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Recent Developments: Rausch v. Allstate Ins. Co.: A Tenant's Liability in a Subrogation Action Is Determined by the Reasonable Expectations of the Parties to the Lease

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RECENT DEVELOPMENT

RAUSCH V. ALLSTATE INS. CO.: A TENANT'S LIABILITY IN A SUBROGATION ACTION IS DETERMINED BY THE REASONABLE EXPECTATIONS OF THE PARTIES TO THE LEASE

By: Nancy Chung

In a consolidated case of first impression, the Court of Appeals of Maryland held that a tenant's liability in a subrogation action is determined by the reasonable expectations of the parties to the lease. *Rausch v. Allstate Ins. Co.*, 388 Md. 690, 882 A.2d 801 (2005). In so holding, the Court held that tenants were not co-insureds with the landlords under their insurance policies *per se*, and may therefore be sued by the insurer to enforce a subrogation clause unless a provision in the contract states otherwise. *Id.* at 694, 882 A.2d at 803.

The first case began in September 1999, when John Dunlop ("Dunlop") appointed American Relo Realty, Inc. ("ARRI") to manage and rent his property. In the agreement, ARRI required Dunlop to maintain fire insurance for damage that may arise from the occupancy or management of the house.

In March 2000, ARRI leased the property to Mr. and Ms. Rausch ("Rausches"). On April 12, 2000, Ms. Rausch left a flammable item on the electric range which was on "high" and left the property, which ignited a fire and resulted in property damage amounting to $152,000. Dunlop's insurer, Allstate Insurance Company ("Allstate") paid Dunlop $138,000 to satisfy his claim for the damages.

Allstate then sued the Rausches in a subrogation action in U.S. District Court to recover the $138,000 paid to Dunlop. The Rausches moved for summary judgment, arguing that tenants are regarded as implied co-insureds, therefore precluding them from subrogation actions by Allstate. The U.S. District Court certified the question because this issue had yet to be addressed in Maryland.

In the second case, Janice Harkins ("Harkins") entered into a one-year lease in May 1999 for one unit of a multi-unit apartment development. The owner of the apartment development had a fire

insurance policy with Harford Mutual Insurance Company ("Harford").

On March 29, 2000, Harkins lit one or more candles on a nightstand in her bedroom and left the room. Harkins, who had earlier ignored the smoke alarm believing it had malfunctioned, did not respond to the fire in her bedroom until she smelled smoke. The fire caused over $83,000 in damage, which was paid out by Harford.

Exercising its rights as subrogee, Harford sued Harkins in the Circuit Court for Harford County. Harkins moved for summary judgment on the ground that the subrogation clause was unenforceable because she was an implied co-insured under the policy. The circuit court agreed and granted summary judgment for Harkins. Harford appealed and the Court of Appeals of Maryland granted certiorari on its own initiative prior to proceedings in the Court of Special Appeals of Maryland by consolidating the *Harkins* and *Rausch* cases.

The Court of Appeals of Maryland began its analysis by noting that Maryland has long held that a negligent tenant is liable in tort for damages caused to the landlord's property. *Id.* at 699, 882 A.2d 806. It has also held that an insurer may not recover from its insured or co-insured as subrogee. *Id.* at 701, 882 A.2d 807.

The Court of Appeals then looked to two major cases that have been frequently cited and relied upon by other jurisdictions. *Id.* at 703-712, 882 A.2d 808-814. In *General Mills v. Goldman*, 184 F.2d 359 (8th Cir. 1950), the United States Court of Appeals for the Eighth Circuit held that the tenant was not liable for damages caused by fire even if it was caused by the tenant's negligence because the lease contained a clause that specifically exonerated the tenant for loss by fire. *Rausch*, 388 at 704, 882 A.2d at 809 (citing *General Mills*, 184 F.2d at 366). In effect, this ruling acknowledged that without the exoneration clause, the tenant would have been liable to the landlord's insurer for any damages reimbursed for loss by fire under the doctrine of subrogation. *Id.* at 705, 882 A.2d at 809.

