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Providing Loss Consulting Services to the Insured

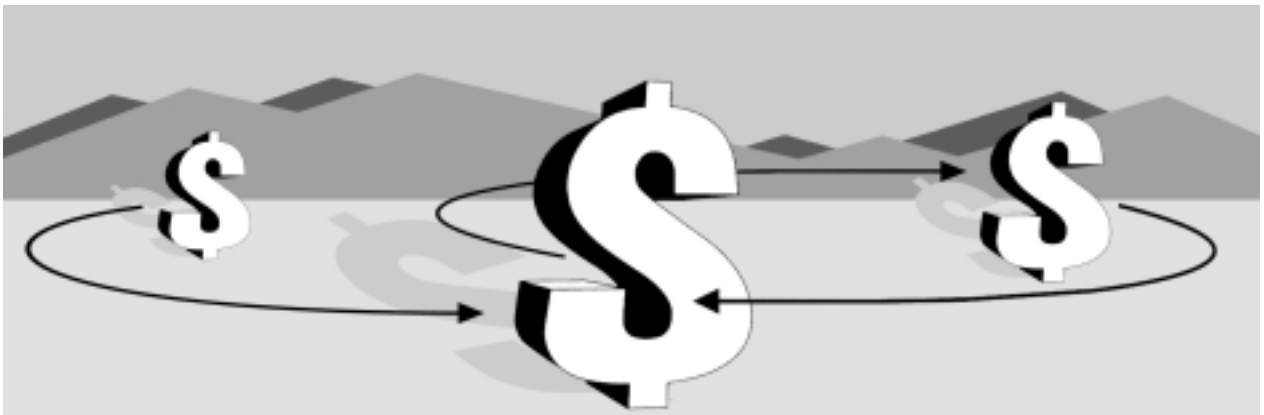
Editor's Note:

As claims adjusting becomes a more sophisticated process, agents and brokers around the world are being challenged to respond to new complexities.

This issue of *Adjusting Today* examines subrogation, and how your knowledge of this procedure can be critical to your clients' welfare.

It also outlines three common (but very different) approaches to subrogation, as well as trends.

We think you'll find this issue interesting and helpful.



Subrogation: Put Your Knowledge to Work for the Client!

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Sub-ro-ga-tion.

The very sound of the word, let alone the principle behind it, can be frightening to those unfamiliar with legal and insurance jargon.

Most agents and brokers have a fundamental understanding of the process, and would agree that such an understanding is essential to their own professional practice. But many of them are less cognizant of the tremendous benefit their knowledge can have for a client who suffers a loss — especially if that loss is partially insured. In the comments that follow, allow me to suggest some ways in which a broker can put his or her knowledge to work for an insured — to not only provide for the client's security, but to enhance the broker-client relationship as well.

A Definition

Because the insured can be significantly affected by the subrogation process, they, too, must have a basic

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understanding of it. So let's start there.

Taken from the dictionary, subrogation is defined as "the substitution of one person (or party) for another." Going a step further, in an insurance sense, three parties will be involved: the insured, who has suffered a loss; the insurer, who has compensated the insured for all or part of their loss; and the tortfeasor, or party who is allegedly responsible for the damages, through negligence. The definition comes alive in the following scenario:

Let's say a manufacturing company hires a contracting firm to renovate its production plant. The repairs require extensive welding, during which sparks fly, igniting nearby materials and setting off a fire that destroys a major portion of the plant. As the insured, the manufacturing firm is compensated for their losses by their insurance company. Under subrogation, the insurance company assumes the right of the manufacturer to sue the contractor — the tortfeasor — to the extent of the damages for which it has reimbursed the insured. The manufacturer also has the right to sue the contractor for any damages not covered by their insurance, which might be substantial if the firm was partially insured.

Agent/Broker's Knowledge is Critical!

As I indicated earlier, despite their knowledge of the subject, agents and brokers often lose sight of how important their understanding of subrogation can be to a client following a loss.

Insureds should be aware of the fact that it is a general tenant of tort law that an injured party can, if willing, bring an action for damages against a third party. Therefore, as an injured party, the insured who has suffered a loss is entitled to bring such an action. This recourse can be critical to full restoration when a loss is partially insured. Obviously, a client in any of these situations has a strong interest in examining the opportunity for a tort claim against the responsible party!

Along the same line, one of the most crucial aspects of an insurer's investigation immediately after a loss is determining cause and origin. Without such an investigation it might be impossible to determine whether a third party tortfeasor is responsible for the loss. If the insurer does not undertake such an investigation, it can be critical for the *insured* to do so! This includes hiring the necessary experts, like cause and origin investigators, forensic investigators, etc. Without the agent/broker's guidance the insured would probably not recognize the need to take such action.

Distributing Costs and Proceeds

Once the awareness of a claim possibility exists, the attention shifts to how the costs associated with pursuing the claim will be distributed — and the proceeds from the settlement or judgement, divided.

I should point out that this is not a concern if the client is on their own, without the involvement of an insurer having a right to subrogation; or if the insured has been fully compensated by the insurer and is only seeking the return of their deductible. In the latter case, most insurance companies will agree up front to reimburse the insured for the deductible from the net proceeds recovered in subrogation. In all remaining cases where an insured and insurer pursue a claim against a third party, the distribution of costs and attorney's fees, and the division of proceeds must be addressed at the outset of the subrogation process.

