SUBROGATION

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1. Introduction

1.1 The doctrine of subrogation

Subrogation literally means the substitution of one person for another\(^1\). The term is used to refer to the situation where an insurer, who has extended indemnity to an insured under a policy of insurance, becomes entitled to exercise the rights that the insured has against a third party who caused or contributed to the loss sustained by the insured\(^2\). The doctrine is not administered as a legal right, but as a principle that is applied to serve the ends of justice and to do equity\(^3\).

In the insurance context, the doctrine of subrogation is associated with two discreet aspects of the relationship between an insurer and an insured:

1. the doctrine allows the insurer to exercise, in the insured's name, rights that the insured may have against third parties; and

2. the doctrine is associated with the principle that an insurer can claim from an insured any double recovery made by that insured.

An example of the latter situation would be where an insurer indemnifies an insured for the total loss of the insured's house by fire and the insured later recovers damages from a third party who caused the fire. In such circumstances, the insurer would generally be entitled to recover these damages from the insured\(^4\).

The doctrine of subrogation only applies to true indemnity insurance, and is generally not applicable to life insurance\(^5\) or some forms of personal accident insurance\(^6\). This principle was considered in some detail by the Supreme Court of Western Australia (Court of Appeal) in the recent case of Insurance Commission of Western Australia v Kightly\(^7\).

The defendant in this case, Mr Kightly was a member of the Denmark Volunteer Sea Rescue Group (the "Volunteer group") which formed part of the W.A. Police Service. Mr Kightly was unfortunately seriously injured on 30 May 1998 while participating in a training session conducted by, Surf Lifesaving Western Australia Inc (SLSWA).


\(^4\) See, for example, Castellain v Preston (1883) 11 QBD 380; British Traders Insurance Co v Monson (1964) 111 CLR 86

\(^5\) Solicitors and General Life Assurance Society v Lamb (1864) 2 De GJ & S 251

\(^6\) Thobald v Railway Passengers' Assurance Co (1854) 10 Exch 45

Mr Kightly claimed under the Volunteer Group's personal accident insurance underwritten by the plaintiff, the Insurance Commission of Western Australia (the “PA Insurer”) and received $70,557.30 in benefits for medical, rehabilitation and travels expenses and loss of income. Mr Kightly then brought an action in negligence against SLSWA and recovered by way of settlement the additional sum of $145,000 plus costs which sum was paid by SLSWA's liability insurer. The PA insurer sought recovery of the sum the that it had paid to Mr Kightly.

The PA Insurer failed at first instance. Relevantly, the issue before the Court of Appeal was whether the PA policy was a contingency policy not requiring proof of actual loss or was it an indemnity policy.

The Court of Appeal found that as the PA policy provided for indemnification in the case of actual, proved, financial loss, it was therefore a policy of indemnity the PA Insurer was able to exercise its equitable rights of subrogation.

Conversely, it was recently held by the Supreme Court of Victoria in HIH Casualty & General Insurance Ltd (in liq) v Insurance Australia Ltd (formerly SGIC General Insurance Ltd) that the principles of subrogation did not apply.\(^8\)

In that case, the Australian Grand Prix Corporation (“AGP”) entered into a contract on 23 February 1998 with Screenco Pty Ltd whereby the latter was to erect a large video screen at the Australian Grand Prix track at Albert Park for use during the Australian Formula One Grand Prix in March of that year. The work was sub-contracted through a variety of businesses such that one Ronald Steele, who traded as Dragon Scaffolding ultimately carried out the work. On 3 March 1998 Mr Steele attended at Albert Park and erected a large scaffold. Whilst the screen was being put up on the scaffolding erected by Mr Steele, the scaffolding gave way resulting in the constructive total loss of the screen (called a “Jumbotron”).

Screenco sued Steele and others in the Supreme Court of New South Wales for damages for the loss of the screen and consequential losses and obtained judgment on 11 November 2002 for $1,461,045 with costs.

At the time the accident occurred Steele was insured with the HIH Group which, not unlike Mr Steele’s scaffolding, notoriously collapsed in 2001 with enormous unmet liabilities. Steele applied for assistance to the HIH Claims Support Scheme established by the Federal Government. HIHCS paid 90% of judgement and as a condition of the grant of relief under the scheme, HIHCS received an assignment of Mr Steele’s rights against third parties arising from the loss.

A claim was then brought by HIHCS in Mr Steele’s name against Insurance Australia Ltd ("IAL") in its capacity as AGP's insurers pursuant to a policy entitled "Contract Works, Material Damage and Third Party Legal Liability Policy" on the basis that AGP's policy extended indemnity to contractors and sub-contractors. The claim relevantly comprised two parts, namely:

\(^8\) [2005] VSC 342; BC200506953
• the amount paid on Mr Steele’s behalf by HIHCS of $1,314,941.01 representing 90% of the judgement awarded against him; and
• the remaining 10% of the judgement for which Mr Steele remained personally liable but which he had not yet paid.

IAL defended the claim on the basis that Mr Steel’s entitlement to indemnity under AGP’s policy was defeated by the equitable principle set out by the High Court in Sydney Turf Club v Crowley (1972) 126 CFLR 420, that once an insured has been indemnified under an insurance policy, the insured has no right to a further indemnity from another insurer under a separate policy.

The Court observed that the outcome depended upon whether it could be said that HIHCS had indemnified Mr Steele in its capacity as an insurer pursuant to an arrangement that could be described as a contract of insurance.

In distinguishing cases involving statutory insurance schemes and medical defence unions, the Court stated the critical element of insurance is the relationship of indemnity between the insured and insurer, not the source of that relationship.

