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BRIEFING

Principles of subrogation: pay up, recover down

Principle of subrogation

The rule of subrogation provides insurers with the right, once they have paid out the insurance monies due under an indemnity policy, to “step into the shoes” of the insured and to exercise any rights or remedies which arise out of the insured event, with a view to recouping all or some of their money from a culpable third party. Such a right is often expressly contained within the policy wording, but is also conferred through common law principles.

Insurers cannot step into the shoes of the insured until the insured has been fully indemnified, unless the parties agree otherwise. That being said, insurance policies often contain an express condition permitting insurers to commence a subrogated claim in the insured’s name, even if negotiations over indemnification have not yet been concluded.

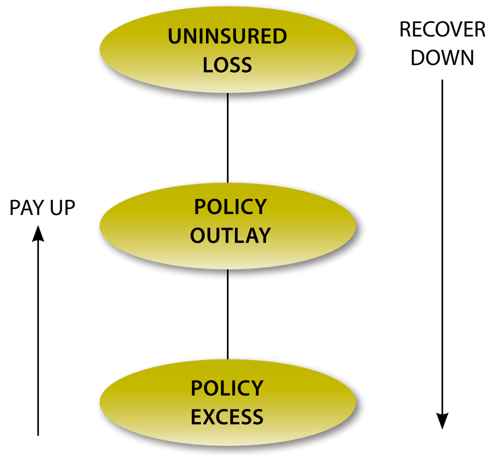
Although insurers must agree to indemnify the insured in respect of any costs associated with bringing a subrogated claim, policies will often contain an express term giving insurers the right to control any proceedings which are brought against a third party.

Insurers can, of course, only pursue actions against a third party who could have been pursued by the insured himself and are only able to recover up to the level initially paid out.

Distribution of monies recovered

The relevant principles dealing with the distribution of monies recovered by way of subrogation were laid down in *Napier and Ettrick (Lord) v R F Kershaw Ltd and Others* [1993] 1 All ER 385.

This case set out what is known as the **“pay up and recover down model”**, with the overriding principle being that the insured shall be fully indemnified before the insurer is entitled to be paid anything.



Pay Up and Recover Down Model

The monies recovered by way of a subrogated claim are therefore applied so that the insured recovers its uninsured losses (excluding the excess) first. Insurers are then entitled to recover the full extent of the indemnity paid out, with any funds remaining going towards the insured’s excess.

Policies subject to average

Average will be applied where there is underinsurance. Where a policy is subject to average, the insured’s claim is reduced in direct proportion to the level of underinsurance under the policy. Insurers and the insured will be deemed to be co-insurers of the loss and any subrogated recovery will be apportioned between them on a pro-rata basis.

Valued policies

The position is different in respect of valued policies. A valued policy is one which specifies the agreed value of the subject matter insured, and the extent of the indemnity provided is dependent upon that value.

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In such cases, the principle from Napier will not apply. The reason is simply that, by virtue of *section 27(3) of the Marine Insurance Act 1906*, the valuation agreed between insurers and the insured is conclusive (save for in instances of fraud). The insured is therefore deemed to be fully indemnified only when he receives payment of the agreed value.

Underinsured and uninsured losses

It often occurs that a large insured loss will also result in a significant uninsured (as opposed to underinsured) loss. For example, when a loss covered under a policy of property insurance also results in an uninsured loss of rental income.

When this happens, disputes can arise between the Insured and the Insurer as to which of them has conduct of the action. In the absence of any specific policy provision, the general rule is that the parties are entitled to separate representation to protect their interests, although the Court will not permit two sets of solicitors to appear on the record, and is even less likely to allow the Claimant to recover two sets of solicitors' costs.

In practice the party with the larger loss will usually take the lead in the action.

In circumstances where there is a mixture of insured and uninsured losses, and the Insurer has conduct of the action, the Insurer will usually pay for the costs of advancing the subrogated claim, but will require a contribution to the legal costs associated with the claim for the uninsured losses.

In such cases it is important to agree early on how any recovery will be distributed. This is because a global settlement offer which does not apportion the settlement sum between individual heads of claim can cause tension between Insured and Insurer, especially when certain heads of claim are perceived to be more speculative than others.

Invariably the Insurer will argue that the balance of the recovery should go to the easily provable material damage claim, say, and not to the more abstract claim for consequential losses. A prior agreement will avoid these disputes and assist in the sensible appraisal of settlement offers.

Contact Details

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