A busy business person's thumbnail guide to: Subrogation

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So, what is subrogation anyway?

1. 'Subrogation' is a legal principle that allows one person to exercise and to enjoy, the legal rights, interests (and in some instances, the obligations) of another person. It can be described, in general terms, as '*stepping into someone else's shoes*'[1] and most often occurs when the subrogating person has provided indemnity to another.

2. The term is most often encountered in the insurance context; however, it can arise in other circumstances as well – perhaps more often that people commonly realise. For example, it can arise in cases involving guarantees and indemnities, where there is no hint of insurance. Where there is an insurance claim, those other instances of subrogation can be available to offset the indemnity payout that has been made. Subrogation is, then, a very important, if sometimes poorly understood, feature of business.

3. It has been neatly defined as:

> "*Subrogation may be described in broad terms as the substitution of one person for another, so that he same rights and duties as attached to the original person attach to the substituted one. It is a transfer or rights from one person to another without assignment or asset of the person from whom the rights are transferred, and which takes place by operation of law in a whole variety of widely differing circumstances. The purpose of subrogation is to prevent one person from being unjustly enriched at the expense of another…*"[2]

[1] As will be seen, this analogy is more accurate than it may seem because: even though you may walk in them, the shoes still belong to the other person, and in walking in them, the shoes will still have whatever the owner had previously stepped in.
[2] Insurance Law in Australia (3rd ed, 1999, LBC), Prof Kenneth Sutton at page 1218

4. The important two aspects of this definition are:

   (a) Firstly, subrogation can take place by operation of law when the applicable circumstances arise.

   (b) Secondly, it involves the availability of rights without them being formally transferred or assigned.

Why is subrogation important?

5. In both cases, this means that rights & obligations of subrogation can arise without anyone realising it. This raises the possibility that valuable subrogation rights can be overlooked, neglected, and so lost – amount to a needless of valuable claims, which are assets in the business sense.

6. On the negative side, if not identified and taken into account, important subrogation obligations can be unintentionally compromised, giving rise to breach of those obligations. Such a breach can have serious knock-on effects. In some cases, breach can bring the value of all of the subrogating person's rights & powers into question – which is not so good.

Why are there complexities in understanding and using the subrogation concept?

7. There are some complicating features of the concept, which is one of the reasons that it is, in general, poorly understood. These are:

   (a) The concept of subrogation has tended to be dominated by Insurance law discussions and considerations. It is so often included in insurance contracts that many mistake subrogation as principally a contractual concept and principally an insurance concept. This is far too limited an approach and can unnecessarily confuse the concept.

   (b) Subrogation can also be used and provided for in statutes, which can lead some to see it only as a 'special' statutory concept[3], or to confuse the statutory use of the term with its general law sense.

   (c) Contracts (including insurance policies) and statutes can be framed so as to create, supplement, modify, alter, or even replace the general law concepts of subrogation.

[3] Sometimes called a *sui generis* concept – meaning that is 'its own thing' and distinct from the concept as used in general law.

Too often that contractual/statutory use of the concept lead to misunderstanding about the elements and features of the concept as a basic principle.

(d) 'Subrogation' is a term that is used in the common law system as well as in the civil law (code) system. However, although the basic way it operates in the common law and in the civil law systems have many *similarities*, there are important conceptual and nuanced *differences* where it is used in the different systems.

Those similarities can shade the significance of the differences – causing confusion and sometimes error.

(e) In common law countries, subrogation can be seen as both a principle of law as well as a principle in equity. The legal and equitable use of the concepts are often very similar, until it is recognised that they aren't. If the difference matters, by the time it is realised, in most cases, there is a problem.

In the UK, for example, subrogation is often viewed as an *equitable* principle. However, that is not always the case. In Australia, for example, another common law system based originally on English law, subrogation has been clearly recognised as a concept in *both law and in equity*.

Again, in many, perhaps most, cases that difference is not important, until a circumstance arises where it is! And if the difference is important, that usually signals that there is a real problem.

Further still, even in countries where subrogation has been recognised as a principle of law, in practice, it can have equitable aspects.

(f) Subrogation often arises in the context of insolvency, as well as in questions of financing and securities. In those instances, the focus of the subrogation concept can be quite different to its use in the insurance context.