The Court held that HIHCS was not an insurer as the benefit that Mr Steele had received was completely discretionary, no premium was payable and no event was insured against. The payment by HIHCS was in fact a "merciful benefit or subvention of the Commonwealth Government."

The principles outlined in Sydney Turf Club v Crowley where therefore inapplicable and Mr Steel was able to claim an entitlement to indemnity from AGP’s insurer, IAL, in respect of 100% of the claim (albeit that 90% of the proceeds would ultimately be paid to HIHCS pursuant to the assignment).

1.2 The source of an insurer’s subrogation rights

In the context of insurance law, there is some doubt whether subrogation is an equitable or common law principle. However, the current view is that the right of subrogation has both contractual and equitable elements.

It is important to understand the nature of the doctrine of subrogation as the manner in which rights of subrogation arise may restrict or expand the extent of those rights. For example, to the extent that a right of subrogation arises in equity, the exercise of that right may be subject to equitable principles and equitable defences. To the extent the doctrine rests on the parties’ intentions it may depend upon what is embodied in the contract.

1.3 The exercise of the right of subrogation

There are generally two preconditions to the exercise of the right of subrogation (subject to the express terms of the policy):

1. the insurer must be liable for the relevant loss; and

9 See Lord Napier v Hunter [1993] AC 713;
2. the insurer must have indemnified the insured to the full extent required by the policy.

In respect of the first requirement, it appears that an insurer is not entitled to exercise its rights of subrogation if the contract with the insured is void, even in circumstances where the insurer has already made a payment under that contract\textsuperscript{11}.

As to the second requirement, it seems that for the right of subrogation to arise, the insurer must have fully indemnified the insured to the extent required under the policy, even if this does not provide the insured with a complete indemnity\textsuperscript{12}.

The case of \textit{Page v Scottish Insurance Co Ltd}\textsuperscript{13} is illustrative of a situation in which the second precondition was not satisfied. In that case the insurer had indemnified the insured for certain motor vehicle repairs, but had disputed its liability under the policy in respect of other losses. The Court held that until it had fully discharged all of its obligations under the insurance policy, the insurer was not entitled to exercise any right of subrogation\textsuperscript{14}. This often poses a dilemma for insurers in circumstances where there are indemnity issues an insurer wishes to reserve its position on but rights of subrogation may be lost (e.g. due to expiry of limitation periods). The insured will generally not be required to take recovery proceedings as part of its duty of utmost good faith.

Further, in \textit{Scottish Union & National Insurance Co v Davis}\textsuperscript{15}, the court held that the insurer was not entitled to exercise subrogation rights where repairs that the insurer had authorised to a motor vehicle were carried out unsatisfactorily, as the insured had not been fully indemnified\textsuperscript{16}.

2. Restrictions on the right of subrogation

As noted above, generally, the right of subrogation enables the insurer to exercise all of the rights that the insured has against a third party (in so far as such rights are connected with the subject matter of the insured's loss). However, these rights can be constrained by the relationship between the insured and a third party and also by the terms of the policy itself\textsuperscript{17}.

2.1 Effect of contracts between the insured and third parties

An insurer's right of subrogation against a third party may be affected by the terms of a contract between the insured and that third party.

\textsuperscript{11} John Edwards & Co v Motor Union Insurance Co Ltd \textsuperscript{[1922]} 2 KB 249
\textsuperscript{12} See for example, GPS Power Pty Ltd and Ors v Gardiner Willis & Associates Pty Ltd \textsuperscript{(2001)} 11 ANZ Ins Cas \textsuperscript{¶61-482}
\textsuperscript{13} (1929) 98 LJKB 308
\textsuperscript{14} CCH Australia Limited, "Australian and New Zealand Insurance Reporter" \textsuperscript{(2004)} at paragraph [27-260]
\textsuperscript{15} 1970) 1 Lloyd's Rep 1190
\textsuperscript{16} CCH Australia Limited, "Australian and New Zealand Insurance Reporter" \textsuperscript{(2004)} at paragraph [27-260]
\textsuperscript{17} Castellain v Preston \textsuperscript{(1883)} 11 QBD 380
(a) Express terms

Generally any contractual modification or limitation of the insured’s rights will apply equally to the insurer’s rights by way of subrogation.

In State Government Insurance Office (Qld) v Brisbane Stevedoring Pty Ltd (1969) 123 CLR 228 the hirer of equipment agreed to indemnify the owner of that equipment against all claims arising out of its use. Consequently, the workers compensation insurer of the hirer was unable to rely on a claim against the negligent owner by way of subrogation.

The contract between the insured and the owner of the equipment prevented any rights against the owner from accruing. At no time was there a right of the insured which the insurer might exercise by way of subrogation.

Some contracts of insurance exclude the insurer’s liability if the insured enters into a contract which restricts the right of the insured to recover damages from a third party in respect of a loss covered by the insurance. Section 68 of the Insurance Contracts Act 1984 (Cth) prevents the insurer from relying on a term of that type unless it is specifically drawn to the insured’s attention.

(b) Implied terms

In some cases, there may be an implied term in a contract between the insured and the third party which operates to exclude claims brought by way of subrogation.

In the English decision of Mark Rowlands Limited v Berni Inns Limited18, premises were destroyed by fire due to the tenant’s negligence. The lease contained a provision stating that the landlord would insure the premises and apply any insurance monies to restoring the premises. The tenant was obliged to pay monies to the landlord in respect of insurance. The tenant was also obliged to effect repairs to the premises but not where the damage was caused by fire. The landlord had taken out an insurance policy over the premises, which did not name the tenant.

