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## The Roof Is on Fire: When, Absent an Agreement Otherwise, May a Landlord's Insurer Pursue a Subrogation Claim Against a Negligent Tenant?

Robert Vanneman Spake, Jr.

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# The Roof Is on Fire: When, Absent an Agreement Otherwise, May a Landlord's Insurer Pursue a Subrogation Claim Against a Negligent Tenant?

Robert Vanneman Spake, Jr.\*

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### I. Introduction

Under the theory of subrogation, courts permit one party to stand in another party's shoes with reference to the former's legal claims or rights.<sup>1</sup> In the insurance context, a subrogated insurer stands in the shoes of its insured and seeks indemnification from third parties whose wrongdoing caused a loss for which the insurer is obligated to pay.<sup>2</sup> An insurer, however, can only be subrogated in reference to third parties and is barred from pursuing subrogation claims against its insured when the claim concerns the property for which the insured is covered.<sup>3</sup> However, the clear distinction between the insured and the

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1. See 73 AM. JUR. 2D *Subrogation* § 1 (2001) ("Subrogation, a legal fiction, is broadly defined as the substitution of one person in the place of another with reference to a lawful claim or right."); see also RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS § 162 cmt. a (1937) (stating that the right to subrogation arises when a court, in order to prevent unjust enrichment, permits a plaintiff, who discharged an obligation owed by the defendant, to revive the discharged obligation and assume the rights that the obligee had against the defendant prior to the obligation's discharge).

2. See GEORGE J. COUCH, COUCH ON INSURANCE § 222:5 (Lee R. Russ in consultation with Thomas F. Segalla, ed. 2005) (noting that when the insurer stands in the shoes of the insured, the insurer's legal rights and claims are identical to those of the insured).

3. See *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 807 (Md. 2005) (citing the long standing legal principle that "an insurer may not recover from its insured, or a co-insured, as subrogee").

third party blurs in the landlord-tenant context. What should result if an insurer reimburses an insured landlord for damage caused by a negligent, uninsured tenant? The courts are currently split as to whether the insurer may pursue a subrogation claim against that negligent tenant.

Consider the following hypothetical: Sally rents a townhouse in Washington, D.C. from Landlord Properties. When entering the lease, Sally does not discuss fire insurance with Landlord Properties; Sally does not purchase renter's insurance to cover her for claims of negligence; but Landlord Properties does procure fire insurance from Ekaps Insurance. One evening when Sally departs for a benefit dinner, she negligently fails to extinguish a scented candle. Several hours later when Sally returns, she finds that her scented candle sparked a fire, reducing the insured structure to a smoldering pile of ash. After Ekaps Insurance compensates Landlord Properties for the loss incurred, Ekaps Insurance wishes to pursue a subrogation claim against Sally.

In responding to this situation, some courts adopt a case-by-case method of analysis, where on some occasions insurers are subrogated against the negligent tenant and on other occasions they are not, providing an unpredictable, unstable approach.<sup>4</sup> Other courts adopt a "no-subrogation" rule, barring insurers from pursuing subrogation claims against negligent tenants, and allowing the negligent party to enjoy a windfall by virtue of escaping liability.<sup>5</sup> Finally, some courts adopt a "pro-subrogation" rule where insurers may pursue a subrogation claim against negligent tenants, allocating the loss to the party responsible for the damage and the party best positioned to avoid such loss.<sup>6</sup>

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4. See, e.g., *id.* at 815 (adopting a "middle approach," where courts employ a case-by-case method of analysis).

5. See, e.g., *Sutton v. Jondahl*, 532 P.2d 478, 482 (Okla. Civ. App. 1975) (stating that a tenant is an implied co-insured and that as a result an insurance company cannot pursue a subrogation claim against the tenant, even if the tenant negligently damaged the insured structure and thereby caused loss); see also *DiLullo v. Joseph*, 792 A.2d 819, 822-23 (Conn. 2002) (rejecting *Sutton's* presumption that a tenant is an implied co-insured, but following *Sutton's* result because of the court's concern regarding renter's insurance, especially in a multi-unit structure, where a tenant would be required to obtain insurance coverage for the replacement cost of the entire building).

6. See, e.g., *Page v. Scott*, 567 S.W.2d 101, 103-04 (Ark. 1978) (concluding that real estate markets set rent prices, not component costs such as insurance premiums, property taxes, and maintenance expenses, and finding that the lessor and the lessee have separate interests in the property each of which may be separately insured). Therefore, absent an express or implied agreement stating otherwise, if a landlord can recover the cost of the damage caused by a negligent tenant, so too can the insurance company pursue a subrogation claim against a negligent tenant. *Id.*

In the abovementioned hypothetical, Sally is clearly the wrongdoer, and Ekaps Insurance clearly suffers financial detriment when it compensates Landlord Properties for the detriment Sally caused to the insured structure. Under these circumstances, should Sally escape liability and enjoy unjust enrichment merely because Landlord Properties had the foresight to purchase insurance?<sup>7</sup> Or should a court permit Ekaps Insurance's subrogation claim against Sally, reimbursing the insurer for the compensation it paid to the insured?<sup>8</sup> Or should a court acknowledge that landlord-tenant relationships vary greatly and that each case's outcome should depend on the reasonable expectations of the parties in regard to the specific lease, including all the relevant admissible evidence at issue?<sup>9</sup>

A situation similar to the above hypothetical arose in *Rausch v. Allstate Insurance Co.*<sup>10</sup> In fact, this situation is not novel and courts continue to resolve this issue in different ways.<sup>11</sup> All of these methods of analysis are supported by public policy rationales and all of these methods of analysis suffer from individual inadequacies. As a result, whenever such a situation arises, courts continue to assign differing weights to each public policy, ultimately concluding one method is superior to another. In order to resolve the current inconsistencies in the law, the American Law Institute (ALI) in its *Restatement (Third) of Restitution and Unjust Enrichment* should endorse a means of addressing this issue, providing direction on this issue of legal divergence.<sup>12</sup>

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7. See *Sutton*, 532 P.2d at 482 (concluding that a tenant is an implied co-insured and that as a result an insurer cannot pursue a subrogation claim against the tenant, even if the tenant negligently damaged the insured property and thereby caused loss); see also *DiLullo*, 799 A.2d at 822–23 (rejecting *Sutton*'s presumption that a tenant is an implied co-insured, but following *Sutton*'s result because of the court's concern regarding renter's insurance, especially in a multi-unit structure, where a tenant would be required to obtain insurance coverage for the replacement cost of the entire building, a cost which may likely prove untenable).

8. See *Page*, 567 S.W.2d at 103–04 (finding that, absent an express or implied agreement otherwise, an insurer can pursue a subrogation claim against a negligent tenant).

9. See *Rausch*, 882 A.2d at 814–15 (adopting a "middle approach," where courts employ a case-by-case method of analysis that looks "to the reasonable expectations of the parties to the lease, as determined from the lease itself and any other admissible evidence").

10. See *id.* at 803 (addressing whether to permit an insurer to pursue a subrogation claim against a negligent tenant who caused damage and subsequent loss to the insured property, the court adopted a "middle approach" in which such cases are decided on a case-by-case basis).

11. See *infra* Part III and accompanying text (exploring exemplary judicial treatment of the issue, including the case-by-case approach, the "no-subrogation" approach, and "the pro-subrogation" approach); see also MICHAEL J. KARTER, JR., FIRE LOSS IN THE UNITED STATES DURING 2004 i–iii (Fire Analysis and Research Div. Nat'l Fire Prot. Ass'n, 2005) (stating that in 2004, a fire occurred in a structure every sixty seconds and noting that structure fires caused \$8,314,000,000 in property damage) (on file with the Washington and Lee Law Review).

12. See generally RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT

This Note analyzes the current jurisdictional split as to whether, absent an agreement otherwise, a landlord's insurer may pursue a subrogation claim against a negligent tenant. In examining this dilemma, this Note explores the different public policy motivations behind the alternative rules and concludes that the ALI should adopt the "pro-subrogation" approach. Part II of this Note defines subrogation and examines its purposes. Part III presents exemplary judicial treatments of this issue, exploring the three different rules courts currently apply to the question of whether, absent an agreement otherwise, a landlord's insurer may pursue a subrogation claim against a negligent tenant. In Part IV, this Note evaluates both the future implications of the three distinct rules and the public policy rationales underlying them. With respect to the public policy rationales, this Note looks to determine the approach that best promotes subrogation's purpose and which best considers the nature of the insurance market. Part V counsels that, although this Note focuses on a default rule solution, all parties at issue could avoid the expense of litigation in the planning stage through careful and thoughtful drafting. Finally, Part VI concludes that, in considering the desire for stable and predictable laws, the purpose of subrogation, and the nature of the insurance market, the ALI, in its *Restatement (Third) of Restitution and Unjust Enrichment*, should endorse the "pro-subrogation" approach.