(g) In practice, the operation and effect of subrogation rights are very similar to *other concepts* – both legal and otherwise. Some of these are listed below.

Some of these concepts have a very similar operation to subrogation. Some of these operate *independently* to subrogation. Some emerge as an alternative to subrogation. And sometimes, these emerge in conjunction with subrogation rights. The whole thing can be difficult for non-lawyers to follow.

The term 'subrogation' is sometimes used broadly, and imprecisely, to refer to these concepts generically, giving the term 'subrogation' the character of legal jargon. This use can sometimes confuse more than it enlightens.

Again, in practice, these distinctions don't matter – until, all of a sudden they do.

(h) For lawyers, subrogation can be tricky because the rights and obligations that are 'created' or involved can be spontaneous, and can change in character from time to time. They often do not resemble other kinds of rights that legal analysists are used to recognising.

8. Some of the complexity around the concept of subrogation arise from these varied circumstances in which it is used. Sometimes aspects of the subrogation concept, despite the simple conceptual explanation advanced above, can give rise to an unnecessary complexity.

9. Sometimes recognising and exercising subrogation rights in precise terms can be complicated, complex, and nuanced. It is an issue that should be approached with respect and with care. Sometimes the problem emerges with the temptation to unnecessarily complicate the simple. Mistakes can be easily made.

10. Despite that complexity, the subrogation concept can be usefully and practically used and managed. It simply takes information and care. Legal advice can help, provided such advice is carefully given and used in an informed manner.

11. Once the issue is correctly identified in the particular case, and the principles are broken down and understood, and distinguished from other commercial or legal issues, then it can be digested by most experienced business people. It is not necessarily a doddle, but it does not require genius level intellect either.

12. Again, in most cases, the more esoteric aspects of the subrogation concept are not important. However, it is not 'most cases' that keep you up at night!

What are the concepts that are similar to subrogation, but that can cause confusion?

13. The similar concepts referred to above extend, without limitation, to:

(a) Assignment & novation of rights (and of contracts);

(b) Agency, the law of attorneys, licenses, and authorities;

(c) Trusts – formal and informal[4]

[4] Such as 'Quistclose' trusts (see *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567,

(d) *Dominus litis* – the principle identifying the person with substantive control of a party's interests in legal proceedings;

(e) Litigation clauses – provisions often found in insurance policies and similar documents that are *similar* to a contractual *dominus litis*, providing one party effectively 'control' of litigation.

14. In most cases, the differences between these concepts and subrogation, and between these concepts and each other, can be seen as esoteric and technical. In many cases, the term 'subrogation' is used without too much regard for the differences. However, in some circumstances, and in some countries, those differences can be important.

15. An instance where these differences can be important is where rights and obligations arise in the context of commercial contracts, and where the applicable legal system restricts the capacity to convey, to assign, or to novate legal rights and obligations. An example of this is the inability to 'transfer' or to 'assign' so called bare rights, such as some causes of action in tort. In those circumstances, subrogation can be used to achieve the same effect as a desired transfer. However, in such a case, it is not a 'transfer' or assignment, and the difference can be significant.

Subrogation in Insurance

16. In the insurance context, the term 'subrogation' refers to three kinds of right/activity.

(a) In the context of indemnity policies, usually professional indemnity policies, subrogation describes the situation where the insurer takes over and conducts the defence of the claims brought against the insured professional.

(b) In almost all insurance contracts, where a claim has been made and honoured, subrogation describes the 'right' to compel the insurer to bring proceedings against third parties in the name of the insured.[5]

(c) In that latter context, it also describes the insurer's right to compel the insured to give to the insurer certain benefits that it has already received with respect to the loss that was subject of the insurance claim.

17. The international nature of insurance means that it is often necessary to be aware of the differences and distinctions between the subrogation concept as understood in different

[1968] UKHL 4), resulting trusts, constructive trusts & remedial constructive trusts.

[5] *Dane v Mortgage Insurance Corp Ltd* [1894] 1 QB 54

countries, different legal regimes, and ultimately in the context of different contracts applying different laws.

