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Subrogation Pitfalls – Navigating the Difficult Insured

I. Introduction

This presentation focuses on recognizing and preventing several potential problems that may arise in subrogation matters, particularly those involving a difficult or uncooperative insured. The presentation will include a discussion of common issues and examples from the perspective of in-house adjusters, independent adjusters, and attorneys and will examine ways to recognize, handle, and/or avoid the issues that can destroy or negatively impact a subrogation claim.

II. Subrogation Basics

A. Definition of Subrogation

Subrogation is the legal and equitable doctrine by which an insurance carrier that has indemnified its insured from a loss caused by a third-party is empowered to prosecute a derivative claim against the responsible third-party to recover the indemnity payment the insurance company has made to its insured. The concept of subrogation is frequently described as the doctrine which permits the insurance carrier to "step into the shoes" of its insured and, in so doing, acquire all legal and equitable rights, claims, and causes of action against responsible third-parties for the insured's loss.

Subrogation has its origins in the concept of indemnity, which allows the insured to be made-whole on the basis of having coverage for the loss from the insurer, but also limiting the insured to one recovery for any particular loss. Subrogation also supports the basic idea that a wrong-doer should be held accountable for the damages it causes and allows the paying entity, the insurer, to recover where it has made payments. Subrogation, like other aspects of insurance and evaluating risk, plays an important role in an insurer's ability to underwrite risk and offset its losses, which is ultimately a benefit to its insured.

The laws impacting subrogation vary from state to state. This presentation is not intended to be specific to any state, but instead to provide an overview of potential pitfalls that may arise in the subrogation context. Most of the presentation will also require some assumptions that the loss is covered and that subrogation is not eliminated by a waiver or issue involving a co-insured or other anti-subrogation concepts.

B. Types of Subrogation

Subrogation is generally divided into two basic forms: 1) legal or equitable subrogation and 2) conventional subrogation, otherwise known as contractual subrogation. Equitable subrogation is based on the concept that when an insurer pays its insured for a covered loss, i.e. fulfills its obligation to the insured under the insurance policy by paying for a loss caused by a third-party, it should be allowed to step into the shoes of the insured and recover from the responsible party. Conventional subrogation arises from the express terms of the insurance policy, granting the insurer the contractual right to step into its insured's shoes in order to recover from the third party who caused the covered loss. Both types of subrogation arise out of payments made by an insurer and are limited to the amounts of those payments.

C. Striking a Balance between Recovery and Obligations to the Insured

While this presentation focuses on the insurer's recovery efforts, in the face of a difficult insured, the reality is that subrogation is most likely a secondary concern behind the insurer's obligation to meet its duties and obligations to the insured. Subrogation efforts must be balanced with meeting these obligations and cannot ignore the primary purpose of the insurance, which is to protect the insured from covered losses. While most policies will contractually require cooperation, some states may also impose a duty of good faith and fair dealing on the insurer and there is a significant body of law regulating the actions of the insurer. Common sense and good business practice will almost always dictate that recovery efforts must take a backseat to meeting the insurer's obligations, especially in the face of potentially devastating bad faith actions by the insured.

The common theme in this presentation is proper communication and efforts to encourage and obtain the insured's cooperation. The underlying message is that the insurer is much better off when the insured cooperates willingly. Forced cooperation requires difficult decisions, is not evenly supported by the law in favor of the insurer, and may subject the insurer to greater liability than the possible recovery in subrogation. However, the insurer is not without rights. Other related obligations in the insurance policy, including prompt notice, providing factual information, sworn proofs of loss, and other policy requirements provide tools to gain the insured's cooperation in recovery efforts. When used wisely, the notice, investigation, and informative duties of the insured can be effectively used to support subrogation.