When the premises burnt down, the insurer attempted to bring an action in negligence against the tenant (after indemnifying the landlord). The English Court of Appeal took the view that having regard to the terms of the lease, it was the intention of the parties that the insurance effected by the landlord was intended to be for the benefit of the tenant. As such, the landlord’s loss was to be recouped from the insurance monies and accordingly, that the landlord would have no further claim against the tenant.

A different result was reached in the Queensland decision of Justice White in Bit Badger Pty Ltd v Cunich19.

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18 [1986] 1 QB 211
19 (1996) 9 ANZ Ins Cas ¶61-312
This matter again concerned a situation where the landlord alone was insured under the relevant policy, although the tenant paid the premiums. A crucial term of the lease was one which provided that the tenant was liable for damage caused by fire unless the fire was not caused by the tenant. Further, the tenant provided several indemnities to the landlord which extended to damage by fire in certain circumstances. Again, the premises were damaged by fire, allegedly due to the default of the tenant.

The tenant argued for an implied term that the landlord was not entitled to recover from the tenant if it had been indemnified by the insurer. Justice White refused to imply such a term into the lease. In particular, it seems her Honour was disinclined to do so in face of an express term making the tenant liable for damage caused by fire which resulted from the tenant’s negligence.

2.2 Multiple Insureds

Special difficulties with exercising rights of subrogation arise in the case of insurance taken out in joint names by two or more parties for their respective rights and interests. In particular, it is generally accepted that an insurer will not bring an action against a co-insured who has a sufficient interest in the loss. This is usually explained on the basis of either:

- the defence of circuity of action;
- an implied term in the insurance contract that the insurer will not exercise its rights of subrogation against a co-insured; or
- it would be inequitable to permit a right of subrogation to be exercised in the case.

It is also commonly the case that policies of insurance that are for the benefit of multiple insureds contain "wavier of subrogation" clauses expressly limiting the rights of an insurer to bring subrogated proceedings.

(a) Circuity of action

It has been frequently stated that purported subrogated action against a co-insured is defeated due to the rule against circuity of action. However, the availability of this defence to defeat an insurer’s subrogated action against a co-insured may be limited.

The defence itself is said to apply "whenver the rights of the competing litigants are such that the defendant [the co-insured] would be entitled to recover back from the plaintiff [the insurer] the same amount which the plaintiff [the insurer] seeks to recover from the defendant [the co-insured], whether those claims are categorised as debts, or damages". It appears that there are two essential elements to this defence:

(i) there must be complete identity between the parties having the competing claims; and

20 Brownie J, Co-Insurance and Subrogation (1990) 3 ILJ 48 at 53 (adopted by the Full Court of the WASC (per Ipp J) in Woodside Petroleum Development Pty Ltd & Ors v E&W Pty Ltd & Ors (1999) 20 WAR 380
(ii) there must be a complete identity between the amounts recoverable by the respective parties\(^{21}\).

There are a number of problems which may arise if an insured purports to rely upon the defence of circuity of action to defeat a subrogated action brought by an insurer including:

- In the case of an insurer exercising its rights of subrogation against a guilty co-insured, the amount of the claim made by the insurer may not be the same as the amount the guilty co-insured is entitled to claim from the insurer. Accordingly, the defence of circuity of action may technically not be available to the guilty co-insured as a defence against the subrogated action.

- Further, doubt has been cast on the availability of the defence of circuity of action where the insurance policy only provides cover for property damage (as opposed to liability cover or combined property/liability cover) ie the policy only covers the guilty co-insured for damage to property and not its liability to an innocent insured\(^{22}\).

- Similarly, if the policy contains an "insured vs insured" exclusion, it is questionable whether the guilty co-insured can rely on the defence of circuity of action because the exclusion clause would mean that the insurer is not liable to indemnify the guilty co-insured in relation to the claim by the innocent insured.

Accordingly, a guilty co-insured may not be able to avail itself of the defence of circuity of action against a subrogated claim brought by an insurer.

(b) **Implied term in the contract**

The cases suggest that the courts are very willing to imply a term into an insurance policy that the insurer agrees to waive its rights of subrogation against a co-insured whose interests are insured under the policy.

However, a term will not be implied into a contract where it would be inconsistent with an express term. Accordingly, each case will depend upon the actual wording of the policy concerned.

For example, it may be argued that a term that the insurer waives its rights of subrogation against a co-insured should not be implied where the policy contains an "insured vs insured" exclusion. This argument arises from the proposition that a waiver of subrogation clause as against a co-insured results in the insurer bearing the ultimate liability for the loss notwithstanding the loss may have been caused or contributed to by a co-insured. To imply such a term would arguably be inconsistent with the existence of an "insured vs insured" exclusion clause which is

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\(^{21}\) Ibid at page 54

\(^{22}\) Ipp J in *Woodside Petroleum Development Pty Ltd & Ors v E&W Pty Ltd & Ors* (1999) 20 WAR 380; *Kelly and Ball Principles of Insurance* at section 9.0050.1.
intended to have the effect of leaving the ultimate liability for a loss with the guilty co-insured.

(c) Equity

Before a co-insured will be entitled to rely upon equitable principles to prevent an insurer exercising a right of subrogation, the co-insured will need to be able to establish that it has abided by the general equitable principles. Accordingly, an insurer may be able to argue that a guilty co-insured is not entitled to rely upon equitable principles to defeat a subrogated action because the guilty co-insured has not complied with equitable principles.

2.3 Waiver of Subrogation Clauses

It is not unusual for parties to an insurance contract to exclude or restrict the rights of the insurer under the doctrine of subrogation. Such terms are particularly common in policies covering multiple insureds.