In *Sutton v. Jondahl*, the Court of Appeals of Oklahoma held that the insurer could not subrogate against the negligent tenant because the law considered the tenant to be a co-insured of the landlord "absent an express agreement between them to the contrary." *Rausch*, 388 at 707, 882 A.2d at 810 (quoting *Sutton*, 532 P.2d 478, 482 (Okla. Ct. App. 1975)). In reaching its holding, the court in *Sutton* relied on the inferences that both the landlord and tenant have an insurable interest in the rented premises and that the tenants rely on the landlord to

provide fire protection for the property unless the agreement states otherwise. *Id.* at 707, 882 A.2d at 810-811.

A majority of the courts have taken a middle approach, adopting the underlying holdings of *Goldman* and *Sutton*. *Id.* at 712, 882 A.2d at 814. Generally, these courts held that a tenant's liability in a subrogation action is determined by the reasonable expectations of the parties to the lease, which is determined by examining the lease as a whole to determine those expectations. *Id.* at 713, 882 A.2d at 814. Most courts have also rejected a per se rule or presumption that tenants are co-insureds. *Id.*

The Court of Appeals of Maryland agreed with the majority of the courts in taking the middle ground approach. *Id.* The Court acknowledged the well reasoned holding of *Union Mutual Fire Insurance Company v. Joerg*, 824 A.2d 586 (Vt. 2003), which held that: "where the lease requires the landlord to carry fire insurance on the leased premises, such insurance is for the mutual benefit of landlord and tenant, and as such, the tenant is deemed a co-insured under the landlord's insurance policy and, is protected against subrogation claims by the landlord's insurer." *Rausch*, 388 at 713, 882 A.2d at 814 (quoting *Joerg*, 824 A.2d at 591).

The Court reasoned that this middle approach is far better than the extreme approach of the *Sutton* court. *Id.* at 713-714, 882 A.2d at 814-815. The *Sutton* court included tenants as co-insureds just to preclude insurers from bringing subrogation claims against them. *Id.* at 714, 882 A.2d at 815. The Court of Appeals of Maryland recognized that although the middle approach forces the court to analyze on a case-by-case basis, there exist clear controlling principles of basic contract and subrogation law that will aid in the analysis. *Id.* First, subrogation against tenants is not against public policy. *Id.* at 715, 882 A.2d 815. Given this, there are two caveats: 1) a provision creating or enhancing a tenant's liability are subject to the rules of contract law; and 2) an insurer may not subrogate against the tenant unless the tenant was liable to the landlord in the first instance. *Id.*

The latter caveat led the Court to their second principle: there is no right to subrogation where a provision in the lease relieves the tenant of liability for fire loss, even if caused by the tenant's negligence, because the tenant would not be liable to the landlord in the first place. *Id.* at 716, 882 A.2d at 816.

Third, if there is an expressed or implied agreement that the landlord will maintain fire insurance on the leased premises without a provision in the lease stating otherwise, the tenant may reasonably

expect that the landlord's insurer would not look to the tenant to recover for fire loss. *Id.*

Fourth, if the leased premises are part of a multi-unit structure, a court may conclude that the tenant reasonably expected the landlord to provide fire insurance outside the leased premises. *Id.* Therefore the tenant is not liable for damages outside the leased premises unless some enforceable provision in the lease states otherwise. *Id.*

The holding in *Rausch v. Allstate Insurance Company* finally provides Maryland with guidelines for evaluating the liability of tenants in subrogation actions brought by the landlord's insurer. Maryland courts must now look to the lease as a whole to determine whether the tenant reasonably expected to be liable for fire damage to ultimately decide whether the landlord's insurer has a right to subrogation against the tenant. As a result of this holding, landlords, insurance companies and tenants are on notice as to their potential liability under the lease between the landlord and the tenant.