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(Tentative Draft No. 4, 2005) (addressing proposals for the new restatement, but not addressing the issue of whether, absent an agreement otherwise, a landlord's insurer may pursue a subrogation claim against a negligent tenant); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (Tentative Draft No. 3, 2004) (same); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (Tentative Draft No. 2, 2002) (same); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (Tentative Draft No. 1, 2001) (same). Of the abovementioned sources, only the RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT (Tentative Draft No. 2) addressed subrogation specifically, when it proposed:

If the claimant renders to a third person a performance for which the defendant would have been liable had the third person asserted a claim against the defendant directly, the claimant is entitled to restitution from the defendant as necessary to prevent unjust enrichment if

(a) the claimant acts in the performance of an obligation owed independently by the claimant to the third person, or otherwise in the reasonable protection of the claimant's own interests; and

(b) as between the claimant and the defendant, the performance or the part thereof with respect to which the claimant seeks restitution is primarily the obligation of the defendant.

RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 26 (Tentative Draft No. 2, April 1, 2002). The comments and illustrations following RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 26 (Tentative Draft No. 2) also fail to propose a solution to the jurisdictional split at issue. *Id.*

## II. Subrogation

Subrogation's definition and purpose frame the analysis of whether, absent an agreement otherwise, a landlord's insurer may pursue a subrogation claim against a negligent tenant. This Part does not argue that the ALI should endorse a case-by-case rule, a "no-subrogation" rule, or a "pro-subrogation" rule. Rather, this Part merely presents the traditional definition and purpose of subrogation, with specific reference to the insurance setting.

### A. Subrogation Defined

Subrogation is a settled legal principle standing for the following proposition: "Where the property of one person is used in discharging an obligation owed by another . . . under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the obligee."<sup>13</sup> Stated metaphorically, subrogation permits one party to stand in the shoes of another with reference to the former's legal claims or rights.<sup>14</sup> The law has recognized two types of subrogation: "conventional" subrogation and "legal" or "equitable" subrogation.<sup>15</sup> Conventional subrogation arises out of a contract in which one party, who has no relation to the specific matter, pays the debt of

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13. RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS § 162 (1937).

14. See RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 26 cmt. f, illus. 30 (Tentative Draft No. 2, Apr. 1, 2002) (providing an illustration about general contractual subrogation in insurance). The *Restatement* stated:

Lessee occupies Blackacre under a lease by which Lessee agrees to indemnify Lessor against any loss caused by Lessee's use of the premises. A fire originating on Blackacre, without the fault of the Lessee, damages Whiteacre, an adjoining tract also owned by Lessor. Lessor's Insurer pays for the damage to Whiteacre, then seeks reimbursement from Lessee. The court determines that Lessee has no liability in tort, but that the indemnification provision of the lease covers the loss in question. Insurer has a claim against Lessee under this Section, via subrogation to Lessor's rights under the lease.

*Id.*; see also 73 AM. JUR. 2D *Subrogation* § 1 (2001) ("Subrogation, a legal fiction, is broadly defined as the substitution of one person in the place of another with reference to a lawful claim or right.").

15. See 73 AM. JUR. 2D *Subrogation* § 3 (2001) (noting that the law has recognized "conventional" and "legal" or "equitable" subrogation and in some jurisdictions the legislature has enacted "statutory" subrogation); see also *Wasko v. Manella*, 849 A.2d 777, 781–82 (Conn. 2004) (citing *Westchester Fire Ins. Co. v. Allstate Ins. Co.*, 672 A.2d 939 (Conn. 1996)) (noting that if the insurer is permitted to pursue a subrogation claim against the negligent tenant such action is based in "equitable" and not "conventional" subrogation).

another, and by agreement subsequently assumes the rights and remedies of the original creditor.<sup>16</sup> Equitable subrogation, however, arises out of equitable principles, with or without a specific agreement.<sup>17</sup> Such action "includes every instance in which one person, not acting voluntarily, has paid a debt for which another was primarily liable and which in equity and good conscience should have been discharged by the latter."<sup>18</sup> In the insurance setting, when an insurer covers a loss of the insured, the insurer assumes all of the insured's rights and claims against the third party, who through negligence or wrongful conduct caused the damage, irrespective of whether the insurer would have been entitled to bring the suit itself.<sup>19</sup> It is important to note that an insurer, who out of a preexisting obligation reimburses an insured for losses caused by a negligent third party, pursues an equitable subrogation claim against the wrongdoer, not a conventional one.<sup>20</sup>

### B. Subrogation's Purpose

Subrogation has "for its purpose the working out of an equitable adjustment between the parties by securing the ultimate discharge of a debt by the person who in equity and good conscience ought to pay it."<sup>21</sup> In the insurance context, subrogation's purpose implicates the perspectives of three

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16. See 73 AM. JUR. 2D *Subrogation* § 4 (2001) (stating that "conventional" subrogation is contractual, but may arise out of express or implied agreement where "an obligee, who receives performance from a third party, subrogates that person to his rights, even without obligor's consent").

17. See *id.* § 5 ("Equitable subrogation' is not a matter of contract and does not arise from any contractual relationship between the parties, but rather, it takes place as a matter of equity.").

18. *Id.*

19. See COUCH, *supra* note 2, § 222:5 (discussing the insurer's role in subrogation). Couch stated:

Accordingly, on paying a loss, an insurer is subrogated in a corresponding amount to the insured's right of action against any other person responsible for the loss, such that the insurer is entitled to bring an action against this third party whose negligent or other tortious or wrongful conduct caused the loss, regardless of whether the insurer would have been entitled to bring such an action in its own right.

*Id.*

20. See *Wasko v. Manella*, 849 A.2d 777, 781-82 (Conn. 2004) ("[I]nsurers that are obligated by a *preexisting* contract to pay the losses of an insured proceed in a subsequent action against the responsible party under the theory of equitable subrogation, and not conventional subrogation.").

21. COUCH, *supra* note 2, § 222:8.



parties: the insured, the tortfeasor, and the insurer.<sup>22</sup> In regard to the insured, subrogation operates to prevent unjust enrichment, where the insured would recover both from the insurer and the tortfeasor.<sup>23</sup> In regard to the tortfeasor, subrogation assures that the wrongdoer will be held legally responsible for the damages caused, blocking the potential windfall of escaping liability merely because the insured had the foresight to purchase insurance for his own protection.<sup>24</sup> Finally, in regard to the insurer, subrogation reimburses the insurer for payments it has made to the insured in order to remedy the damage caused by a third party.<sup>25</sup>

Additional wrinkles complicate subrogation's purpose in the landlord-tenant context. First, the insurer cannot pursue a subrogation claim against the insured.<sup>26</sup> This naturally follows because the insurer contractually accepted the risk of loss resulting from the insured's negligence, and equity bars an insurer's claim of re-indemnification.<sup>27</sup> Therefore, under traditional subrogation theory, when a party other than the insured damages the insured property and the insurer compensates the insured, the insurer remains subrogated to the insured's claim against the wrongdoer.<sup>28</sup> Second, courts are abandoning the traditional rule with increasing frequency and are barring the insurer's subrogation claim by concluding that the wrongdoer is an "implied" or "quasi" co-insured.<sup>29</sup> Although courts invoke the implied or quasi co-insured legal

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22. See *id.* (stating that "subrogation's purpose has been described from the perspective of the insured, the tortfeasor, and the insurer, often in terms of the effect of the other parties or in combination").

23. See *id.* (noting that although there is authority to the contrary, from the insured's perspective subrogation has the objective to prevent double recovery).

24. See *id.* (discussing that from the tortfeasor's perspective, "a wrongdoer who is legally responsible for the harm should not receive the windfall of being absolved from liability because the insured had the foresight to obtain, and had paid the expense of procuring, insurance for his or her perspective.").

25. See *id.* (noting that when an insurer compensates an insured for damage caused by a third party, it is only equitable for the insurer to seek reimbursement).

26. See James M. Fischer, *The Presence of Insurance and the Legal Allocation of Risk*, 2 CONN. INS. L.J. 1, 5 (1996) (discussing the general rule, in American jurisdictions, that there is no subrogation against the insured).

27. See *id.* (noting that because the insurer contractually "accepted the risk and agreed to indemnify the insured from loss (within contract limits) if the loss occurs (i.e., the risk is realized), the insurer cannot seek reindemnification from the insured under general equity theories of indemnity, contribution or subrogation"). Fischer also notes, however, that when an insured's actions cause loss, such actions may provide the insurer with a contractual defense that would deny the insured the right to collect under the insurance policy. *Id.*

28. See *id.* at 6-7 (citing a diagram in which "the insurer indemnifies the victim for the loss and is in turn subrogated to the victim's claim against the wrongdoer").