Two issues arise in relation to these types of clauses. The first is who is entitled to enforce it – where the waiver is in respect of any "insured", clearly an insured is able to do so. So too is a third party who is entitled to enforce the benefits conferred (see Trident General Insurance Co. Ltd v McNiece Bros Pty Ltd (1988) 165 CLR 107) or under section 48 of the ICA. However, if the wording is broad enough it appears that the courts will also allow an entity to rely on a waiver of subrogation clause even if that entity is not a party to, or entitled to enforce the benefits of the contract.

(a) Woodside Petroleum Development Pty Ltd & Ors v E&W Pty Ltd & Ors

In this case, Woodside constructed a drilling platform and entered into a contract with the defendant for design services for the substructure of the platform. A construction risks policy covered Woodside as the "Principal Assured" with "other assureds" defined to include contractors and any others with whom Woodside had entered into agreements in connection with the subject matter of insurance.

A defect in the piles for the platform was detected and Woodside was indemnified under the policy for the approximate $280 million cost of remedying the defect. The insurer alleged that the defendants were responsible for the loss and sought to recover this amount from the defendants pursuant to a right of subrogation. By way of hearing of a preliminary issue, the defendants contested the insurer's capacity to bring the subrogated action.

At first instance and on appeal to the Full Court of the Supreme Court of Western Australia, it was held that the insurer had no right of subrogation against the defendants as a result of the waiver of subrogation clause contained in the policy.

The waiver of subrogation clause relevantly stated:

Underwriters agree to waive rights of subrogation against any Assured and any person...whose interests are covered by this Policy and against any...contractor of the Principal Assured or any individual, agent, firm or affiliate or corporation for

23 (1999) 20 WAR 380
whom the Principal Assured may be acting or with whom the Principal Assured may have agreed prior to any loss to waive subrogation...The foregoing shall not apply in respect of operations not connected with the project.

In relation to the insurer's argument that the waiver was a contractual promise between the parties to the policy, the Full Court (per Ipp J) stated:

In my view, waiver clauses such as cl 16 affect rights of subrogation, as it were, at their birth. They prevent any rights of subrogation, to which they apply, from being implied under the contract of insurance or arising in equity. Neither the rules relating to the implication of terms in a contract nor the principles of equity will countenance the existence of a right of subrogation which is in direct conflict with the intention of the policy as reflected by an express waiver recorded therein.

On this construction, cl 16 is not a contractual promise, nor is it a "benefit of this insurance"; it is merely a convenient way of defining and qualifying the rights of subrogation to which, by the policy, the underwriters became entitled. Thus, in my opinion, by cl 16, the underwriters do no have (and never had) rights of subrogation against persons who fall within the categories it defines. Further, once persons establish that they fall within such a category, they are entitled to challenge the existence of the underwriters' rights of subrogation against them. Their entitlement to do so does not arise because benefits are conferred on them under the policy, but because a basic element is missing from the underwriters' cause of action.

There is some debate whether the decision in Woodside can be reconciled with principle, namely, how a person who is not entitled to enforce the contract can take advantage of it. Nevertheless, to the extent an insurer is relying upon an equitable right of subrogation, it is possible that a court would refuse to allow an insurer to enforce the right in these circumstances in any event.

(b) **GPS Power Pty Ltd v Gardiner Willis & Associates Pty Ltd**[^24]

The decision in Woodside was approved in the GPS Power case, The Queensland Court of Appeal also emphasised some important principles for construing waiver of subrogation clauses.

In this instance the court was considering a waiver of subrogation clause that appeared in a construction works type policy. The appellant (GPS Power) had engaged the respondent (GW) to provide engineering services (particularly design and drawing details) with respect to the insured works. GPS Power suffered loss as a result of damage to the power station caused by GW. GPS Power recovered most of its loss under the insurance policy. However, GPS Power sued GW for the whole loss. To the extent that the loss was covered by the insurer, the claim against GW was brought by the insurer using GPS Power's name.

Under the insurance policy, "Insured" was defined in the policy schedule to include:

(c) all contractors and subcontractors …but only to the extent of their activities in connection with the Insured Operations and their interests therein;

[^24]: [2000] QCA 495
(g) any unnamed party being of other category than specified under (a) to (f) above, having an insurable interest in the Insured Operations and/or Insured Property.

... The definition of 'the Insured' shall exclude consultants but only in respect of such consultants' professional duty of care to other persons &/or parties included in this definition of 'the Insured'.

It was held that GW was a "contractor" within paragraph (c) of the definition of Insured and a "consultant" and therefore caught by the proviso in the definition of the "Insured".

For the purposes of the appeal, the parties agreed that GW was a consultant and that the claim in question related to its professional duty of care to other parties included in the definition.

The policy contained the following clause in relation to subrogation rights:

(a) Upon the payment of any claim under this Policy, subject to any restrictions imposed by the Commonwealth Insurance Contracts Act 1984, the Insurers shall be subrogated to all the rights and remedies of the Insured arising out of such claim against any person or corporation whatsoever.

... (c) In the event of the Insurers indemnifying or making a payment to any Insured(s), the Insurers shall not exercise any rights of subrogation against any other Insured(s) hereunder.

(d) The Insurers agree to waive any rights and remedies or relief to which they may become entitled by subrogation against:

(i) any corporation or organisation (including its directors, officers, employees or servants) owned or controlled by the [principal] Insured …;

(ii) any Insured named or described by this Policy (including its directors, officers, employees or servants).

Accordingly, the case turned on whether GW was an "Insured" for the purposes of the subrogation clause.