III. Subrogation Pitfalls

A. Preservation of Evidence/Protecting Claim

Preservation of evidence, the first major hurdle faced in a subrogation claim, requires the immediate and thoughtful cooperation of the insured. It is for this reason that efforts should be made to educate and obtain cooperation from the insured from the first notice of the claim. At this early stage the insured is in a position to both provide critical information and to preserve evidence that might otherwise be destroyed or thrown out during the repair/adjustment process. This is especially true in situations where the potential cause of a loss will require expert

inspection and/or investigations by representatives of third-parties. The insurer is often at the mercy of the insured that is in possession and control of the property to preserve all relevant evidence for future inspection and investigation. An insured who is unaware or ill-informed about the subrogation process and/or its obligations to cooperate is a subrogation claim's worst enemy and the first major pitfall that can destroy subrogation before it starts. While the obligation is ultimately on the insured to preserve evidence, it is the insurer's representatives, vendors, and attorneys who must take necessary steps to educate the insured on the process and the necessity of security evidence.

The insurer's representative, most likely an adjuster, is generally concerned with determining whether the loss is covered under the policy and ascertaining the extent of the loss. However, as the initial point of contact, an educated adjuster who considers the subrogation potential of a loss can have an immediate impact on avoiding destroyed evidence. Because this representative likely will have the first opportunity to educate the insured about the process and obtain its cooperation, the insurer's representative should be able explain the insured's obligations under the policy and secure the insured's cooperation for both preserving evidence and supporting future subrogation efforts. Time is of the essence. Again, gaining the insured's cooperation may be as simple as notifying the insured about the potential for subrogation, explaining the policy obligations, and communicating the importance of preserving evidence so that a proper investigation can be completed. Most of this cooperation runs parallel to the insured's obligation to provide information about the loss. Cooperation may be further secured by explaining the potential benefits of participating in the subrogation process, including recovery of deductibles or to pursue uninsured losses, if any. Early education may also communicate to the insured that the adjustment and recovery process are a collaborative effort and places the insured in a position of trust with the insurer and its representatives.

A more difficult or less cooperative insured may require additional motivation to preserve evidence. If educating the insured of its obligation and potential benefit is not sufficient to obtain the insured's cooperation, the insurer may send a sterner message to the insured regarding the potential legal consequences should the insured fail to meet its obligation under the policy. However, such efforts must be balanced with the duties of the insurer to use good faith in investigating and responding to the insured's covered claim. Again, some states may support that an insured has a reciprocal duty of good faith and fair dealing which may strengthen the insurer's position. In other states, providing written notice of obligations and seeking the insured's acknowledgment of those obligation, may be a necessary step to further encourage cooperation. Whether difficult or uneducated, the eager or careless insured is a major pitfall that can destroy subrogation potential before it begins.

Another important aspect of cooperation from the insured will be to make the property available for inspection and investigation. This is another area where the insured's obligation for the coverage/adjustment aspects of the claim may further support any contractual obligation the insured has to support subrogation. An insured that is unwilling to participate in the scheduling process or to make the loss site available for inspection risks violating non-recovery based obligation that can ultimately result in the insurer denying, delaying, or limiting the insured's claim. Failing to identify or secure information from important witnesses is a surefire way of missing critical information that could make or break the future subrogation claim. Again, the

insurer should provide the insured with information regarding the process as it relates to recovery in a potential subrogation claim. Costly delays caused by a disinterested or unorganized insured may prevent the necessary investigation or deny other parties the opportunity to complete investigation into potential claims, impacting subrogation. It also impacts the adjustment process, which may be the more important aspect of the claim to the insured. An educated insured who understands its obligations and the potential benefit of cooperation to both the adjustment and recovery sides of its claim are much more likely to participate. Again, the adjuster who is in contact with the insured, whether independent or otherwise, plays an important dual role in the adjustment and subrogation process, both of which have a major impact on the success of each side of the claim. In this presentation we will provide helpful practices to streamline the process and some adjustment actions that will ultimately benefit subrogation.