29. See *id.* at 7 (noting that courts are employing the "no subrogation against the insured"

fiction in few contexts, one of those contexts is the landlord-tenant relationship.<sup>30</sup> This Note will discuss how the implied co-insured legal fiction in the landlord-tenant context violates subrogation's original purpose and will argue that the ALI should recommend its abolition.

### III. Exemplary Judicial Treatment of the Issue

An examination of the three primary treatments that the courts employ to resolve this issue will properly introduce the competing public policies at play. First, some courts adopt a case-by-case method of analysis, favoring an individualized decision-making process that fails to provide stability and predictability.<sup>31</sup> Second, other courts employ a "no-subrogation" rule, invoking differing rationales, such as the implied co-insured legal fiction rationale,<sup>32</sup> or the economic waste and reasonable expectations of the parties rationale.<sup>33</sup> Finally, some courts adopt a "pro-subrogation" rule, permitting the insurer's subrogation claim against a negligent tenant, thus upholding traditional subrogation law.<sup>34</sup>

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rule to prevent the insurer from pursuing a subrogation claim against the wrongdoer claiming the wrongdoer is an "implied" or "quasi" co-insured).

30. See *id.* (proposing that "[i]n general, creation of implied or quasi co-insureds has been limited to situations where a relationship exists between the named insured and the tortfeasor, such as that of landlord-tenant, contractor-subcontractor, and vendor-vendee").

31. See, e.g., *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 814–15 (Md. 2005) (adopting a "middle approach," where courts employ a case-by-case method of analysis); *Union Mut. Fire Ins. Co. v. Joerg*, 824 A.2d 586, 589–90 (Vt. 2003) (same); *Bannock Bldg. Co. v. Sahlberg*, 887 P.2d 1052, 1056 (Idaho 1994) (same); *Middlesex Mut. Assurance Co. v. Vaszil*, 873 A.2d 1030, 1033–34 (Conn. App. Ct. 2005), *rev'd and remanded*, 900 A.2d 513 (Conn. 2006) (same); *Fire Ins. Exch. v. Hammond*, 99 Cal. Rptr. 2d 596, 600–01 (Cal. Ct. App. 2000) (same).

32. See, e.g., *Sutton v. Johdahl*, 532 P.2d 478, 482 (stating that a tenant is an implied co-insured and as a result an insurance company cannot pursue a subrogation claim against the tenant, even if the tenant negligently damaged the insured structure and thereby caused loss); *Tri-Par Invs., L.L.C. v. Sousa*, 680 N.W.2d 190, 198–200 (Neb. 2004) (same); *N. River Ins. Co. v. Snyder*, 804 A.2d 399, 403–04 (Me. 2002) (same); *Peterson v. Silva*, 704 N.E.2d 1163, 1165–66 (Mass. 1999) (same); *Cmty. Credit Union v. Homelvig*, 487 N.W.2d 602, 604–05 (N.D. 1992) (same); *GNS P'ship v. Fullmer*, 873 P.2d 1157, 1163–64 (Utah Ct. App. 1994) (same); *United Fire & Cas. Co. v. Bruggeman*, 505 N.W.2d 87, 88–90 (Minn. Ct. App. 1993) (same); *Lexington Ins. Co. v. Raboin*, 712 A.2d 1011, 1016–17 (Del. Super. Ct. 1998) (same).

33. See, e.g., *DiLullo v. Joseph*, 792 A.2d 819, 822–23 (Conn. 2002) (rejecting *Sutton's* presumption that a tenant is a co-insured, but following *Sutton's* result because of the tenant's concern regarding renter's insurance, especially in multi-unit structures, where a tenant would be required to obtain insurance coverage for the replacement cost of the entire building, a cost which may likely prove untenable).

34. See, e.g., *Page v. Scott*, 567 S.W.2d 101, 103–04 (Ark. 1978) (rejecting the co-insured legal fiction). In rejecting the co-insured legal fiction the court noted that the market

### A. The Case-by-Case Approach

The first group of courts decline to adopt a "no-subrogation" rule or "pro-subrogation" rule, alternatively opting to endorse a "middle approach" that employs a case-by-case method of analysis. In *Rausch*, the Maryland Court of Appeals consolidated two cases in which it decided whether to permit an insurance company to pursue a subrogation claim against a tenant who negligently caused damage to property insured by the landlord.<sup>35</sup> In *Rausch*, the Rausches entered into a six-month lease for property managed by Relo Realty and owned by John Dunlop.<sup>36</sup> During the lease, Mrs. Rausch left the rented property, negligently failing to remove a flammable item from the rear burner of the electric range, a burner which was set on "high."<sup>37</sup> The electric range sparked a fire that caused \$152,000 worth of damage, of which Allstate Insurance paid Dunlop \$138,000.<sup>38</sup> Allstate next sought to enforce a subrogation clause against the Rausches.<sup>39</sup>

In *Hartford Mutual Insurance Co. v. Harkins*, the companion case, Janice Harkins entered into a one-year lease for an apartment in a multi-unit building.<sup>40</sup> During the term of the lease, Ms. Harkins lit a scented candle in her bedroom and then left the room to answer a telephone call.<sup>41</sup> While on the phone, Ms. Harkins ignored the sounding smoke detector, dismissing it as a false alarm.<sup>42</sup> When Ms. Harkins realized that her bedspread was on fire, she made a failed attempt to extinguish the blaze.<sup>43</sup> Hartford Insurance ultimately

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sets rent prices, not component costs. *Id.* The court also found that the lessor and the lessee have separate interests in the property each of which may be separately insured. *Id.* Finally, the court concluded that, absent an agreement otherwise, as a landlord can recover the cost of the damage caused by a negligent tenant so too can the insurance company pursue a subrogation claim against a negligent tenant. *Id.* *Osborne v. Chapman*, 574 N.W.2d 64, 67–68 (Minn. 1998) (rejecting the co-insured legal fiction); *Neubauer v. Hostetter*, 485 N.W.2d 87, 89–90 (Iowa 1992) (same); *Zoppi v. Traurig*, 598 A.2d 19, 21–22 (N.J. Super. Ct. Law Div. 1990) (same); *Regent Ins. Co. v. Econ. Preferred Ins. Co.*, 749 F. Supp. 191, 195 (C.D. Ill. 1990) (same).

35. See *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 803 (Md. 2005) (deciding "under what circumstances, if any, the insurer may pursue its contractual right of subrogation against a tenant of the insured who negligently damaged the insured premises and thereby caused the loss").

36. *Id.*

37. *Id.* at 804.

38. *Id.*

39. *Id.*

40. *Rausch*, 882 A.2d at 805.

41. *Id.*

42. *Id.*

43. *Id.*

paid the owner of the building \$83,000.<sup>44</sup> Hartford next pursued a subrogation claim against Ms. Harkins.<sup>45</sup> In resolving these two cases, the court adopted a "middle approach" and concluded that such cases should be decided using a case-by-case method of analysis.<sup>46</sup>

In its legal analysis, the court rejected the "no-subrogation" and "pro-subrogation" rules as rigid, *per se* approaches.<sup>47</sup> Rather, the court favored a flexible, case-by-case analysis that looked "to the reasonable expectations of the parties to the lease, as determined from the lease itself and any other admissible evidence."<sup>48</sup> The court buttressed its holding by arguing that its rule "avoids . . . 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."<sup>49</sup>

In its analysis, the court laid out a set of guiding principles to advise future courts. First, the court concluded that absent an agreement otherwise, landlords and tenants are not implied co-insureds as a matter of law.<sup>50</sup> The court deconstructed the *Sutton v. Jondahl*<sup>51</sup> rationale, noting that: (a) the tenant's insurable interest in continued possession of the leased property does not make the tenant a co-insured;<sup>52</sup> (b) a tenant in the landlord-tenant context is not properly analogous to a permissive user in the automobile context;<sup>53</sup> and (c) courts that label tenants as implied co-insureds for the sole purpose of barring a subrogation action are relying upon a tenuous, "unsupportable legal

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44. *Id.* at 805–06.

45. *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 806 (Md. 2005).

46. *Id.* at 815.

47. *See id.* at 814 (concluding that the middle approach is the "appropriate one to follow").

48. *Id.*

49. *Id.*

50. *See Rausch*, 882 A.2d at 815 (noting that the implied co-insured legal fiction has "no valid foundation" as a matter of law).

51. *See Sutton v. Jondahl*, 532 P.2d 478, 482 (Okla. Civ. App. 1975) (holding that a tenant is an implied co-insured and consequently an insurer cannot pursue a subrogation claim against the tenant, even if the tenant negligently damaged the insured property and thereby caused loss); *see also supra* Part III.B.1 and accompanying text (summarizing *Sutton's* legal analysis and holding).

52. *See Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 815 (Md. 2005) (stating that if a fire renders the leased structure uninhabitable, "the tenant would have no right of recovery under the landlord's policy for the loss of possession, unless the policy provides such coverage").