At first instance, GPS's claim against GW was dismissed to the extent that it was brought by way of subrogation, on the ground that the subrogation clause referred to above protected GW from such a claim.

By a 2-1 majority, this decision was upheld by the Queensland Court of Appeal. Williams J (with whom De Jersey CJ agreed) found that, adopting a literal construction, the reference to "Insured" in the subrogation clause included GW because it was a named and described party in the definition of the "Insured" in the policy schedule, albeit for limited risks. Williams J concluded that in this case, had the insurer wished the definition of "Insured" to encompass only the parties described therein insofar as they were insured against a particular risk, it would have been easy for the policy to say so in express terms.
Importantly, all three judges agreed that, as a matter of policy, in determining the scope of a waiver of subrogation clause, a construction which enhances (as opposed to restricts) the scope of the waiver is "sounder".

2.4 Provisions of the ICA

For completeness, it is noted that the ICA precludes or limits an insurer's rights of subrogation in relation to certain classes of potential defendants. It should also be noted that these provisions refer to "insureds" and not third party beneficiaries.

Section 66 of the ICA states that an insurer has no right of subrogation against an insured's employee provided that the conduct of the employee which gave rise to the loss:

- occurred in the course of or arose out of the employment; and
- was not serious or wilful misconduct.

Accordingly, s66 of the ICA may defeat any purported subrogated action by an insurer against a co-insured who was also an employee.

Section 65 of the ICA limits an insurer's rights of subrogation against persons who the insured has not pursued and might reasonably be expected not to pursue because of:

- a family or other personal relationship between the insured and that person; or
- the insured having expressly or impliedly consented to that person's use of a road motor vehicle which is the subject matter of the insurance contract.

Section 65 does not apply where the conduct of the third party giving rise to the loss:

- was serious or wilful misconduct; or
- occurred in the course of or arose out of the third party's employment by the insured.

In such cases, the insurer's rights of subrogation are effectively limited to the extent that the third party has insurance in respect to his or her liability to the insured.

For example, in the case of property damage insurance (ie no liability cover), s65 would prevent an insurer from bringing a subrogated action against a guilty co-insured, who has the requisite relationship with the indemnified co-insured, unless (and to the extent that) the guilty co-insured has other insurance which covers its liability to the indemnified co-insured.

3. Control of proceedings

If an insurer has fully indemnified an insured in respect of a loss, it will be entitled, by virtue of its subrogation rights, to control any proceedings brought against a third party in respect of that loss.

3.1 Partially covered losses

However, the situation is somewhat unclear where the insured is not fully covered under the policy for the loss sustained and both the insurer and the insured have an interest in the outcome of the proceedings. The general position appears to be that the insured is
entitled to retain control of the proceedings (subject to any term in the policy or agreement to the contrary)\textsuperscript{25}.

It has been suggested, however, that there may be an exception to this principle in a situation in which the insured's interest in the outcome of the subrogated action is small compared with the insurer's, in which case the insurer would be entitled to control the proceedings \textsuperscript{26}. In any event, the party in control of the proceedings must have due regard to the interests of the other party in conducting or settling the proceedings \textsuperscript{27}.

It is important that the party in control of the proceedings act diligently in pursuing the whole of the loss, including losses recoverable by the other party. Often, situations arise where the interests of the insured and insurer conflict. For example, consider the situation where an insured has control of proceedings and has received indemnity in full from the insurer but has a substantial uninsured loss. Its interest is in obtaining a settlement for the amount of the uninsured loss. However, the insurer may prefer to pursue the claim to recover a greater amount, leading to reimbursement to the insurer as well. If this situation arises, one possible solution is for the insured to permit the insurer to take control of the proceedings on receipt of a guarantee of payment in any event of the insured's outstanding loss\textsuperscript{28}.

3.2 Obligations in relation to the pursuit of proceedings

It must be remembered that a contract of insurance involves a requirement for the parties to act in good faith. If the party in control of proceedings fails to have proper regard to the interests of the other party, and by doing so prejudices the other party's interests, that other party is entitled to make a claim for damages\textsuperscript{29}.

An insured is under a general duty not to engage in any conduct that would prejudice the subrogation rights of the insurer, even in the absence of an express term to that effect in the insurance policy\textsuperscript{30}. However, the duty is not absolute. In Arthur Barnett Ltd v National Insurance Co of New Zealand Ltd [1965] NZLR 874, for example, the High Court of New Zealand recognised that the insured was not bound to claim against a negligent third party any more than the amount of loss reasonably attributable to that party's conduct. The insured was not bound to claim for the full loss merely because that might appear to be in the insurer's interest.

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\textsuperscript{26} See Kelly & Ball’s “Principles of Insurance Law” (2004) at [9.0110]

\textsuperscript{27} Discussed in section 4 below


\textsuperscript{29} Yorkshire Insurance Co. Ltd v Nisbet Shipping Co Ltd [1962] 2 QB 330; Broadlands Properties Ltd v Guardian Assurance Co Ltd (1984) 3 ANZ Ins Cas 60-552

\textsuperscript{30} See discussion in Law Book Company, "Laws of Australia" (2004) at paragraph [237]
The English Court of Appeal had occasion to consider the insured's duties in this regard in the recent case of Euler Hermes UK Plc v Apple Computer BV\(^{31}\) in which judgement was handed down on 4 April 2006.

On 1 June 1999 Apple entered into a policy of insurance underwritten by Euler in respect of losses resulting from the failure of trade debtors to pay amounts due from them. The policy included the following clause:

(ii) You will take all practicable measures available to you to prevent any loss arising (to you and/or us) and should any loss arise to minimise it.