B. Prosecuting Claim/Litigation with an Uncooperative, Adversarial, Questionable Insured

Impacts on Litigation

Beyond the initial investigation and securing of evidence, additional pitfalls arise when an uninterested, uncooperative, or adversarial insured is reluctant or unwilling to participate and/or support litigation efforts. The insured is a required participant in supporting any claim against a liable third-party. Without the insured's participation, litigation will be difficult and will likely fail. The insured ultimately controls the means for supporting the insurer's case. If the insurer is unable to gain the insured's cooperation, subrogation may not be worth the pursuit.

Identifying and Addressing Points of Contention

Avoiding this pitfall may be as simple as early identification and resolution of potential points of contention before litigation commences. A common issue arises when the insured has either a personal or business relationship with the subrogation target. This situation can be difficult as it often creates a conflict between the insured wanting to meet its contractual obligations and its equal desire to protect a friend or business partner. Again, education can be the best tool for mitigating this potential issue. Concerns can frequently be eliminated by simply explaining the concept of subrogation, including the likelihood of the exchange of money between insurers who have accepted premiums for different risks. Putting an insured at ease regarding the potential ramifications to the target by explaining the business of insurance may entice a reluctant insured to participate in recovery efforts despite a personal connection. The insured's cooperation can also be bolstered by their own interests, especially where they may benefit from subrogation.

Using Policy Language and the Insured's Other Obligations to Gain Cooperation

If cooperation cannot be obtained through education or other encouragements, all is not lost. Unlike the issue of evidence preservation where the insurer has very little ability to force the insured's hand, litigation provides protection through the enforcement of the insured's obligations to cooperate via subpoena power. While not ideal, a subpoena to the insured allows the insurer,

at the very least, to obtain necessary documentation and depositions that will support recovery efforts. The subpoena power is also another means of educating the insured and obtaining cooperation because there is a legal obligation to cooperate.

Filing Suit in the Name of the Insurer

In some instances the insured may not be the best face for subrogation efforts. Those situations can create another pitfall if the subrogation is not distanced from an undesirable insured. This situation may arise when an insured does not wish to have suit filed in his name, but also when the insured may do damage to the potential claim. One means of creating distance includes filing suit in the name of the insurance company. Filing suit in the name of the insurer may alleviate some of the difficulty created by an insured with connections to the third-parties. It may also provide a safe distance from an undesirable insured. It is important to know the jurisdictional requirements on this issue, as some rules limit the insurer's ability to file suit in the insured's name.

C. Subrogating While the First Party Claim is Being Contested

It is always difficult when the insured and the first party property carrier do not agree on the scope or the amount of damages recoverable in the first party property insurance claim. Litigation, including bad faith claims, may result. This may limit or eliminate the cooperation otherwise available from the first party insured. It may also make access to information difficult, if not impossible. Conflicts abound, particularly with respect to the quantification of the recoverable damages and what factors must be considered in deciding at what point the insured is to be made whole.

Avoid Bad Faith Claims

The prosecution of a subrogation case while the first party property claim is being litigated is fraught with danger. Mistakes can result in foreclosing or limiting the first party property insured's recoverability of damages. A bad faith claim can be added for actions and omissions allegedly occurring during the subrogation case. Extreme care should be taken in the handling of evidence to avoid spoliation, in the evaluation and presentation of damages, to avoid conflicts with the evaluation of damages in the first party claim, and with respect to the direction and control of the litigation.

The Requirement of Separate Representation

There is no hard and fast rule on this issue. However, if the relationship between the first party property carrier and its insured is contentious then separate representation is better for both parties. Experience has shown that counsel will be able to accomplish a greater level of cooperation than if the parties remain unrepresented.

