is often considered after the loss, by which stage the policyholder may have been dissolved. An insurer cannot step into the shoes of a company that no longer exists.

Assigning an alternative

It may be possible to get round some of these difficulties by assigning to the insurer the benefit of a policyholder's claim.

An assignment enables an insurer to sue a third party in its own name. The plus points of this include that:

- the insurer will not be limited to the amount it has paid its policyholder; and
- the insurer's chances of success will not depend on the insurance claim having actually been finalised.

On the down-side, the insurer may be unenthusiastic about the publicity. It will also need its policyholder's consent to such an assignment, and the policyholder may not want to give up its rights without some sort of compensation in return.

What happens next?

Once the insurer has indemnified its policyholder and established that a claim exists against a third party, the next step is to decide how to proceed.

Often, there will be express provisions in the policy giving the insurer full control of any proceedings taken, and enabling it to negotiate a settlement, providing it acts in a bona fide way. But even if there are no contractual terms to this effect, an insurer will still retain control if:

(1) it has indemnified its policyholder in full; and
(2) there are no uninsured losses.

At this point, it is important to note how the courts prioritise sums of money obtained in successful subrogation proceedings. The leading House of Lords case of Napier & Ettrick v Kershaw (1993) established the 'pay up – recover down approach'. Insurers will be paid first, with the policyholder's deductible or excess recovered last. The fly in the ointment is where there are uninsured losses. The courts regard such losses as having been expressly intended by the policyholder – or put another way, they treat the policyholder as having intended to selfinsure in part. As a result, such uninsured losses will be paid first out of any sums recovered from a third party. For example, a property is burnt down in a fire at a cost of £500,000. The insurer provides cover up to £400,000, with a £25,000 excess. It pays its policyholder £375,000. £490,000 is recovered from a third party. The policyholder's uninsured loss of £100,000 is paid first. The insurer recoups its £375,000 second. The balance of £15,000 is then paid to the policyholder as a contribution towards the excess.

The policyholder will, therefore, have a vested interest in any action its insurer decides to take against any third party. In the absence of an express term in the policy, the insurer may, therefore, be left in a situation where, because of uninsured losses, it must obtain the policyholder's consent to any third party action and its settlement. Alternatively, the insurer may settle only a part of the loss without prejudicing its policyholder's entitlement to seek a separate recovery. A third party is unlikely to be enthusiastic about such a bit-part settlement.

Costs agreements

This potential problem is often best dealt with upfront in a costs agreement.

If there are substantial uninsured losses, an insurer may be able to persuade its policyholder to act on a pro-rata basis. Alternatively, if the policyholder only has to recover its excess, then it may be prepared to hand over the conduct of the case to its insurer, on the basis that the insurer will meet the costs of the recovery. This way, the insurer will have a free hand when it comes to negotiations and settlement.

An agreement of this kind can ensure that distribution of the money recovered – and the resolution of any disputes – are dealt with at the outset so as to avoid any difficulties later in negotiations.

Practical steps

Subrogation is usually the last decision that is made when settling an insurance claim. Obviously, the priority is to repair the damage and to indemnify the policyholder. But, as highlighted above, a great deal can happen in the interim to affect an insurer's ability to pursue recovery later on.

There are a number of steps, however, that an insurer can take to improve its position.

Firstly, it is important to identify any key documentation that is likely to be in the hands of the policyholder. For instance, if a fire causing loss occurs through negligent works undertaken by another, then those works may be governed by a contract with insurance and/or liability provisions that affect the insurer's ability to seek a recovery. The contract, and any related documentation/ information, must be obtained promptly.

Then there is limitation to think about. Any claim in negligence must usually be brought within six years from the date of the loss. A contractual claim, however, must be brought within six years of the breach of contract. If a contractor undertook works giving rise to the loss four years before the damage actually occurred, then the insurer's ability to pursue a subrogated contractual claim will expire that much earlier.

Staff of the policyholder may prove a useful source of information, not only in terms of obtaining documentation, and establishing what losses have been suffered, but also as to whether any third party is at fault. Obtaining staff accounts promptly, preferably in witness statement format, can prove invaluable later on in the claim when solicitors are instructed and a decision has to be taken about whether or not to issue proceedings.

Claims will often involve expert assistance in establishing why particular damage has occurred. Such contemporaneous expert evidence should also help to establish: (1) whether the damage is covered under the terms of the policy; and (2) whether any fault lies with a third party (or even with the policyholder).

This kind of information may prove invaluable when decisions on subrogation and the issue of proceedings have to be taken.

Subrogation may not be the top of an insurer's To Do list, but taking into account some of the things discussed here, should make life easier in the long run.

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