Questioning the General Principle

The Discussion Paper

309. The discussion paper questioned the general utility of the doctrine of subrogation:

> If a negligent third party is not insured, he may well be unable to pay the full amount of the claim. It might be better if a loss now recoverable by subrogation were to be spread among the whole body of policyholders rather than imposed on an uninsured person who might well be bankrupted. If the third party *is* insured against liability for negligence, a different question arises. The third party will not be harmed personally by the shifting of the loss which is entailed in subrogation. But the question arises whether there is any overall benefit in a system under which the insured's property insurer is allowed to shift certain losses onto the third party's liability insurer. The cost of determining whether liability exists in these cases may be an unwarranted additional expense in the conduct of general insurance business.[37]

Knock-for-knock agreements in the field of motor vehicle insurance were given as an example of voluntary deprivation of rights of subrogation. A knock-for-knock agreement operates when the parties to an accident have comprehensive motor vehicle cover with different insurers, each of which is a party to the agreement. It provides that each insurer will carry the risk of loss to its own insured. Its aim is to avoid the costs of establishing the existence and extent of liability. The assumption is that, over time, the costs saved will exceed the excess, if any, of the net amount actually paid over the net amount which would have been paid in the absence of the agreement. If the knock-for-knock principle were extended to other fields of insurance, property insurance would cover all property loss and liability insurance would be restricted to liability in respect of loss caused to uninsured property. If the insured were permitted to select between suit or indemnity, the liability insurer would also cover the possibility of suit by the insured himself. Such a change would have a considerable effect on rating scales and would require adjustment of premiums between the two types of cover. The discussion paper suggested that subrogation should not be available in respect of rights arising from third party conduct which was neither reckless nor intentional.

Arguments in Favour

310. The proposal in the discussion paper was in line with an earlier submission presented to the Commission.[38] That submission argued that subrogation is both expensive and unfair, that it has no value in curbing negligent behaviour and that subrogation recoveries do not affect premium rates. Subrogation is potentially unfair because the action may be brought against someone who does not carry liability insurance and cannot realistically be expected to do so. Examples include employees and residential tenants. While *Morris* v. *Ford Motor Co.*[39] provided some measure of control against inequitable use of subrogation, it did so in vague and uncertain terms.[40] Subrogation is expensive because, when the defendant is insured against liability, wasteful litigation often follows. Litigation involving Harbutt's Plasticine Ltd in the first half of the 1970s was given as an example:

> In the original action, *Harbutt's 'Plasticine' Ltd* v. *Wayne Tank and Pump Co. Ltd*, [[1970] 1 QB 447] the insurer was able to argue that the exemption clause did not apply and that the defendant was liable to pay 146 581 pounds. The cost of determining the questions in this original action I estimate, conservatively, to be about 50 000 pounds. In a subsequent action, *Wayne Tank* v. *Employers' Liability Insurance*, [[1974] QB 57] the defendant sought to establish that it should be indemnified by its liability insurer. The costs of this action I estimate, again conservatively, to be again about 50 000 pounds. Thus, it cost 100 000 pounds to shift a loss of 146 000 pounds from one liability insurer to another. In the end result, it was held by the Court of Appeal in the second litigation ... that the liability policy did not indemnify Wayne Tank but nothing of major importance seems to turn on this fact.[41]

---

37. ALRC DP 7, para. 82.
38. R.A. Hasson, *Submission*, 24 August 1977, 27f.
39. [1973] 1 QB 792.
40. Its authority is, in any event, questionable. See above, n. 23.
41. *Submission*, 24 August 1977, 28.

Subrogation had no effect in curbing negligent behaviour. If Wayne Tank were not deterred by the fear of disruption of its business over a considerable time, it would hardly be deterred by the imposition of a liability against which it was insured.[42] If deterrence against truly reckless conduct were required it could be achieved by a rule under which subrogation was limited to cases of that type. It was not necessary to preserve subrogation for merely negligent conduct. It had little effect in reducing premiums and might even be a factor in their increase:

> According to one insurance authority, insurance companies fix their rates after having taken into account 'net subrogation recoveries'. [See Horn, *Subrogation in Insurance Theory and Practice* (1964) at p. 25] It seems to me that an insurer will only be able to operate on this basis if it does not also underwrite liability insurance. Once an insurer underwrites liability insurance as well as first-party insurance (and I believe that this is nearly universally true) then, in addition to computing 'net subrogation recoveries', it will also be necessary to compute 'net subrogation liabilities'. Since one would expect subrogation recoveries and subrogation liabilities to cancel each other out on a 'swings-and-roundabouts' basis, it seems difficult to see how subrogation could help lower rates. Instead, it seems more likely that subrogation actions have the effect of making insurance *more* expensive since it is an expensive business to shift costs from one liability insurer to another. [See also Kimball & Davis, *The Extension of Insurance Subrogation*, 60 Michigan L. Rev. 841 (1962)][43]