D. Other Valuation/Adjustment Issues

One of the more difficult scenarios in subrogation arises from unsubstantiated or unsupported damage claims by the insured. Not only does this scenario have the potential to impact the subrogation claim by damaging the overall credibility of the damages in a suit, it may also impact recoverability because of limited coverage or a requirement that the insured be made whole before any subrogation recovery can be made. In some situations it may, again, be about setting and managing expectations throughout the process. The adjuster will play a huge role in securing proper valuations and accounting of both insured and uninsured losses. An independent adjuster may need to hire experts to provide additional damage analysis. Again, a balance has to be struck between the insurer's obligations and supporting potential subrogation efforts. A well-documented and supportable adjustment is the best protection against an insured's unrealistic damage claims.

The Insured Should be Invested in the Outcome

Having an insured with an uninsured loss is not a bad thing. The insured has a stake in the successful outcome of the subrogation case. They are usually more willing to cooperate, attend depositions and hearings, and provide documentation and information in support of the subrogation claim. It is good if the insured has skin in the game. The goal in this situation is to avoid exacerbation of the relationship during the course of settlement negotiations, so it is preferable if the insured and the carrier can enter into a written pro rata agreement in an effort to avoid conflicts and disputes during the settlement phase of the subrogation case.

Made Whole Rules

Some states require the insured to be made whole before the subrogated property insurance carrier may make a recovery. These rules can also affect the standing of the subrogated insured carrier. This is a complicated issue.

The question of whether an insured has been "made whole" makes reference to comparing the amount of money recovered from the insurance carrier against the amount of money the insured would be able to recover in a claim against a responsible third party. Different measures of damage may apply and the insured may be suing for injuries or damage to person or property which may not be insured in the first place. The applicable state law will have to be researched to identify specific requirements in the event the insured makes a claim for uninsured losses and to guide the carrier's conduct prosecuting the claim in a situation where the insured is claiming that they have not been made whole.

IV. Key Steps to Prevent or Avoid the Pitfalls

A. Initial Contact

Again, the initial contact with the insured is the first opportunity to gain cooperation and avoid some of the above pitfalls. This is the first opportunity to educate the insured, communicate obligations, and manage the insured's expectations. It is also an opportunity to identify whether the insured may have a vested interest in the recovery that could bolster their willingness to cooperate. Building rapport and selling the benefits of subrogation will go a long

way toward securing the insured's quality and active cooperation in the subrogation process. The initial contact is the first opportunity to set objectives for subrogation and to communicate what the insured may be required to provide.

B. Sell the Benefits of Subrogation

Gaining the insured's cooperation and participation may simply be about selling the benefits of subrogation. From a practical standpoint, it is about holding the responsible party accountable. It is also part of the insurance underwriting/adjustment process which plays a critical role in reducing losses for the paying carrier or spreading liability to other carriers who have responsibility for the payment of damages suffered by an insured. In addition to the potential direct monetary benefits, the insured will likely benefit from an improvement on its loss history or less impact on its future ratings which will reduce the insured's loss experience and provide favorable underwriting and rate changes in the future.

C. Joint Prosecution Agreements

It is always helpful to employ written Joint Prosecution Agreements for parties with several plaintiffs, all of whom have suffered losses arising from an event. An important point to consider in the Joint Prosecution Agreement is the express acknowledgement that confidential information will be exchanged and that such information will remain privileged. It must be the intent of the signing parties to maintain common interest privileges. If the parties can agree on a pro rata share of expenses and recoveries, all the better. This may be difficult if a defendant is impecunious or if the insured's limits of liability insurance are insufficient to make everyone whole. The unavailability of insurance or assets to satisfy all claims may make some parties reluctant to enter into Joint Prosecution Agreements. In that case, it is simply a rush to judgment and execution.

A more reasonable approach may be for the parties to enter into a Joint Prosecution Agreement in which the parties agree to share equitably on a pro rata basis the prosecution expenses of a third party claim and any recoveries made therein.

D. Communicate & Educate

Again, most of the pitfalls discussed above can be addressed through active communication with the insured to educate them about subrogation, their obligations, and the many ways it potentially benefits them.