53. *See id.* (arguing that unlike the default landlord-tenant relationship, "[p]ermissive users are regarded as insureds under such a policy because the policy expressly provides coverage for them, usually by including them in the definition of 'insured'").

fiction."<sup>54</sup> Second, the court concluded that an insurer's subrogation claim against a negligent tenant may further public policy, not frustrate it.<sup>55</sup> Third, the court stated two caveats: (a) general contract laws apply regarding construing ambiguous provisions against the draftsman and invalidating contracts of adhesion that violate public policy;<sup>56</sup> and (b) no right to subrogation exists "save [where] there is liability in the first instance by the tenant to the landlord."<sup>57</sup> Finally, the court created the presumption that in a large multi-unit structure, absent a provision otherwise, the parties reasonably expect the landlord to procure proper fire insurance.<sup>58</sup> Therefore, the court found:

Within the construct of these principles, a court must look at the lease as a whole, along with any other relevant and admissible evidence, to determine if it was reasonably anticipated by the landlord and the tenant that the tenant would be liable, in the event of a fire loss paid by the landlord's insurer, to a subrogation claim by the insurer.<sup>59</sup>

Ultimately, if the parties reasonably anticipated that the landlord's insurance policy would cover the tenant, the court barred the insurer's subrogation claim, otherwise the court permitted it.

### *B. The "No-Subrogation" Approach*

The second group of courts bar insurers from bringing claims against tenants, even those who negligently cause damage to an insured structure and thereby cause loss. Of the range of rationales the "no-subrogation" courts invoke, this Note examines two principal examples. First, a court prohibits such action when it invokes the legal fiction that a tenant is an implied co-insured party and as such the insurer cannot pursue a subrogation claim against

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54. *Id.*

55. *See id.* (noting that "equitable principles . . . if anything, favor the enforcement of subrogation claims by insurers," absent two caveats).

56. *See id.* at 815–16 (discussing that the first caveat concerned issues of general contract law, such as ambiguities, which are construed against the draftsman and contracts of adhesion, which violate public policy and are invalid).

57. *Rausch*, 882 A.2d at 816.

58. *See id.* at 816 ("If the leased premises is a unit within a multi-unit structure, absent a clear, enforceable provision to the contrary, a court may properly conclude that the parties anticipated and reasonably expected that the landlord would have in place adequate fire insurance covering the entire building.").

59. *Id.*

her.<sup>60</sup> Second, a court prohibits such action when it embraces the same result but relies on a different rationale that disfavors economic waste and looks to the parties' reasonable expectations.<sup>61</sup>

### 1. *The Implied Co-Insured Rationale*

The Oklahoma Court of Appeals created the legal fiction that a tenant is an implied co-insured in *Sutton v. Jondahl*, and consequently found that insurers are barred from pursuing subrogation claims against tenants, even if the tenant negligently damaged the insured property and thereby caused loss.<sup>62</sup> In *Sutton*, John Jondahl rented a house from the Suttons.<sup>63</sup> On January 17, 1970, Jondahl's ten year-old son, when playing with an electric popcorn popper and a chemical set, negligently ignited his bedroom curtains, sparking a fire that caused \$2,382.57 in damages.<sup>64</sup> Central Mutual Insurance Company, from which the Suttons procured fire insurance for the damaged structure, paid the loss as obligated under its policy.<sup>65</sup> After reimbursing the Suttons for the covered loss, Central Mutual Insurance pursued a subrogation action against Jondahl and his son.<sup>66</sup>

In its legal analysis, the court first examined the principle of subrogation, noting its equitable roots and fluid nature.<sup>67</sup> Next, without citation, the court found that: "Under the facts and circumstances in this record the subrogation should not be available to the insurance carrier because the law considers the tenant as a co-insured of the landlord absent an express agreement between

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60. See, e.g., *Sutton v. Jondahl*, 532 P.2d 478, 482 (Okla. Civ. App. 1975) (holding that a tenant is an implied co-insured and consequently an insurer cannot pursue a subrogation claim against the tenant, even if the tenant negligently damaged the insured property and thereby caused loss).

61. See, e.g., *DiLullo v. Joseph*, 792 A.2d 819, 822–23 (Conn. 2002) (favoring a default rule that embraces a "policy against economic waste" and that considers that "in most instances, neither landlords nor tenants ordinarily expect that the landlord's insurer would be proceeding against the tenant, unless expert counseling to that effect had forewarned them").

62. See *Sutton*, 532 P.2d at 482 (stating that a tenant is an implied co-insured and that as a result an insurance company cannot pursue a subrogation claim against a tenant, even if the tenant negligently damaged the insured structure and thereby caused loss).

63. *Id.* at 479.

64. *Id.*

65. *Id.*

66. See *id.* (noting that the insurance company alleged negligence against both Jondahl and his son).

67. See *Sutton v. Jondahl*, 532 P.2d 478, 481–82 (Okla. Civ. App. 1975) (characterizing subrogation as "begotten of a union between equity and her beloved—the natural justice of placing the burden of bearing a loss where it *ought to be*").

them to the contrary, comparable to the permissive-user feature of automobile insurance."<sup>68</sup> The court derived the implied co-insured principle from the "relational reality" between the landlord and the tenant, noting that because the landlords have fee interests and tenants have possessory interests, both parties, through their relationship, have insurable interests in the property.<sup>69</sup> Further, the court concluded that as "a matter of sound business practice" any premium paid for by a landlord trickles down to the tenant as a portion of rent payments.<sup>70</sup> Next, relying upon what the court described as the "realities of urban apartment and single-family dwelling renting," the court concluded that, absent an express agreement otherwise, tenants depend upon landlords to procure fire insurance.<sup>71</sup> To bolster its contention, the court argued that insurance companies themselves understand this relationship, evidenced by a lack of insurance salesmen peddling fire insurance policies to tenants.<sup>72</sup> In conclusion, the court determined that in the spirit of equity and fundamental justice, a fire insurance policy for a property, absent an express agreement otherwise, protects all joint owners and all those with possessory interests.<sup>73</sup> As a result, "[t]he company affording such coverage should not be allowed to shift a fire loss to an occupying tenant even if the latter negligently caused it."<sup>74</sup>

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68. *Id.* at 482.

69. *See id.* (arguing that the implied co-insured principle "is derived from a recognition of a relational reality, namely, that both landlord and tenant have an insurable interest in the rented premises—the former owns the fee and the latter has a possessory interest").

70. *See id.* (proposing that according to business practice, the landlord's fire insurance premium payments "had to be considered in establishing the rent rate on the rental unit . . . chargeable against the rent as overhead or operating expense . . . [and] it follows . . . that the tenant actually paid the premium as part of the monthly rental").

71. *Id.*

72. *See Sutton*, 532 P.2d at 482 (stating that if such coverage was not the status quo, insurance companies "would have long ago made such need a matter of common knowledge by promoting the sale to tenants of a second fire insurance policy to cover the real estate").

73. *See id.* ("[E]quity and fundamental justice upon which the equitable doctrine of subrogation is established requires that when fire insurance is provided for a dwelling it protects the insurable interests of all joint owners including the possessory interests of a tenant absent an express agreement by the latter to the contrary.").

74. *Id.*

## 2. *The Reasonable Expectations of the Parties and Economic Waste Rationale*

In *DiLullo v. Joseph*,<sup>75</sup> the Connecticut Supreme Court, as a matter of law and policy, followed the result in *Sutton*, but, as a matter of insurance and contract law, rejected the *Sutton* rationale.<sup>76</sup> In *DiLullo*, Michael Joseph rented commercial property from Michael and Fioretta DiLullo from December 1, 1995 to December 1, 1996.<sup>77</sup> Following the expiration of the lease, the parties continued the rental agreement on a month-to-month basis.<sup>78</sup> There was no agreement between the parties regarding fire insurance coverage.<sup>79</sup> On March 24, 1998, Joseph negligently sparked a fire that damaged the premises causing losses, which the plaintiffs, Public Service Mutual Insurance Co., partially covered.<sup>80</sup> Following these payments, the insurance company pursued a subrogation action against Michael Joseph.<sup>81</sup> The issue for the court concerned whether, as a default rule, an insurer has a subrogation claim against a tenant who negligently damages the insured property.<sup>82</sup>

The court based its result on two rationales: (1) the public policy disfavoring economic waste;<sup>83</sup> and (2) the landlord's and tenant's reasonable expectations concerning an insurer's right to subrogation.<sup>84</sup> First, citing the long held public policy against economic waste, the court expressed concern about a default rule that would encourage duplicative insurance.<sup>85</sup> The court reasoned that a "pro-

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75. See *DiLullo v. Joseph*, 792 A.2d 819, 822 (Conn. 2002) (rejecting *Sutton*'s implied co-insured presumption, but following *Sutton*'s result). The court agreed with the "criticism of the *Sutton* rationale, as a matter of the general principles of insurance and contract law," noting that "a tenant is not a coinsured on his landlord's fire insurance policy simply because he has an insurable interest in the premises and pays rent." *Id.* But, the court ultimately upheld the *Sutton* result as a matter of subrogation law and policy. *Id.*

76. See *id.* at 822 (rejecting *Sutton*'s presumption that a tenant is an implied co-insured, but following *Sutton*'s result because of the court's concern regarding renter's insurance).