(iii) After we have made a claim payment to you in respect of an INSURED BUYER you will continue to take all practicable measures to collect or realise or apply any SALVAGE and if required by us you will assign the relevant INSURED DEBT to us and we shall account to you for any uninsured proportion of any recoveries.

Apples subsequently terminated a distribution agreement with a third party distributor in Saudi Arabia resulting in the distributor withholding payment of various invoices totalling over US$500,000.

Euler paid the claim in the sum of US$410,954.66 (after the deductible had been applied) subject to certain conditions including that Apple would:

- continue to take action to recover the debt; and
- account to the insurer for monies recovered.

Apple ultimately failed to pursue a claim for the outstanding monies and Euler sought to recover the claims monies paid.

There was considerable debate as to what "action" meant but the Court of Appeal ultimately found that the parties intended "action" to include the institution of proceedings and not just sending a letter of demand.

The Court also held with the assistance of expert evidence as to the enforcement of judgements in Saudi Arabia that Apple was likely to succeed in the proceedings and that by not pursuing the proceedings against the defaulting distributor, Apple was in breach of the settlement agreement.

Furthermore, the Court held that Euler had not failed to mitigate its loss by failing to pursue the claim itself pursuant to its rights of subrogation as it was entitled to rely upon Apple’s agreement to do so.

The Court therefore found that the measure of Euler's loss was the full amount of the claim that it had paid to Apple in the sum of US$410,954.66.

The reasoning in Euler Hermes seems appropriate to a case where indemnity has been granted. However,, adopting the reasoning of the Full Federal Court in AMP Financial Planning Pty Ltd v CGU Insurance Limited\(^{32}\), where an insured has been instructed to act

\(^{31}\) [2006] EWCA Civ 375
\(^{32}\) [2005] FCAFC 185
as a "prudent uninsured" and accepts a settlement without obtaining the insurer's consent, it is arguable as to whether such a settlement would be held to be prejudicial to the insurer's rights.

3.3 Release of a third party/Settlement

The availability of an action against a third party is the fundamental basis of an insurer's subrogation rights and an insurer will generally be bound by any settlement or abandonment of a claim by the insured\(^33\).

If a third party accepts a release provided by the insured and is unaware of the insurer's interests, the release will act as a defence against a claim by the insurer. In addition, if proceedings have already been unsuccessfully commenced by the insured against a third party, the insurer will be faced with a defence that "the insured himself has already taken and concluded proceedings in respect of a claim based upon a loss which was outside the cover"\(^34\), for example, proceedings for an uninsured part of a loss.

There is some doubt as to the extent to which a settlement or release of a claim by the party in control of the proceedings binds the other, where the third party has knowledge of the insured's interests\(^35\).

The better view appears to be that expressed in *State Government Insurance Office (Qld) v Brisbane Stevedoring Pty Ltd*\(^36\), in which the Court indicated that an attempt by the insured to prejudice the insurer's subrogation rights may be ineffective "because of knowledge of the circumstances which the person under obligation to the insured may have"\(^37\). In the case of *Morganite Ceramic Fibres Pty Ltd v Sola Basic Australia Ltd*\(^38\), Justice Smart cited the following passage from *State Government Insurance Office (Qld) v Brisbane Stevedoring Company* with approval:

> It is settled law that an insured may not release, diminish, compromise or divert the benefit of any right to which the insurer is or will be entitled to succeed and enjoy under his right of subrogation. On occasions an attempt by the insured to do so will be ineffective against the insurer because of the knowledge of the circumstances which the person under obligation to the insured may have. On other occasions, when the insured's act has become effective as against the insurer, the insured will be liable to the insurer in damages or possibly, on some occasions for money had and received.

The Court in *Morganite* held that as the defendant was aware that an insurer was involved the release entered into was ineffective against the insurer\(^39\).


\(^{34}\) Derrington & Ashton, "The Law of Liability Insurance," (1990) at page 761-762

\(^{35}\) See Kelly & Ball "Principles of Insurance Law" (2004) at [9.0110.15]

\(^{36}\) (1969) 123 CLR 228


\(^{38}\) (1988) 5 ANZ Ins Cas ¶60-883

\(^{39}\) Law Book Company, "Laws of Australia" (2004) at paragraph [234]
3.4 Conduct of the Insurer

It is worth noting that settlement of an insured’s claim by an insurer in such a way as to prejudice the insured’s rights, may allow the insured to claim damages against the insurer by “relying on an implied term in the policy to the effect that the insurer shall not exercise rights of subrogation to the insured’s prejudice”\(^{40}\). However, this remedy is unlikely to be of much practical importance except in the situation in which the insured has lost the prospect of recovering an amount in excess of its loss or where the insurer has settled a claim which includes a potential claim for an uninsured loss\(^{41}\).

It is worth noting that the conduct of an insurer can also constitute a waiver of its rights of subrogation and thereby all of its rights and remedies to which it may have been entitled by way of subrogation\(^{42}\). For example, if the insurer agrees to conduct an insured’s defence, this may constitute a waiver of the insurer’s right to rely on the breach of the policy by the insured to avoid liability\(^{43}\). If the insured can show that it would suffer material detriment, the doctrine of estoppel may also act to prevent the insurer from denying liability under the policy\(^{44}\).

4. Distribution of the proceeds of recovery from third parties

4.1 The issues relating to sharing of proceeds

A significant issue is how, following indemnity to the insured, the proceeds of any recovery against third parties are shared between insured and insurer. The distribution of the proceeds may be affected by the following matters:

- whether the recovery action is brought by the insured or the insurer;
- the quantum of any otherwise covered losses that fall outside the applicable deductible and/or policy limit;
- the extent to which the recovery relates to uninsured losses;
- the inclusion of any component for interest; and
- the effect of s67 of the *Insurance Contracts Act 1984* (Cth).