Industry Response

311. The suggestion contained in the discussion paper met with considerable opposition from the general insurance industry, not only at the seminars arranged by the Australian Insurance Institute and State and Territorial Insurance Institutes but also in later oral and written submissions. The ICA expressed strong opposition to the suggestion. It emphasised the inequity involved in imposing the burden of uninsured liabilities solely on those who are prudent enough to insure themselves against such risks. It suggested that the standard of care exercised by uninsured motorists might deteriorate in the absence of the incentive to take care which is created by the fear of incurring a heavy liability. It also pointed to the danger of considerable premium increases if insurers were denied their present appreciable recoveries from negligent third parties.[44] Valuable information on the latter point was provided separately by NRMA Insurance:

> In 1978, we recovered approximately $5.5 million from persons responsible for damage to our insured's cars. 13% of this money was recovered through our solicitors and the balance was paid direct to our Claims Department at our branches following the actions of our staff.
>
> The cost of these recovery operations would not have exceeded $1 million. Thus we contend that, had we not the right which it has been suggested we should be denied, our 1978 claims costs would have been increased by $4.5 million. In turn, each of our 725 000 car policyholders was saved approximately $6.20 in premium charges.[45]

42. Or, more accurately, against which it believed itself to be insured.
43. R.A. Hasson, *Submission*, 24 August 1977, 29–30.
44. ICA, *Submission*, 9 August 1979, 13–4.
45. *Submission*, 3 May 1979, 13. The recoveries of $5.5 million were from persons not affected by the operation of knock for knock agreements to which NRMA Insurance Ltd is a signatory. Accurate information on the proportion of the $5.5 million representing recoveries from uninsured persons is not available. It is estimated that that proportion may have been as high as 90%.

Reinsurance Implications

312. Direct insurers were not alone in expressing opposition to the Commission's proposals. Several reinsurers made a joint submission in which they explored the effects which the discussion paper's proposal might have on reinsurance of Australian insurers.[46] The following hypothetical case is a variation upon one of those contained in that submission:

> Shortly after take-off, an aircraft crashes into an oil refinery, causing several hundred million dollars damage. In the examination of the wreckage, it is established that the crash resulted from defects in the design and manufacture of the aircraft rather than from negligence on the part of the operator.

Under the discussion paper's proposal, the insurer of the refinery would be unable to exercise by subrogation rights which the refinery owners might have against the manufacturer of the aircraft. The insurer of the refinery would have to bear the loss itself. Moreover, the Australian-based aviation hull insurers would be precluded from recovering against the manufacturer even though, in a similar case overseas, the hull insurers would be entitled to exercise their insured's rights by way of subrogation. Reinsurers of Australian risks might well be hesitant about accepting additional risks of this type. The reinsurance of some large risks would be made difficult, if not impossible. The Australian insurance market is, by international standards, a small one. Some international reinsurers might be unwilling to devise special terms and rates for that market in isolation from all others. Rating adjustments would, in any event, be complex and costly. Implicit in the arguments put to the Commission is the contention that the removal of rights of subrogation would involve an inappropriate change in the incidence of enterprise costs. The costs of defects in the aircraft would be borne by the refinery owners rather than the airline operators or the manufacturers of the aircraft. Yet those costs are generally regarded as costs properly associated with airline operations and aircraft manufacture, not with the running of oil refineries.

Conclusion

313. The arguments put forward by the industry are strong ones. While the criticisms of subrogation carry great weight, the Commission has concluded that an alteration to the doctrine of subrogation with such wide-reaching effects as those indicated in industry submissions would not, at present, be justified. Although the likely effect of such a change on the behaviour of uninsured motorists may well have been substantially over-estimated in many submissions, the information provided by NRMA Insurance Ltd demonstrates that a substantial additional and undeserved burden would fall on those prudent enough to insure themselves against equivalent risks. This burden would be imposed on them in order to protect third parties who might reasonably be expected to insure themselves against the relevant liabilities. But the major factors are the possibility of unintended and untoward effects on reinsurance and the inappropriateness in principle of imposing losses on the wrong enterprises, particularly, though not exclusively, in relation to large commercial risks. The exercise of rights of subrogation should not be restricted to cases of intentional or reckless conduct on the part of the relevant third parties.

---

46. American Reinsurance Co., Australian Reinsurance Co. Ltd, Cologne Reinsurance Co., Copenhagen Reinsurance Co. (Aust.) Ltd, INA Reinsurance Co., Munich Reinsurance Co. of Australia Ltd, New Reinsurance Co., NRG London Reinsurance Co. Ltd, Reinsurance Co. of Australasia Ltd, Storebrand International Reinsurance Co. of Aust. Pty Ltd, Union Reinsurance Co., Unione Italiana di Riassicurazione, Vesta Insurance Co. of Australia Ltd and Mercantile & General Reinsurance Co. of Australia Ltd, *Submission*, 23 March 1979. Further submissions were received from J. Winter (Australian Reinsurance Co. of Australia Ltd) and S. France (Mercantile & General Reinsurance Co. of Australia Ltd), 29 March 1979 and 4 April 1979.