77. See *id.* at 819–20 (noting that Joseph operated his business, Random Remnants, out of the leased property).

78. *Id.* at 820.

79. *Id.*

80. *DiLullo*, 792 A.2d at 820.

81. *Id.*

82. See *id.* at 821 (discussing that the question posed on appeal was "what the appropriate default rule of law should be where, as here, the parties have not made such an agreement [allocating specific risks and coverages]").

83. See *id.* at 822 (noting that the policy against economic waste has long been recognized in American jurisprudence).

84. See *id.* at 823 (citing Judge Keeton and Professor Widiss who argued that "neither landlords nor tenants ordinarily expect that the landlord's insurer would be proceeding against the tenant, unless expert counseling to that effect had forewarned them").

85. See *DiLullo v. Joseph*, 792 A.2d 819, 822–23 (Conn. 2002) (discussing that



subrogation" rule, which allocates responsibility to the tenant for her negligent behavior, incentivizes that tenant to procure coverage for insurer subrogation claims.<sup>86</sup> Therefore, the court concluded that this default rule strongly encouraged both the landlord and each tenant to purchase separate insurance policies covering the same structure.<sup>87</sup> The court found that such duplicative insurance constituted economic waste that violated notions of policy and fairness, violations that are greatly compounded in multi-unit buildings where there are potentially hundreds of units.<sup>88</sup>

Second, the court looked to the reasonable expectations of the landlord and the tenant as a rationale for upholding the "no-subrogation" approach. The court noted that, absent expert legal advice, a majority of tenants do not enter into landlord-tenant relationships under the expectation that the landlord's insurer will pursue a subrogation lawsuit against them.<sup>89</sup> "Thus, barring subrogation in such a case comports with the equities of most situations."<sup>90</sup> Relying on both of the aforementioned equitable principles, the court found in favor of the "no-subrogation" rule and barred subrogation in this context.<sup>91</sup>

### C. The "Pro-Subrogation" Approach

The third group of courts adopt a "pro-subrogation" rule. In *Page v. Scott*,<sup>92</sup> the Arkansas Supreme Court held that, absent an express agreement in

subrogation, as an equitable doctrine, disfavors economic waste such as duplicative insurance).

86. See *id.* ("Such a rule . . . create[s] a strong incentive for every tenant to carry liability insurance in an amount necessary to compensate for the value, or perhaps even the replacement cost, of an entire building, irrespective of the portion of the building occupied by the tenant.").

87. See *id.* at 823 (noting that the default rule permitting subrogation would create strong incentives for tenants to purchase insurance policies for structures for which the landlord already has insurance and that such duplicative insurance constitutes economic waste, violating notions of policy and fairness).

88. See *id.* ("[I]t surely is not in the public interest to require all the tenants to insure the building which they share, thus causing the building to be fully insured by each tenancy."); Road Runner, *41st Street: A New York Songline*, <http://home.nyc.rr.com/jkn/nysonglines/41st.htm> (last visited Nov. 7, 2006) (noting that River Place 1 is the largest apartment building in the United States, with 921 units totaling 908,000 square feet) (on file with the Washington and Lee Law Review).

89. See *DiLullo*, 792 A.2d at 822–23 (citing Judge Keeton's and Professor Widiss's argument that "neither landlords nor tenants ordinarily expect that the landlord's insurer would be proceeding against the tenant, unless expert counseling to that effect had forewarned them").

90. *Id.*

91. See *id.* ("[B]arring subrogation in such a case comports with the equities of most situations.").

92. See *Page v. Scott*, 567 S.W.2d 101, 103–04 (Ark. 1978) (rejecting *Sutton*'s implied

the lease to the contrary, a landlord's insurer may pursue a subrogation claim against a negligent tenant.<sup>93</sup> In *Page*, under an oral lease, Scott leased property owned by Page.<sup>94</sup> During the lease, Scott negligently created a fire that caused \$8,050 in damage.<sup>95</sup> Hartford Insurance Co., consistent with its preexisting fire insurance policy with Page, paid Page \$8,000 to compensate him for the damage.<sup>96</sup> Next, Page sued Scott for the entire extent of the damages.<sup>97</sup> As a defense, Scott claimed that Page's insurance policy was procured for the mutual benefit of both Page and Scott and therefore Page could only seek relief under the insurance policy.<sup>98</sup>

The court distilled this dispute into a single issue: whether, absent an agreement otherwise, a landlord procures fire insurance for personal benefit or also for the mutual benefit of the tenant.<sup>99</sup> In addressing this issue, the court concluded that "[t]he lessor and the lessee each had an insurable interest in the property, independent of the other; and either, or both, may separately insure his interest for his own benefit."<sup>100</sup> Recognizing the separate insurance interests, the court rejected the implied co-insured legal fiction, dismissing the argument that rent payments impliedly include insurance premiums and subsequent insurance coverage.<sup>101</sup> In dismissing this legal fiction, a fiction many courts embraced after *Sutton*, the court found that "[t]here is no evidence that [the tenant] paid any greater rent because of the insurance than he would have paid had [the landlord] not taken insurance."<sup>102</sup> The court argued that component costs—such as property taxes, construction costs, maintenance expenses, acquisition costs, and insurance premiums—do not set rent prices but rather that a dynamic real estate market of willing lessors and lessees negotiate such rent prices.<sup>103</sup> Consequently, a

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co-insured presumption and adopting a "pro-subrogation" approach).

93. *See id.* at 103–04 (rejecting *Sutton*'s implied co-insured rationale as a legal fiction, noting that the markets set rent prices, not the component costs such as insurance premiums, property taxes, and maintenance expenses).

94. *Id.* at 102.

95. *Id.*

96. *See id.* (noting that Page's fire insurance policy covered damages in excess of fifty dollars).

97. *Page*, 567 S.W. 2d at 102.

98. *See id.* (noting that Scott's real basis of his defense was that "the policy was procured for the mutual benefit of the lessor and the lessee with the implied agreement that Page would look solely to the insurance policy in case of loss by fire and not to the lessee").

99. *See id.* at 103 ("The only issue then, is whether the insurance taken by the lessor was for the benefit of both parties.").

100. *Id.*

101. *See id.* at 103–04 (arguing that "[t]he fiction that by paying the rent, the lessee paid the insurance premium is not appropriate").

102. *Page v. Scott*, 567 S.W. 2d 101, 104 (Ark. 1978).

103. *See id.* (contending that market forces, and not component costs, fix rent prices).

lessor may pursue a claim against a negligent lessee and thereby recover damages for the loss.<sup>104</sup> Ultimately, the court permitted Page's suit against Scott and entered judgment for the full amount of damages, \$8,050.<sup>105</sup> Thus, as stated in *Page*, absent an agreement otherwise, a landlord procures fire insurance for personal benefit only, not also for the mutual benefit of the tenant; consequently, the landlord's insurer remains free to pursue a subrogation claim against a tenant whose negligence damages the insured property.<sup>106</sup>

#### *IV. Analysis of the Rules: Considering Both Their Future Implications and Their Public Policy Rationales*

When determining which rule to adopt, the ALI should consider each approach's future implications and public policy rationales. First, in regards to the future implications, the ALI should endorse a bright line rule that provides stability and predictability, rather than a muddied, middle approach that punts the balancing of interests to future judicial discretion. Second, the ALI should examine the competing public policy rationales that support each approach and select the one that best promotes subrogation's purpose and that best considers the nature of the insurance market.

##### *A. The Case-by-Case Approach: Unstable, Unpredictable, and Unacceptable*

As a general matter, law ought to be stable and predictable.<sup>107</sup> Therefore, when a court decides an issue, it should do so in reference to a concrete rule. When courts, such as the one in *Rausch*, adopt a case-by-case method of analysis, they insert

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104. *See id.* at 103–04 (concluding that because absent an agreement otherwise, a lessor procures fire insurance for personal benefit, and not also the mutual benefit of the lessee, here the lessor may recover from the lessee for fire damage caused by the lessee's negligence).

105. *See id.* at 104 (reversing the trial court's denial of recovery and entering judgment in favor of the lessor for the full amount of his damages).

106. *See id.* at 103–04 (noting that the court favored a "pro-subrogation" default rule).