18. In broad terms, subrogation can be said to operate both *positively* and *negatively*.

19. Negatively where policy requires the insurer to adopt the obligation to defend and to protect the insured. Positively, where the insurer takes over the rights the insured has against third parties – where it exercises those rights in order to minimise or offset the outlays involved in providing the indemnity.

20. What I have called the 'negative' aspect of subrogation is probably the best known and the simplest. In that case, subrogation is simply the promised activity subject of the insurance contract.

The 'positive' aspect to Subrogation?

21. What I have called the 'positive' aspect of subrogation is less well known and understood but can be the most intriguing.

22. The right to bring proceedings in the insured's name is, in strictly legal terms, a strange one. It is the epitome of the distinction between a 'legal' personality and an actual one. Where an insurer takes over the insured's rights and brings proceedings, it uses the insured's name and legal personality for, essentially, its own purposes. In bringing the proceedings the insurer usually is exercising the *dominus litis*, the right to bring proceedings.

23. The insurer decides what proceedings to bring, what causes of allegation to press and what allegations to make. It appoints its own lawyers and largely takes its own counsel as to how the case should be brought and run. It usually must rely upon contractual provisions in order to compel the actual cooperation of the insured and its personnel, and in most cases must provide the insured with an indemnity for potential costs orders. There is some debate as to how that indemnity might stand up in the case of challenge.

24. Unlike the case of assignment, the subrogated rights being sued upon remain the insured's. The ambit of those rights are widely interpreted (and can extend to advantages that are, strictly speaking, not always legally recognised rights or property interests). Subrogated rights can involve claims against strangers to the claim against the insured, those rights can extend to all causes of action that might be available, as against anyone

– provided there is a sufficient link to the cause subject of the claim pressed against the insured.

25. For example, an insured builder might be sued for breach of contract and may make a claim on an indemnity insurance. However, the subrogating insurer is not limited by that claim. In order to rationalise the indemnity provided by the policy, that insurer might sue others: subcontractors, suppliers, trades, consultants and the like for conduct involved in the builder's breach. Those claims might be in contract, tort, statutory causes, restitution or other conceivable bases of claim. A subrogating insurer can even use the insured's rights to make claims upon *other* insurance that the insured might hold.

26. Because the subrogated rights were, and remain, the insured's rights, they are subject to the same conditions and limitations that would accompany those rights if they were being exercised by the insured. Those rights can be adversely affected by: the expired and running limitations periods, estoppel and the operation of equity on the insured's conduct, set-off, contractual provisions and requirements (including dispute resolution provisions and contractual notice requirements) and the like.

27. However, the point is that in many instances, the insured looks as the insurance cover and the first, and often the last, port of call. Whether for commercial, financial, or a range of other reasons, when an insured makes a claim on the insurance, there is a temptation not to think about, much less to fund, the exercise of other rights / entitlements against other people. Particularly where pursuing a third party is thought to be more expensive, complicated, or involved than simply claiming on the insurance.

28. In practice however, those 'other' rights / claims against third parties can be very important and valuable to the overall net liability – of the insured, that is, by claiming on the policy, effectively transferred to the insurer. In some instances, they can give rise to a substantial reduction of the net payout, and in some instances, eliminate a net payout completely.

29. For all this, one of the reasons that the insured relies on the claim rather than the exercise of these rights against third parties is that they involve more risk, expense, and inconvenience than making the insurance claim. In most instances, subrogated claims have a commercial/legal/practical complexity to them – which is why the insured made the claim.

30. However, the specialisation and resources available to an insurer can mean that it has advantages of the economies of scale, and the range of technical / legal / financial resources that the insured does not have access to. Those resources and advantages

may make the range of third party recoveries commercially feasible for the insurer where they are not feasible for the insured. Even where the rights are literally identical – as between the insured and the insurer – in practical terms, the net commercial position of each in regard to such claims can be **very** different.

So, why is subrogation often neglected – if it can have so many benefits?

31. There are financial, legal, and importantly, psychological hurdles, for the insurer as well as for the insured, to exercising subrogation rights on a difficult claim.

32. One of the principal challenges to subrogated recovery is the question of evidence. It is common only to think about subrogation after a claim has been made and resolved, which sometimes involves litigation between the insurer and the insured. By that time, it can be difficult to go back and source evidence to maintain the same allegations. And sometimes it is difficult then to uphold a series of contentions that those in the insurer's camp have been busy demolishing.