4.2 Who brought the recovery action

The identity of the party controlling the proceedings is important as it affects the issue as to who is liable for the costs of the proceedings and who may recover those costs in the event that the action succeeds.


\(^{42}\) *Larson-Juhl v Jaywest* (2001) 11 ANZ Ins Cas ¶61-499


\(^{44}\) *Territory Insurance Office v Adlington* (1993) 7 ANZ Ins Cas ¶61-149
At common law the insured will be liable for the costs of proceedings if they are instituted without the consent of the insurer. Further, if the insurer commences proceedings, it appears that it will be liable for the costs thereof if the proceedings are unsuccessful.

If the proceedings are successful, the House of Lords considered that the costs borne by the insured (e.g. the amount exceeding the insured's indemnity) should be recovered first. If the insurer brings the proceedings and the action succeeds, it may require the insured to bear the costs to the extent of any recovery for the benefit of the insured.

Alternatively, the insurer and the insured may reach agreement as to the payment of the costs of the action.

4.3 The applicability of policy limits and deductibles

Where the loss is an insured loss, but is not covered by the policy by reason of the application of the deductible or by reason of the application of the policy limit, the general principle of "recover down" or "top down" is applied. This means that recoveries are applied to reduce the total loss suffered by the insured. All recoveries reducing the loss down to the policy limit will be for the benefit of the insured. Any recovery in excess of this amount will then be for the benefit of the insurer. Only if the recoveries exceed the indemnity and reduce the net loss to the insured below the excess will any part of the recovery be applied to the excess.

An illustration is provided by the decision in Lord Napier v Hunter [1993] AC 713; [1993] 1 All ER 385. In that case a Lloyd's syndicate had a stop loss policy which insured each member for £100,000 in excess of £25,000. The members each suffered a loss of £160,000. They recovered £100,000 under the policy. They then sued their managing agents for negligence and settled that claim for £130,000. Ignoring the insurance recovery, this had the effect of reducing the net loss to £30,000. Applying the recovery down principle, £35,000 was applied to the amount in excess of the limit (for the benefit of the insured) and £95,000 was for the benefit of the insurer. The net loss borne by the insurer was £5,000 and by the insured £25,000.

4.4 Uninsured Losses

The "recover down" principle achieves a fair result because it ensures that the net loss is borne in the way envisaged by the policy. More difficulty arises where the recovery, or part of it, includes a recovery in respect of uninsured losses. Uninsured losses can arise because the terms of the policy exclude particular heads of claim e.g. policies which exclude economic loss; or contract works' policies which cover damage to property as a result of defective workmanship but may not cover the costs of rectifying the defect. A subsequent action against a professional in respect of the defect would generally cover all of the property damage and the costs of rectifying the defect in the works (and indeed any economic loss).


46 See Kelly & Ball "Principles of Insurance Law" (2004) at [9.0110]
There is surprisingly little authority on this issue. The question is of considerable importance when considering what is a reasonable distribution of the proceeds of any settlement. As a matter of general principle, there is no reason why an insurer should benefit to the extent to which recoveries relate to heads of claim not covered under the policy. On the other hand, it is also reasonable for the insured to expect that the extent to which the recovery relates to losses for which the insured has been indemnified, the recovery down principle should apply.

Often, the strength of the claim will not differ between the insured and uninsured components. In that case, it is appropriate to apply any settlement pro rata. Where there is a basis for distinguishing, a different apportionment may be appropriate. This will generally be based on legal advice as to the merits of the different heads of claim. In such circumstances it is appropriate to apportion the settlement having regard to the likelihood of success in respect of the insured compared with the uninsured components of loss.48

However, a different conclusion was reached by the Court of Appeal of Western Australia in the recent case of Insurance Commission of Western Australia v Kightly referred to earlier in this paper 49. It was put to the Court of Appeal on behalf of Mr Kightly in that case that because his claim against the third party liability insurer was resolved by compromise, without any liability being established or admitted, the lump sum which was received by him was no more than an ex gratia payment which was not attributable to any particular expense incurred by him and hence could not be the subject of the exercise of a right of subrogation.

The Court of Appeal held that the settlement was reached in circumstances in which there was no bona fide consideration of the PA Insurer's interests. Mr Kightly therefore breached the duty which was owed by him to the PA Insurer. As it was impossible to tell how the amount of $145,000 was comprised, equitable compensation should be awarded for the whole of the amount of $70,557.30 paid by the PA Insurer.

4.5 Interest

Most claims will include a component for interest. Based on the principle in Lord Napier v Hunter, it is appropriate to allocate interest to the insurer to the extent that:

(a) it relates to amounts recovered to which the insurer is entitled; and

(b) it relates to a period after which the indemnity was provided.

4.6 Effect of s67 of the Insurance Contracts Act and proposals for its reform

Section 67 of the Act provides (emphasis added):

(1) Where an insurer, in exercising a right of subrogation in respect of a loss, recovers an amount, the insured may recover that amount from the insurer.

47 Lord Napier v Hunter [1993] AC 713
(2) Unless the contract expressly provides otherwise, the insured may not recover under subsection (1)-

(a) an amount greater than the amount (if any) by which the amount recovered by the insurer exceeds the amount paid to the insured by the insurer in relation to the loss; or

(b) an amount that, together with the amount paid to the insured under the contract, is greater than the amount of the insured's loss.