107. *See* LARRY ALEXANDER & EMILY SHERWIN, *THE RULE OF RULES* 12–15 (Duke Univ. Press, 2001) (asserting that society benefits from stability when it resolves concrete moral disagreements and uncertainties with authoritative settlements); *see also* RONALD CASS, *THE RULE OF LAW IN AMERICA* 11 (The Johns Hopkins Univ. Press, 2001) (arguing that the goal of the rule of law should be principled predictability providing "predictability that is adequate to allow individuals to plan their lives"); Frederick Schauer, *Formalism*, 97 *YALE L.J.* 509, 539 (1988) ("One of the things that can be said for rules is the value variously expressed as predictability or certainty."). *But see* *Union Mut. Fire Ins. Co. v. Joerg*, 824 A.2d 586, 589–90 (Vt. 2003) (citing the need to avoid per se rules in favor of flexibility and emphasizing the need to examine the parties' reasonable expectations as the determinative factor).

too much judicial discretion into the system, fostering disagreement and uncertainty and undermining the basic rule of law.<sup>108</sup> The court in *Rausch* should have committed to either the "no-subrogation" result or the "pro-subrogation" result, rather than committing to a "middle approach" that provides no result at all. The court compromised on this muddled, middle approach because it concluded that the wide variety of circumstances under which this issue arises present "a clash between what a direct application of basic and well-established legal principles would produce and what the courts have come to regard as either impractical or inequitable to tenants, or at least certain classes of tenants."<sup>109</sup> Many, if not most, courts acknowledge the split in authority between the "no-subrogation" rule and the "pro-subrogation" rule, concluding that both rules are supported by persuasive public policy arguments. Nonetheless many still adopt a rule. Because this muddled, middle approach punts the balancing of interests to the judicial discretion of future courts—creating an unstable, unpredictable legal climate—it flunks the future implications prong of this Note's two-tier analysis.

Second, in addition to failing the future implications prong of this Note's analysis, the case-by-case approach permits a "no-subrogation" result—a result that frustrates subrogation's purpose. As discussed in Part II.B, subrogation has "for its purpose the working out of an equitable adjustment between the parties by securing the ultimate discharge of a debt by the person who in equity and good conscience ought to pay it."<sup>110</sup> In the insurance context, subrogation's purpose implicates three parties: the insured, the tortfeasor, and the insurer.<sup>111</sup> Of particular importance here, subrogation (a) assures that the tortfeasor will be held legally responsible for the loss by virtue of blocking the windfall of escaping liability and (b) reimburses the insurer for payments made to the insured when such compensation stems from third party damage.<sup>112</sup>

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108. See ALEXANDER & SHERWIN, *supra* note 107, at 13 (arguing that "concrete disagreements and uncertainties about the more particular shapes of moral principles and about factual matters resulted in . . . disagreements and uncertainties [which] are potentially quite destructive").

109. *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 803 (Md. 2005).

110. COUCH, *supra* note 2, § 222:8.

111. See *id.* (discussing that "subrogation's purpose has been described from the perspective of the insured, the tortfeasor, and the insurer, often in terms of the effect of the other parties or in combination"); see also *supra* Part II.B and accompanying text (same).

112. See COUCH, *supra* note 2, § 222:8 (discussing that from the tortfeasor's perspective, "a wrongdoer who is legally responsible for the harm should not receive the windfall of being absolved from liability because the insured had the foresight to obtain, and had paid the expense of procuring, insurance for his or her perspective"); see also *supra* Part II.B and accompanying text (same).

However, when the case-by-case approach permits a "no-subrogation" result: (a) the tortfeasor enjoys the windfall of escaping liability; and (b) the insurer may not seek reimbursement for compensation paid as a result of third party damage. Because the case-by-case analysis shields some tortfeasoring tenants from liability, it directly frustrates subrogation's purpose and fails the second prong of this Note's two-tier analysis. Consequently, the ALI should reject this approach.

*B. The "No-Subrogation" Approach: Stable, Predictable, but Based on Improper Rationales*

First, courts that adopt the "no-subrogation" approach endorse a bright line rule, providing stable and predictable results.<sup>113</sup> Consequently, these courts pass the future implications prong of this Note's two-tier analysis. Second, although the "no-subrogation" courts provide a stable, predictable rule, the various public policy rationales they invoke undermine subrogation's purpose and rely on mistaken assumptions regarding the nature of the insurance market. Because the "no-subrogation" approach fails the second prong of this Note's two-tier analysis, the ALI should reject this standard.

*1. The Implied Co-Insured Rationale: Stable, Predictable, but Frustrating to Subrogation's Purpose and Mistaken as to the Nature of the Insurance Market*

The ALI should reject the *Sutton* approach because it: (1) frustrates subrogation's purpose and (2) relies on mistaken assumptions about the nature of the insurance market. First, because the implied co-insured rationale produces a "no-subrogation" result, shielding all tortfeasoring tenants from liability, it frustrates subrogation's purpose. Under the implied co-insured rationale: (a) the "implied co-insured" tortfeasoring tenant enjoys the windfall of escaping liability; and (b) the insurer may not seek reimbursement for compensation paid as a result of third party damage. Therefore, because the implied co-insured rationale shields the tortfeasoring tenant from liability, it directly frustrates subrogation's purpose and partially fails the second prong of this Note's two-tier analysis.

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113. See *supra* Part II.B and accompanying text ("In regard to the tortfeasor, subrogation assures that the wrongdoer will be held legally responsible for the damages caused, blocking the potential windfall of escaping liability merely because the insured had the foresight to purchase insurance for his own protection.").

Second, in addition to frustrating subrogation's purpose, the implied co-insured rationale relies on mistaken assumptions about the nature of the insurance market.<sup>114</sup> The *Sutton* court derived the implied co-insured principle from "a recognition of a relational reality, namely, that both landlord and tenant have an insurable interest in the rented premises—the former owns the fee and the latter has a possessory interest."<sup>115</sup> Bolstering its conclusion, the court analogized the landlord-tenant relationship in the fire insurance context to the permissive-user relationship in the automobile insurance context.<sup>116</sup> The court concluded that rent payments necessarily include a fire insurance premium component and proclaimed that, absent an agreement otherwise, equity and fundamental justice demand that fire insurance protects all joint owners and all those with possessory interests in the property.<sup>117</sup> However, many, if not most courts in this jurisdictional split have rejected *Sutton*'s legal reasoning. The court in *Rausch*, in concluding that the implied co-insured rationale had "no valid foundation," noted:

*Sutton*, the leading modern case denying subrogation of lessees, cites no cases for the proposition that the lessee is a co-insured of the lessor, comparable to a permissive user under an auto insurance policy. Contrary to the court's statement, the fact both parties had insurable interests does not make them co-insureds. The insurer has a right to choose whom it will insure and did not choose to insure the lessees, and under this holding the lessee could have sued the insurer for loss due to damage to the realty, e.g., loss of use if [the] policy provides such coverage.<sup>118</sup>

The court added that "[i]f the tenant *were* a co-insured, he/she would be entitled to some part of the proceeds, which even the *Sutton* followers have not suggested."<sup>119</sup> Next, the *Page* court concluded that dynamic markets, and not

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114. See *Sutton v. Jondahl*, 532 P.2d 478, 482 (Okla. Civ. App. 1975) ("Under the facts and circumstances in this record the subrogation should not be available to the insurance carrier because the law considers the tenant as a co-insured of the landlord absent an express agreement between them to the contrary . . .").

115. *Id.*

116. See *id.* ("Under the facts and circumstances in this record the subrogation should not be available to the insurance carrier because the law considers the tenant as a co-insured of the landlord absent an express agreement between them to the contrary, comparable to the permissive-user feature of automobile insurance.")

117. See *supra* Part III.B.1 and accompanying text ("[T]he court concluded that . . . any premium paid for by a landlord trickles down to the tenant as a portion of rent payments . . . and that, absent an express agreement otherwise, tenants depend upon landlords to procure fire insurance.")

118. See *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 813 (Md. 2005) (quoting 6A, J. A. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4055 (2005)).

119. *Id.* at 814.

component costs, operate to fix rent prices.<sup>120</sup> Therefore, because a tenant does not implicitly pay fire insurance premiums as a part of his or her rent, the court dismissed the implied co-insured rationale.<sup>121</sup> Finally, even the court in *DiLullo*, which followed *Sutton*'s rationale, found that under insurance law, even though he pays rent and has an insurable interest in the premises, a tenant is not a co-insured on his landlord's fire insurance policy. Because many, if not most, courts reject as a legal fiction the implied co-insured rationale, the *Sutton* approach fails the second prong of this Note's analysis. Ultimately, because the implied co-insured rationale flunks both aspects of this Note's two-tier analysis, the ALI should reject this approach.