33. Often, by the time the claim is settled, paid and the time for subrogation comes about, the parties are exhausted and too much time and damage has been done to the case for 3rd party recovery. Insurers, wary of expensive and extensive litigation, often become shy of risk in subrogated claims. The effluxion of time and the contest over evidence often gives subrogated action the perception of a higher degree of risk than is otherwise the case.

34. This poor management of a subrogation portfolio of claims necessarily means that recoveries are undervalued, and more of the particular portfolio is viewed as a net outlay – a loss or cost centre in management speak.

35. However, this need not be the case. There <u>are</u> strategies that can be followed to enhance the value of a subrogated recovery book. These include:

    (a) Including 'litigation clauses' in insurance policies, allowing an insurer to take timely action to preserve a subrogated claim even before the claim is resolved. Some policies allow the insurer to institute subrogated 3rd party litigation on receipt of the claim – to be handed over if the claim is rejected.

    (b) Having a separate, specialised, dedicated team within the claims management structure to objectively consider and evaluate potential future subrogation action, with the ability to 'flag' such claims at an early part of the claims stage, and to document evidence etc for later retrieval.

(c) Facilitating the insured in bringing 3rd party claims, to offset the extent of payout on the insurance claim.

36. The advantage of having a team dealing with *future* subrogation possibilities - that is dedicated, resourced, and importantly that is separate to those dealing with claims is significant, but not always so obvious.

37. What I sometimes call *claim fatigue* - for those dealing with claims, including litigating claims, is a complicated and important concept in the overall management of an insurance product. Often those managing claims, and legal advisors acting to resist such claims, can develop a hostility to the whole idea of positively embracing and utilising the insured's rights. It is hard to embrace the merits and entitlements of someone against whom the claims team is in the process of undertaking, or has just undertaken, a vigorous and sometimes vicious, attack.

38. The separate subrogation team should not be seen as expressing doubt in the competence of the team defending the claim. Rather, it recognises that that specific involvement can blunt the objectivity of the best and most balanced litigators. Advancing third party claims for an insured that is being resisted involves a duality that lends itself to internal conflict.

39. It is the same reason that 'only a fool has itself as a client' – because of the loss of objectivity between client and lawyer. And why it is advantageous to take an independent second opinion on certain questions. Any person's 'investment' in a complicated contest can make it difficult to see a wider picture, and lead some opportunities (involving diametrically different consideration of issues) to be missed or inappropriately devalued.

40. The separateness and specialisation means that the questions of a future subrogation do not become a distraction to the team contesting the claim. Thus, the claims team can focus on their task, leaving the subrogation team to focus on theirs.

41. If the kinds of inquiry involved in identifying, evaluating and taking steps to preserve third party subrogation rights, are made by a separate part of the insurer's apparatus, one might expect a more energetic provision of cooperation and information from the insured than is the case after all the dust raised by a contested insurance claim has settled.

42. The distinct teams can, and should, have provision to share information and to co-operate. It does not have to be a *Chinese wall*. The whole idea is efficiency and effectiveness.

43. Subrogation can involve bringing separate third-party claims, cross-claims, as well as rights of set-off and contribution. It calls for care and a degree of sophistication, as identifying and pursuing avenues of third-party recovery can require imagination, proactive consideration of circumstances, and awareness of some less frequently raised legal principles and claims.

44. These kinds of steps can mean that more of the subrogated recovery rights can be exercised, giving a greater offset to the ultimate claim payout. The subrogated action can be taken earlier (or at least in a more timely way, allowing less waste of valuable rights being caused by the expiry of limitations) and in a more satisfactory way.

45. This kind of management of subrogated claims (or *future* subrogated claims) mean that the insurer can afford to take a more objective, less pessimistic approach to litigation risk in subrogated claims – effectively increasing the chances of recovery of a substantial figure.

46. It can also contribute to a reduction of overall insurance payout per claim, by facilitating recovery by the insured in circumstances in which it might not otherwise be capable of doing so. In short, less of the insured payout becomes dead money for the insurer and its underwriters.

47. Further, one might expect less recklessness about those of the insured's third-party rights that might be available for subrogation. With more awareness by those involved, a more reasoned, measured approach to those issues can be expected.

