Burning New Ground in Maryland Subrogation Law: *Rausch* v. *Allstate Insurance Co.*

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Introduction

In a landlord-tenant relationship, when should a tenant be concerned about its liability if its negligence, or the negligence of its employees, causes great damage to the leased premises or to the remainder of the shopping center? Does existing law offer protection to unwary tenants? An insurer may have the right to sue the tenant if its policy contains a subrogation provision. Subrogation is the substitution of one person for another, giving the substitute the same legal rights as the original party. For example, an insurance company usually has a right of subrogation to sue anyone whom the person it compensated had a right to sue. Where real property is damaged and an insurer invokes a subrogation action, it stands in the shoes of the insured to recover against the third party that caused damage to the insured's property. As a result, without appropriate lease language, a tenant may be liable for the total cost to rebuild a shopping center.

In 2004, the Court of Appeals of Maryland decided *Rausch* v. *Allstate Insurance Company,* 388 Md. 690, 882 A.2d 801 (2005), clarifying Maryland law as it relates to a tenant's liability in a subrogation action. The issue before the court was: "Under what circumstances, if any, [may] the insurer pursue its contractual right of subrogation against a tenant of the insured who negligently damaged the insured premises and thereby caused the loss." *Rausch,* 388 Md. at 694. The court recognized that, in other states, most courts addressing the issue have held in favor of the tenant, finding against the insurance company based upon an express or implied waiver of subrogation or a release by the landlord of its right of recovery against the tenant.

Rausch Facts

The *Rausch* case was actually the consolidation of two cases in which residential tenants—Rausch and Harkin—burned down their respective leased property. Even though residential leases were involved, the same law would apply to commercial leases. In each case, the landlord maintained a fire insurance policy on the leased premises. Each of the tenants signed leases with similar provisions stating, generally: (1) the tenant was required to reimburse the landlord for any damages to the property caused by any act of negligence by the tenant; (2) the tenant would surrender the property in the same condition received; and (3) the tenant was required to maintain adequate personal liability and personal property insurance.

In both cases, insurance covered the landlord's losses. Following the insurance payments, the insurers sued the tenants in reliance upon the subrogation clauses in the fire insurance policies. In both insurance policies, the subrogation clause gave the landlord the right to waive its subrogation rights as to "another person" (Rausch) and a "tenant" (Harkin); but in the leases, the landlords did not expressly waive their rights of recovery or agree to obtain a waiver of the insurer's right of subrogation.

Discussion

The law of subrogation varies widely from state to state. Some states, by virtue of the landlord-tenant relationship, view the tenant as an additional insured and, therefore, not subject to a subrogation claim. Other states allow subrogation claims, with no concern for the landlord-tenant relationship.

The 'Majority' View: *Sutton* v. *Jondahl*

Many holdings state that the Oklahoma case, *Sutton* v. *Jondahl,* 532 P.2d 478 (Okla. Ct. App. 1975), best expresses the majority view on how tenants are regarded with respect to subrogation. In *Rausch,* the court states that *Sutton* is not the majority view and goes on to explain the *Sutton* holding, applicable in Oklahoma, as follows:

> [A]bsent an express agreement in the lease to the contrary, landlord and tenant are co-insureds under a landlord's fire insurance policy, and, as a result, the insurer has no right of subrogation against the tenant to recover amounts paid on the policy by reason of a fire loss, even if caused by the negligence of the tenant. *Id.* at 708.

Basically, by virtue of a landlord-tenant relationship, tenants are implied co-insureds under the landlord's existing fire insurance policies. Jurisdictions following the *Sutton* rule include Connecticut, Delaware, Maine, Massachusetts, Nebraska, Nevada, North Dakota, Utah and Washington. Consequently, these jurisdictions prohibit insurance companies from bringing a subrogation action against an "insured," with tenants being considered insured by virtue of the landlord-tenant relationship.

For two primary reasons, Maryland has refused to adopt the Oklahoma position. First, the *Rausch* opinion states that the Oklahoma court essentially pulled its holding out of thin air, with no legal backing for such a hard-and-fast rule. Second, the

Rausch court states that the Oklahoma court made assumptions about the "realities" of the landlord-tenant relationship, some of which may not be applicable to all circumstances. In essence, the Oklahoma court concluded that the rent charged to the tenant must necessarily reflect the expenses of the landlord, capturing the premium the landlord pays to the insurer. In this regard, the tenant's possessory interest in the premises entitles it to be an implied co-insured.