2. *The Reasonable Expectations of the Parties and Economic Waste  
Rationale: Stable, Predictable, but Frustrating to  
Subrogation's Purpose and Mistaken as to the Nature of the  
Insurance Market*

The ALI should reject the *DiLullo* approach because it: (1) frustrates subrogation's purpose and (2) relies on mistaken assumptions about the nature of the insurance market. First, because the economic waste and reasonable expectations of the parties rationale often produces a "no-subrogation" result similar to the implied co-insured rationale, discussed above in Part IV.B.1, this approach also frustrates subrogation's purpose. Specifically, this rationale often shields tortfeasors from liability, and when it so operates it: (a) assures that the tortfeasor will enjoy a windfall by virtue of escaping liability and (b) fails to reimburse the insurer for payments made to the insured when such compensation stems from third party damage.<sup>122</sup> Consequently, it violates two of subrogation's three purposes in the landlord-tenant context: (a) assuring that the tortfeasor will be held legally responsible for the loss by virtue of blocking the windfall of escaping liability and (b) reimbursing the insurer for

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120. See *supra* Part III.C and accompanying text ("The court argued that component costs; such as property taxes, construction costs, maintenance expenses, acquisition costs, and insurance premiums; do not set rent prices, but that a dynamic real estate market of willing lessors and lessees negotiate these rent prices.").

121. See *supra* Part III.C and accompanying text (noting that because component costs do not set rent prices, "a lessor may pursue a claim against a negligent lessee and thereby recover damages for the loss").

122. See *supra* Part IV.B.1 and accompanying text (discussing that under the "no-subrogation" rationale "(a) the 'implied co-insured' tortfeasor tenant enjoys a windfall of escaping liability; and (b) the insurer may not seek reimbursement for compensation paid as a result of third party damage").

payments made to the insured when such compensation stems from third party damage.<sup>123</sup> Similar to the implied co-insured rationale, the economic waste and reasonable expectations of the parties rationale frustrates subrogation's purpose and partially fails the second prong of this Note's two-tier analysis.

Second, in addition to frustrating subrogation's purpose, the reasonable expectations of the parties and economic waste rationale relies on mistaken assumptions about the nature of the insurance market. In order to properly analyze this rationale's failings with respect to this prong of the analysis, this subsection will separate the rationale into its two components: (1) economic waste and (2) the parties' reasonable expectations. Ultimately, both of these rationales rely on mistaken assumptions about the nature of the insurance market, thus failing the other part of this Note's two-tier analysis.

*a. "Palpable Waste": Rare in the Current Insurance Market*

With regards to economic waste, this rationale only applies where such overlapping insurance policies prove "palpably wasteful."<sup>124</sup> In *Hartford Fire Insurance Co. v. Warner*,<sup>125</sup> Linda Warner leased part of a duplex from Dana Taylor.<sup>126</sup> The lease expressly stated that, absent landlord negligence, the tenant bore responsibility for loss, expense, or damage to the leased property resulting from the negligence of the tenant or that of her family, employees, guests, and invitees.<sup>127</sup> Approximately three months into the lease, Scott Warner, a nephew and guest of Linda Warner, negligently sparked a fire that caused \$43,951 in damages.<sup>128</sup> Taylor's fire insurer, Hartford Fire Insurance Co., subsequently compensated Taylor under their preexisting policy and pursued a subrogation claim against Linda and Scott Warner.<sup>129</sup>

In its analysis, the Appellate Court of Connecticut narrowed *DiLullo's* economic waste rationale to those situations in which the duplicative insurance

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123. See *infra* Part II.B and accompanying text (noting that subrogation has purposes in regard to the insured, the tortfeasor, and the insurer).

124. *Hartford Fire Ins. Co. v. Warner*, 881 A.2d 1065, 1069 (Conn. App. Ct. 2005).

125. See *id.* at 1066 (concluding that a tenant in a duplex, whose rental agreement allocated responsibility to her for damage caused to the property resulting from her negligence, was subrogated to her landlord's insurer in the amount of the damages paid by the insurer to the owner caused by the negligence of the tenant's guest).

126. *Id.*

127. *Id.*

128. *Id.*

129. *Hartford Fire*, 881 A.2d at 1066–67.



proves "palpably wasteful."<sup>130</sup> The court noted that although *DiLullo's* multi-unit residence reasonably implicated the public policy against economic waste, the duplex residence failed to create such a reasonable implication. Rather, the court concluded that a "pro-subrogation" rule would promote the existence of two fire insurance policies, "admittedly an overlap but not palpably wasteful."<sup>131</sup> Consequently, *Hartford* stands for the proposition that as long as subrogation does not create "palpable waste," a "pro-subrogation" rule fails to violate *DiLullo's* economic waste rationale.

Although *Hartford* did not extend this reasoning to all structures, this Note invites such an extension. First, in nearly every case, either (a) a landlord will procure fire insurance for the mutual benefit of the tenant or (b) the tenant may purchase subrogation insurance that is not palpably wasteful. With respect to mutual fire insurance coverage, landlords typically procure fire insurance for the mutual benefit of both the landlord and the tenant.<sup>132</sup> Because the majority of landlords that procure fire insurance for the mutual benefit of the tenant are more likely to manage high value properties and access expert legal counsel, they are more likely, as a matter of good business practice, to protect their property through self-insurance rather than through reliance on possible legal claims against their tenants. Conversely, the minority of landlords that procure fire insurance for personal benefit alone are more likely to manage low value properties and lack legal sophistication, thereby failing to protect their property through the more reliable means of self-insurance.<sup>133</sup> In the former situation, there is no duplicative insurance and therefore no waste of any kind. In the latter situation, where the tenant remains vulnerable to an insurer's subrogation claim, such subrogation protection remains reasonable and not palpably wasteful. For example, a tenant in Kansas City can purchase \$100,000 of renter's insurance, including a subrogation premium, for \$217 a year.<sup>134</sup> Although the extra \$217 policy creates waste, it does not create palpable waste.

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130. *Id.* at 1069.

131. *Id.*

132. See State Farm Insurance, *Renters Insurance Made Simple*, <http://www.statefarm.com/insurance/renters/renters.asp> (last visited Jan. 2, 2007) (stating that a landlord's insurance policy typically covers the tenant's building, although it does not cover the tenant's personal belongings); see also Assurant Specialty Property, *Renters Insurance*, <https://w2.assurant.com/rentersecurity/gck/?cmsJobnumber=234233> (last visited Jan. 2, 2007) (same) (on file with the Washington and Lee Law Review).

133. See *supra* Part III.A-C and accompanying text (demonstrating illustratively that this Note explores the minority of landlord-tenant relationships, where the landlord procures fire insurance for personal benefit alone, and that in such situations the total damages in dispute ranged from \$2,382 in *Sutton* to \$138,000 in *Rausch*).

134. See E-Mail from Marianne Craig, Underwriting Coordinator III, Multi-Lines Underwriting—Assurant Specialty Property, (Feb. 16, 2006, 5:13 EST) (discussing that because

Second, with regard to the multi-unit context, multi-unit landlords are (a) likely to procure fire insurance for the mutual benefit of the tenant,<sup>135</sup> and (b) regardless of the landlord's fire insurance policy, multi-unit landlords are now joining with property insurers to sell renter's insurance to their tenants.<sup>136</sup> With respect to the latter phenomenon, as landlords continue to recognize a profitable role for themselves in the marketing of renter's insurance, more will likely seek active involvement. This Note assumes that a universal "pro-subrogation" default rule would incentivize additional landlords to market renter's insurance to tenants. Further, in a competitive marketplace, insurers and landlords would compete for the tenant's business, likely driving down the price of the subrogation premium to a level of non-palpable waste.

*b. Reasonable Expectations: Arise in a Vast Array of Landlord-Tenant Situations and Are Dynamic in Nature*

Next, with regard to the reasonable expectations of the parties, this rationale fails because (a) the landlord-tenant relationship arises in a vast array of situations in which there is no uniform reasonable expectation; and (b) reasonable expectations are dynamic in nature. First, a court should not create a default rule grounded in an inevitable overgeneralization. Landlord-tenant settings can be rural, urban, commercial, residential, between parties of varying degrees of legal sophistication, and between parties of varying degrees of bargaining power.<sup>137</sup> A law firm leasing commercial space in Manhattan likely approaches the landlord-tenant relationship with different expectations than an undergraduate student renting a country house in Lexington, Virginia. The Massachusetts's Supreme Judicial Court, in *Seaco Insurance Co. v.*

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few claims go into subrogation, the premium does not reflect a significant subrogation expense) (on file with the Washington and Lee Law Review). In addition, tenants can purchase \$100,000 of renter's insurance, including a subrogation premium, for \$229 in Manhattan, NY, \$213 in Lexington, VA, and \$217 in Mission Hills, KS. *Id.*

135. *See supra* notes 133–34 (proposing that landlords that manage high value property and that access expert legal counsel, characteristics of a typical multi-unit landlord, are more likely to procure mutual fire insurance coverage).