48. The careful, proactive management of subrogation rights and obligations is a prudent, commercially advantageous and profitable exercise to take in the course of managing any portfolio of insurance policies. This nuanced and measured approach to the subrogation question arising from current insurance claims is an exercise that, if properly are carefully undertaken, can reduce net payout, increase profitability of that portfolio, and can even be seen to increase insured's satisfaction with the insurance cover provided.

49. Whilst such an approach to the management of subrogation issues will not always or inevitably turn a claim portfolio into a profit centre, the methodical and measured management of subrogation rights can go a long way to reducing the extent of net outlay on a particular insurance product to a respectable extent.

50. Further, whist the immediate parties to an insurance claim may be in dire financial straits, this will not necessarily be the case for the wider range of potential targets of subrogated

claims. This aspect should be of interest not only to insurers, but also to security holders, banks, and financiers.

So, what about the wider social significance to a managed subrogation strategy?

51. On a broader, interests of justice and community satisfaction perspective, a properly and maturely managed strategy for subrogation of claims serves a number of objectives. My shifting the focus from the liability of the insured to the liability of those that contributed to the loss, it generally serves to advance the tie between *responsibility* and *liability*.

52. If managed carefully, early and methodical consideration of subrogation issues can make litigation, both of claims and the subrogated claims, more efficient, faster, and most cost effective. From the professional indemnity insurance perspective, it can lend itself to a desirable commercial objectivity into the process of claims against professionals, as well as the recovery of the professional's claims against third parties.

53. From the community's perspective, in very broad terms, if they are carefully managed, use the recognition and exercise of principles of subrogation can provide cost saving and efficiency, and contribute to the broader availability of justice.

54. The defence of insured professionals, for example, by experienced, objective, and appropriately resourced insurers can mean that litigated claims are dealt with by suitably experienced, specialised professionals – presumably making them both quicker and cheaper to run, and providing an objective commercial approach to the conduct and importantly the compromise and settlement of such claims.

55. Aside from the purely financial / commercial aspects, from a public relations perspective, and in relation to brand enhancement as well as industry lobbying efforts, there are marked gains for insurers in adopting a mature, proactive, and positive strategy for managing the subrogation entitlements that flow with receiving and dealing with an insurance claim.

Summary

56. Subrogation is an important feature of commercial activity. It is best known in relation to insurance, but also features in a wide range of other transactions. It is this breadth of application that can give rise to a quite unnecessary perception of complexity and difficulty with the concept.

57. For insurers, it is important to properly manage and value the various, and sometimes contradictory obligations and entitlements that arise in the operating a particular insurance product. In a claims context, it is best to recognise the net outlay aspects of a claim as well as those rights that, by subrogation, can offset the net financial effect of such an outlay. It is both claim evaluation and the accurate evaluation of the subrogation rights that accompany indemnity for a claim that gives the net financial position of any particular claim, and any particular insurance product portfolio as a whole.

58. However, in practice, since insurance products are operated by people, the arguments raised in an insurer's defence of a claim can, in practice, taint, sometimes subtly and unexpectedly, the perception of the value and availability of subrogated claims. This can mean that some aspects of the overall economic impact of a claim can be overlooked, needlessly lost, or underestimated.

59. In most cases, the necessary evidence and information underpinning subrogation rights lay with the insured, who at the critical time may be in a vigorous contest as to entitlement to indemnity, with the claims team. In practice, an insured, whilst subject to attack by the insurer's claims team, may not have the capacity or the awareness to advance.

60. In broad portfolio terms, a well-managed subrogation strategy helps to realise the real value of insurance outlay by vigorously advancing offsetting claims.

61. That being said, subrogation can involve some complicated, nuanced, and 'tricky' elements. It is not a particularly difficult concept, but it is not ridiculously easy either. Exercising subrogation calls for awareness, care, and respect. If successfully managed, it can bring about satisfaction in various different aspects of liability management.

62. Business people who can successfully recognise and manage subrogation rights and responsibilities will not only have the satisfaction of dealing with an otherwise obscure concept, but also will be better equipped to effectively manage, deal with, contract and negotiate with both assets and liabilities.

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