A Different Principle

The underlying principle behind insurance is to *indemnify the insured* against a loss. The principle behind the law of torts — under which subrogation falls — is to *allocate responsibility* for the loss among the parties involved. In an insurance context it means that the insurance company becomes *subrogated* to the rights of the insured, to the extent of the monies it paid to the insured as indemnification for a loss.

This distribution of a loss settlement by the legal system is known as the *doctrine of equitable subrogation*. The law recognizes this doctrine as a means of guarding against *undue enrichment*. A settlement would not be properly allocated if, upon suffering a loss, the insured was able to collect from their insurance company and then through litigation, also collect from a third party. This would amount to a double recovery — or undue enrichment. Most insurance policies contain a subrogation provision that contractually grants the insurer subrogation rights.

Three Approaches

Each state has its own rules of law on subrogation, so it's important to understand how the courts in each will apply the doctrine in practice. Generally speaking, they will address allocation in one of three ways:

1. The insurer is reimbursed first, from the net proceeds, for the full amount of the benefits paid to the insured; the insured is then entitled to any remaining balance. Costs and fees are borne by the insurance company, since often the recovery will not exceed the insurer's share.

2. The recovery is prorated between the insurer and the insured according to the percentage of recovery sought by each party in relation to the total loss. Costs and fees are prorated on the same basis.

3. The insured is reimbursed first, out of the recovery from the third party, for any loss that was not covered by insurance. The insurer is then entitled to be fully reimbursed for its payment to the insured. Anything remaining goes to the insured. Costs and fees are prorated, based on the recovery, unless otherwise agreed to before the litigation begins. The following scenario helps explain the three approaches.

Assume that an insured has a loss for $150,000. The insurance company paid the limits of the policy, which were $100,000. The tortfeasor has no assets other than a liability policy for $75,000, and its carrier is willing to tender the policy limits. Attorneys' fees are $20,000 and costs are $5,000.

Under the first approach, the insurance company would receive $75,000 minus the attorneys' fees and costs — or $50,000. The insured would recover none of their $50,000 uninsured loss.

Under the second approach, the insured and insurer would share the recovery and expenses of litigation as follows: the insurer would pay two-thirds of the expenses, and the insured would pay one-third. (Note: This is important only if the recovery does not exceed the expenses, because these costs will always be paid from the gross recovery before either party shares in recovery.) The insurance company would receive $33,333 (two-thirds of $50,000 [$75,000 minus $25,000]), and the insured would receive $16,667.

Under the third approach, the insured would receive the entire $50,000 of net proceeds. The insurer would have recovered all other proceeds if the tortfeasor had additional assets or a larger policy.

The Trend

Obviously, insurers prefer the first approach, but such is clearly *not* the trend in the courts or in state statutes throughout the United States. Opponents stress that the insured paid a premium to have the benefits of the insurance policy provided, and that in collecting the premium, the insurance company agreed to bear the risk of loss to the extent stipulated in the policy. Theoretically, the premium — property invested — covered this risk. The prevailing feeling today is that allowing the insurer to be paid back before the damaged party is made whole does not properly align the risk of loss and is inconsistent with the principles of equity.

The trend is toward approach number three. The basis for this was set forth in *Couch on Insurance 2d*

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S. 61:20, which said, "Subrogation is an established branch of equitable jurisprudence, and equity requires that the insured be made whole before the insurer's right to subrogation."

Approach number two actually represents a compromise between numbers one and three. The insured gives up some benefits by sharing the costs pro rata with the insurer. It is often the easiest place to start if the insured, who is virtually certain to have their lawyer involved in a subrogation matter, is attempting to negotiate a custom subrogation agreement with the insurer.

Negotiate Ahead of Time!

Of course, since it is impossible to know the circumstance of a loss before it happens, a subrogation agreement cannot be negotiated before the loss takes place. But it should be negotiated before the *final settlement* of the claim; once the insured's losses have been established and the insurer has paid its obligations under the insurance contract. At this stage the insured still has leverage in arranging a pro rata agreement.

Whenever it appears that a third party might be responsible for a loss, the claim should be prepared and adjusted with *subrogation in mind!* This means carefully following all of the steps associated with a thorough proof of loss review, giving particular attention to the cause and origin investigation, how the physical and economic losses are documented, and making sure that actual damages are carefully noted in the final settlement agreement.

An Essential Element

In the final analysis, it is ironic that a subject about which most insureds need to know more is something they would not have to be concerned with at all if insurance programs could be ideally constructed and implemented; that is, so that all aspects of all risks were always fully covered. Then, the insurance settlement alone would bring full restoration.

It goes without saying that the agent/broker deals with the practical rather than the ideal. That means sometimes helping clients cope with risks that are uninsurable — and losses that are intentionally or unintentionally underinsured or uninsured. As emphasized earlier, in these instances, the subrogation process can be critical to the client's recovery — and possible survival. This makes the introduction of subrogation an essential element in the broker-client relationship. It's another important way you can put your knowledge to work for your client!

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