136. *See* Morris Newman, *Landlords Moonlight as Insurance Salesmen*, NAT'L REAL EST. INVESTOR, Aug. 1, 2004, at 12 (noting that landlords have teamed up with property insurers to sell renter's insurance policies, covering personal property and third-party liability, with landlords acting as "front men" for marketing purposes). Landlords perform this function to provide tenants with an added service and/or to earn a percentage of the commission. *Id.*

137. *See* Rausch v. Allstate Ins. Co., 882 A.2d 801, 803 (Md. 2005) (discussing the wide variety of differing circumstances that arise in the landlord-tenant relationship including "commercial or residential . . . single-unit structure or part of a multi-unit structure").

*Barbosa*,<sup>138</sup> recognized one element of this vast variance when it found that "[c]ommercial tenants tend to be more sophisticated about the terms of their leases and, unlike residential tenants, commercial tenants generally purchase liability insurance."<sup>139</sup> After identifying this distinction, the court decided to approach commercial and residential tenancies differently.<sup>140</sup> *Seaco's* approach, however, is grounded in another overgeneralization that all parties in commercial and residential tenancies are uniform in their degrees of legal sophistication. In contrast to the hypothetical above, a real-estate attorney renting a Chicago apartment likely enters into a tenancy with more legal sophistication than a layman entrepreneur renting a storefront in Prouts, Maine. Ultimately, because the landlord-tenant relationship is remarkably diverse and because no uniform reasonable expectation exists, this rationale is ultimately unconvincing.

Second, the parties' reasonable expectations regarding fire insurance in the landlord-tenant context are dynamic, likely to change if courts adopt a universal "pro-subrogation" rule. Therefore, courts, such as *DiLullo*, are mistaken when they treat the parties' reasonable expectations as a universal or static factor. In response, the ALI should recognize this factor's discordant, dynamic nature and consequently resist reliance on this rationale when formulating a default rule.

*C. The "Pro-Subrogation" Rule: Stable, Predictable, Promotes  
Subrogation's Purpose, and Understands the Nature of the  
Insurance Market*

The ALI should endorse the "pro-subrogation" approach because it provides a stable, predictable bright line rule that promotes subrogation's purpose and invokes accurate assumptions regarding the nature of the insurance market. First, the "pro-subrogation" approach provides a stable and predictable bright line rule. As discussed above in the critique of the case-by-case approach, law ought to be stable and predictable.<sup>141</sup> Therefore, when the "pro-subrogation" approach provides a single default rule that limits judicial

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138. See *Seaco Ins. Co. v. Barbosa*, 761 N.E.2d 946, 950 (Mass. 2002) (distinguishing the landlord-tenant relationship in the commercial and residential context, noting the different reasonable expectations of the parties).

139. *Id.*

140. See *id.* at 951 (declining to examine commercial and residential tenants similarly, the court looked to "the terms of the lease and other evidence to ascertain the intent of the parties").

141. See *supra* Part IV.A and accompanying text ("As a general matter, law ought to be stable and predictable.").

discretion, fosters stability, and promotes predictability, it satisfies the future implications prong of this Note's two-tier analysis.

Second, the "pro-subrogation" result promotes subrogation's purpose. As outlined in Part II.B, subrogation has "for its purpose the working out of an equitable adjustment between the parties by securing the ultimate discharge of a debt by the person who in equity and good conscience ought to pay it."<sup>142</sup> As previously discussed, with respect to the insurance context, subrogation's purpose implicates three parties: the insured, the tortfeasor, and the insurer.<sup>143</sup> Subrogation operates to prevent an insured's unjust enrichment; blocks the tortfeasor from enjoying the windfall of escaping liability for her wrongdoing; and reimburses the insurer for compensation paid to the insured resulting from third party negligence.<sup>144</sup> Because the "pro-subrogation" rule assigns legal liability to the tortfeasor, who in equity and good conscience ought to discharge the debt, and because it reimburses the insurer for compensation paid to the insured for damage caused by the tenant's wrongdoing, this approach protects subrogation's purpose. Consequently, this rule passes the first part of the second prong of this Note's two-tier analysis.

Finally, the "pro-subrogation" approach complements the contemporary insurance market. First, as discussed in subsection IV.B.2.a, landlords typically procure fire insurance for the mutual benefit of both the landlord and the tenant.<sup>145</sup> Because the majority of landlords procure fire insurance for the mutual benefit of the tenant, the "pro-subrogation" result only affects a minority of tenants. Further, of the affected tenants, most if not all are likely to rent low value property, for which subrogation insurance is inexpensive.<sup>146</sup> Second, in the multi-unit context, a "pro-subrogation" approach incentivizes landlords to market renter's insurance, including subrogation premiums, to tenants. Third, unlike the case-by-case approach or the "no-subrogation" approach, the "pro-subrogation" approach respects existing contracts and champions consumer free

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142. COUCH, *supra* note 2, § 222:8.

143. *See id.* (discussing that in the insurance context, subrogation's purpose implicates the insured, the tortfeasor, and the insurer); *see also supra* Part II.B and accompanying text (same).

144. *See* COUCH, *supra* note 2, § 222:8 (noting that subrogation operates to prevent unjust enrichment, assures that the wrongdoer will be held legally responsible for the damages caused, and reimburses the insurer for payments it has made to the insured in order to remedy the damage); *see also supra* Part II.B and accompanying text (same).

145. *See supra* Part IV.B.2.a and accompanying text (noting that a landlord's insurance policy typically covers the tenant's building, but does not typically cover the tenant's personal property).

146. *See supra* Part IV.B.2.a and accompanying text (demonstrating illustratively that this Note explores situations where the landlord procures fire insurance for personal benefit alone and that the total damages discussed ranged from \$2,382 in *Sutton* to \$138,000 in *Rausch*).

choice. Parties thus remain free to enter into any contractual agreement. Once completed, however, the court will not reopen the contract to insert new, "implied" parties. Ultimately, this rule passes both the first and second prong of this Note's two-tier analysis. As a result, the ALI should endorse this approach.

In conclusion, as this Note's Introduction suggested, each of the previously discussed approaches suffers from individual inadequacies. The "pro-subrogation" approach's weakness is inflexibility. As *Rausch* noted, an application of the "pro-subrogation" rule is "either impractical or inequitable to tenants, or at least certain tenants."<sup>147</sup> If the ALI wishes to address this concern, it should place an affirmative burden on landlords to disclose to the tenant, likely in writing, the nature of the insurance that the landlord possesses. Specifically, if the landlord procured personal fire insurance, the landlord should inform the tenant of their potential liability. Finally, the sanction for nondisclosure ought to be the denial of the insurer's subrogation claim.

#### V. The Importance of Drafting

This Note focuses exclusively on a default solution that would apply where the landlord and tenant either had no agreement, or an ambiguous one, outlining each party's insurance responsibilities. "Careful and thoughtful drafting of leases can eliminate, or at least greatly reduce, the problems that arise as to the insurance and liability of landlord and tenant."<sup>148</sup> Even the court in *Page*, which favored the "pro-subrogation" approach, concluded that an insurer would have no subrogation to the landlord's claim against the negligent tenant "if the parties had agreed as a part of the transaction that insurance would be provided for the mutual protection of the parties."<sup>149</sup> Also, the court in *Rausch*, which favored the case-by-case approach, found that, absent an exception for a contract of adhesion or an exception for a violation of public policy, a court, using principles of contract law, will turn to the lease to determine how the parties allocated risk.<sup>150</sup> Thus, the parties could avoid the expense of litigation if they considered the issue of fire insurance in the planning stage of the agreement, rather than after the damage is done.

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147. *Rausch v. Allstate Ins. Co.*, 882 A.2d 801, 803 (Md. 2005).

148. John Dwight Ingram, *Should an Illinois Tenant Get the Benefit of the Landlord's Insurance?*, 17 N. ILL. U. L. REV. 51, 70 (1996).

149. *Page v. Scott*, 567 S.W.2d 101, 103 (Ark. 1978).

150. *See Rausch*, 882 A.2d at 815 (noting that a lease provision that clearly establishes the liability of the parties is enforceable under contract law; however, it is also subject to the relevant statutory constraints).

## VI. Conclusion

Currently there exists a jurisdictional split as to whether, absent an agreement otherwise, a landlord's insurer may pursue a subrogation claim against a negligent tenant. The ALI should address this issue of legal divergence and propose a resolution in its *Restatement (Third) of Restitution and Unjust Enrichment*. When considering which approach to endorse, the ALI ought to follow a two-tier analysis, evaluating each rule's future implications as well as each rule's public policy rationales. In order to provide a stable, predictable law that promotes subrogation's purpose and that compliments the contemporary insurance market, the ALI should endorse the "pro-subrogation" approach. Further, to address concerns of inequitable and impractical results under this rule, the ALI should place an affirmative duty of disclosure on landlords, where the consequence of nondisclosure is the denial of the insurer's subrogation claim.