Divergent Interpretations of *Sutton*

The Court of Appeals of Maryland points out that several courts come to the same conclusion as *Sutton*—that is, that tenants are impliedly co-insured—but through a different logic. In Utah and Maine, the courts view the tenants as impliedly co-insured for economic reasons. Those courts hold that landlords are in a better position to insure the property, making such an arrangement "the most efficient way to allocate insurance costs." Connecticut courts, on the other hand, do not even attempt to justify their holding that tenants are impliedly co-insured. Their courts state that "the *Sutton* result is sound" as a matter of "policy" and "fairness." *DiLullo* v. *Joseph,* 792 A.2d 819 (Conn. 2002).

The 'Minority' View—Courts Adamantly Opposed to *Sutton*

Several jurisdictions have criticized the *Sutton* holding, including Arkansas, Illinois, Iowa, Kentucky, Minnesota, New York, North Carolina and Rhode Island. These jurisdictions have a strict constructionist view of the topic, looking to the terms of the lease in rendering their decisions. These courts hold that an insurer may bring such a claim, unless there is an express or implied agreement precluding a subrogation claim against a tenant.

Although the logic behind the laws of the states varies, the logic of several states is worth mentioning. In Arkansas, a court opined that, absent an agreement otherwise, if the landlord has no insurance he can clearly recover from the tenant and, therefore, the insurer should have the same right. In Iowa, the courts discount *Sutton,* based on the fact that the landlord and the tenant have "separate estates capable of being separately valued and insured." *Rausch* at 711-12. Rhode Island courts, reaching the opposite view of *Sutton,* refuse to rewrite insurance policies to include an insured that is not a party to the contract.

The Real Majority View—Reasonable Expectations of the Parties

After reviewing the national state of subrogation law, the Rausch court concluded that the real majority view is a middle-of-the-road approach. This approach is summed up in *Union Mutual Fire Ins. Co.* v. *Joerg,* 824 A.2d 586 (Vt. 2003), where the court observed:

> The majority of courts, however, have avoided per se rules and taken a more flexible case-by-case approach, holding that a tenant's liability to the landlord's insurer for negligence causing a fire depends on the intent and reasonable expectations of the parties to the lease as ascertained from the lease as a whole [extensive citations omitted]. Of the courts following this approach, most that have denied subrogation have done so because of the existence of specific provisions in the lease, such as a provision obligating the landlord to purchase fire insurance on the premises or a clause excepting fire damage from the tenant's responsibility to maintain or return the property in a good state and condition.

The middle-of-the-road approach looks at the lease and the surrounding circumstances, and reaches an ultimate conclusion based on the reasonable expectations of the landlord and tenant.

In *Rausch,* the Court of Appeals of Maryland adopted the "reasonable expectations" approach as Maryland's law, stating:

> We believe that this middle approach, of looking to the reasonable expectations of the parties to the lease, as determined from the lease itself and any other admissible evidence, is the appropriate one to follow. It avoids the court making assumptions and adopting fictions that are largely conjectural, if not patently illogical, and instead applies basic contract principles and gives proper credence to the equitable underpinning of the whole doctrine of subrogation.

The court rejected any hard or fixed rules for subrogation claims, choosing instead to examine each dispute on a case-by-case basis.

After stating Maryland's acceptance of the "reasonable expectations" approach, the court set forth a general analytical framework for reaching a conclusion as to the reasonable expectations of a landlord and a tenant. The court looked at four general principles on which such decisions should focus:

1. A subrogation claim is not contrary to public policy—normal contract law applies, and the tenant can only be liable to an insurer to the extent of the landlord's liability;
2. If a tenant is released from liability for fire loss in the lease, an insurer stepping into the shoes of the landlord has no right to a subrogation claim against the tenant;
3. A waiver of subrogation is implied where the landlord expressly or impliedly communicates to the tenant that the landlord will maintain fire insurance on the leased premises; and

4. If the leased premises is a unit in a multi-unit building, absent an express agreement to the contrary, a Maryland court will conclude that the landlord has a duty to have adequate fire insurance in place as to the entire building.

Under the fourth principle, the tenant may not be liable for the subrogation claim of the landlord's insurer as to damage to parts of the landlord's building outside of the portion of the building actually occupied by the tenant, but still could be - liable for damage to the leased premises.

Conclusion

What the *Rausch* holding means to Maryland landlords is simple—within the lease, the landlord should be clear as to the right of subrogation. Tenants should also always insist on a clause in the lease mandating that the landlord carry property damage coverage on the entire property. A waiver of subrogation clause without a duty on the landlord's part to carry any insurance may not be of any benefit to the tenant. A well-drafted lease should not require a Maryland court to apply a lengthy reasonable expectations test, but should make the intentions of the parties clear on its face. The lease should simply state that there is (1) a release of claims by the landlord to the extent of insurance, (2) a duty for the landlord to obtain and keep in force property damage insurance, and (3) a requirement that the landlord's policy permit the waiver of subrogation. The result of ambiguity in a lease is the potential for lengthy and costly litigation with the court attempting to interpret the reasonable expectations of the parties.

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