(3) The rights of an insured and insurer under the preceding provisions of this section are subject to any agreement made between them after the loss occurred.

(4) A reference in this section to an amount recovered by an insurer shall be construed as a reference to the amount so recovered less the administrative and legal costs incurred in connection with the recovery of the amount.

This is a difficult section to interpret and has been the subject of much controversy. It is the subject of discussion in the paper on the second stage of the current review of the Act, published in May 2004.50

The addition of subsection (2)(a) gives priority to the insurer in respect of recovery. Subsection (2)(b), has the effect of preventing "double recovery" by the insured.

It is submitted that subsections 67(2)(a) and 67(2)(b) operate as dual prohibitions, so the most the insured can recover is the lesser of what remains after applying each prohibition.51 Under section 67 as currently drafted, a windfall would therefore fall to the insurer, at least where the insurer brings the proceedings. At common law, the insured would generally be entitled to keep any windfall.52

The Review Paper noted that it has been suggested that the additional rule in subsection 67(2)(a) should be removed. It considered that this would mean that proceeds would be distributed in accordance with the "recovery down" principle. However, in the absence of subsection 67(2)(a), the terms of s67 would appear to operate more favourably to the insured than under the application of the recovery down principle. The reason is that it appears to require moneys to be applied to the deductible (which is part of the insured's loss) before being applied to the amount of any indemnity.

A further issue concerns the effect of the prefacing words in subsection 67(2) "Unless the contract expressly provides otherwise”. It is submitted that they mean that the policy may relax one or other of the prohibitions in favour of the insured. However, the effect of subsection 67(3) is to prevent the insurer from increasing its rights other than after the loss occurs. In short, the policy may not be more generous to the insurer than subsections 67(1) and 67(2) provide, but it may be more generous to the insured.

The Review Paper noted that it is uncertain whether in fact the opening words of subsection 67(2) are meant to operate only to protect insureds. It observes that an


52 See Sutton, "Insurance Law in Australia" 3rd ed (1999) at paragraph 16.63
alternative interpretation is that the subsection merely provides "default rules", which are subject to any contrary provision in the insurance contract. On that view, s67(2) permits any kind of arrangement regarding distribution of recovered moneys to be included in the insurance contract, but that agreement and the rules in subsection 67(1) and (2) may be varied by a subsequent agreement made after the loss occurred.

In addition, the Review Paper observed that s67 does not provide for any interest component to be added to the maximum amount that can be recovered. If the insured has borne a loss many years ago, it is clearly reasonable to expect that it ought to be entitled to recover interest which a Court would award on that loss, as well as the original loss.

The Review Panel recommended that s67 be amended to provide that, subject to any agreement between the insurer and the insured, money recovered from third parties either by the insurer under its rights of subrogation or by the insured is distributed in the following order:

(a) Reimbursement for the administrative and legal costs of the recovery action. If both the insured and insurer funded the recovery action and there are insufficient funds for full reimbursement, they are to be reimbursed pro rata.

(b) If the insurer funded the recovery action it is entitled to retain an amount equivalent to the amount it has paid to the insured under the contract of insurance. The insured is then entitled to be paid an amount so that the total amount that it receives under the contract of insurance from the recovery action equals its total loss.

(c) If the insured funded the recovery action it is entitled to retain an amount so that the total amount that it receives under the contract of insurance and from the recovery action equals its total loss. The insurer is then entitled to be paid an amount equal to the amount that it paid under the contract of insurance.

(d) If the insurer and insured both funded the recovery action, they are entitled to amounts referred to in (a) and (b) above, pro rata if there are insufficient funds to reimburse them in full.

(e) Any excess or windfall recovery is paid to the parties in the same ratio that they contributed to the administrative and legal costs of the recovery action.

(f) Any separate or identifiable component in respect of interest should be paid to the parties in such proportions as fairly reflect the amounts that each has recovered and the periods of time for which each lost the use of the money.

This proposal is in line with proposed amendments to the Marine Insurance Act which have been advocated by the Law Reform Commission. The proposals are broadly in favour of insurers where the insurer is entitled to (and does) exercise a right of subrogation. However, they do not satisfactorily address the position in relation to uninsured losses. This would need to be addressed in any draft legislation.
5. Conclusion

In conclusion, when considering the applicability of the equitable principles of subrogation, it is critical to look carefully at the manner in which the insured party is reimbursed for the loss suffered. Rights of subrogation can only come into being where there is an appropriate relationship of indemnity between insurer and insured that arises from a policy of insurance and not from some other form of payment.

The existence or otherwise of rights of subrogation may significantly affect the profile of a given exposure, particularly in relation to large and complex risks involving multiple insureds. Underwriters should therefore take account of this factor in their assessment or the risk prior to binding cover.

The party taking control of proceedings after a loss has occurred will need to take care in respect of any settlement, to ensure that it complies with its duty of good faith. The settlement will need to be consistent with legal advice as to the merits of the overall claim.

Where a subrogated claim includes losses which are not covered under the policy, there remains some uncertainty as to who is entitled to control the proceedings and how the proceeds of any recovery should be distributed between insurer and insured.

In the event that the insured and insurer possess potentially competing interests in relation to a subrogated recovery, it would be prudent for them to ensure that their expectations are clear from the onset. This may be achieved for example by the parties entering into an appropriate written agreement addressing each party’s rights and obligations prior to the instigation of contemplated subrogated proceedings.

The effect of proposed reforms to s67, if implemented, would be to confer priority on a party controlling the proceedings. The rationale appears to be to reward the party bearing the risk associated with any recovery proceedings. In the absence of a written agreement between the parties this would seem to be a sensible approach.