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Sixth Circuit Upholds An Insurers Right To Subrogate Against Its Own Insured

By Amanda B. Fopma

In *Nationwide Mutual Fire Ins. Co. v McDermott,* __F3d___(6th Cir 2015) (released February 24, 2015, not recommended for publication), the U.S. Court of Appeals for the Sixth Circuit upheld an insurance carrier's right to subrogate against its own insured where the carrier has made payments to the mortgagee and denies payments to the Insured because the Insured was not entitled to coverage under the Policy. The Court held "[b]ecause McDermott is not entitled to recover under the Policy, Nationwide is also contractually entitled to subrogation. The mortgage clause clearly and unambiguously provides, '[i]f [Nationwide] pay[s] the mortgagee for the loss and den[ies] payment to you[,]…[Nationwide is] subrogated to all the rights of the mortgagee granted under the mortgage on the property." *Id.* at *9.

The litigation arises out of a fire loss on January 13, 2012, at the McDermott/Mathews home. McDermott's then-husband Brien Mathews became a registered primary caregiver under Michigan's Medical Marihuana Act (MCL § 333.26421 *et seq*). Mathews then invested upwards of $20,000 in the set-up and continued growing operations in the basement facility. McDermott testified she was aware of the growing operation. On January 13, 2012, Mathews began operations to produce "honey oil" through the process of butane extraction.[1] Mathews testified he would use six cans of butane for a single production. He testified he produced four pie plates of "honey oil" requiring the use of 24 cans of butane. Mathews became impatient to "tests the fruits of his labor," while butane was still evaporating he used a razorblade to collect some "honey oil" before lighting a welding torch to produce the intoxicating THC-rich fumes. Mathews, inexplicably, did not move away from the still partially filled butane pie pans or outside of the butane filled air of the basement. Not unexpectedly the remaining liquid butane ignited resulting in a total loss to the dwelling.

Mathews testified at his deposition he was aware the process of butane extraction was dangerous, and took extensive safety precautions as butane is highly flammable. After the fire, McDermott made a claim against the homeowners insurance policy in effect issued by Nationwide. Under the policy, Nationwide would provide coverage for "accidental direct physical loss to…the dwelling on the residence premises used mainly as [McDermott's] private residence." *McDermott,* 2013 U.S. Dist. LEXIS 98514 at *11. As the District Court pointed out, the policy also clearly excluded certain losses as set forth in the "Property Exclusions" section; including, rather importantly, "loss to any covered property resulting directly or indirectly…by an 'Increased Hazard, meaning any loss occurring while hazard is increased by a means within the control and knowledge of an insured." *Id.*

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McDermott was not recommended for publication and is not precedentially binding on the federal courts in Michigan. However, the decision is founded on well-established precedentially binding principles and certainly serves as a very persuasive case where there are strong factual similarities.

This case highlights the importance of conducting a thorough investigation post loss into all aspects of coverage, including whether all of the conditions precedent to coverage have been met. The Court relied, in part, on *McGrath v Allstate Ins. Co.,* 802 NW2d 619 (Mich. Ct. App. 2010) which stands for the proposition that failure to notify the insurance carrier about a change in the use or occupancy of the insured premises is a sufficient basis to deny coverage.

One of the most important aspects of this decision is the affirmation an insurance carrier is entitled to subrogate against its own insured where it has made payments to the mortgagee before it determines there is no coverage available under the policy. This reasoning may provide an avenue under the right circumstances to recoup those funds from the insured.

While continuing its investigation, Nationwide issued checks totaling $160,209.50 for McDermott's temporary accommodations, personal property and the mortgage held by Chase. After completing its investigation, Nationwide denied coverage on eight separate, distinct grounds; including "(a) that the one family private residence was being used as a marijuana… manufacturing facility which was illegal and not insured under the Policy; (b) there was no *accidental* direct physical loss; (c) even if there was coverage…[it] was excluded by the Increased Hazard exclusion…(e) [t]here was a failure to comply with the General Policy Conditions including failure to advise of the change in use of the "Residence Premises" to be used as a marijuana…manufacturing facility…"[2] *Id.* at *13-15. Nationwide subsequently instituted a Declaratory Action to determine the rights and obligations of the parties and to recoup the amounts it paid McDermott.

On initial consideration before the U.S. District Court for the Eastern District of Michigan was Nationwide's Motion for Summary Judgment as to its denial of McDermott's claims and to recover the $160,209.50 it had paid. In concluding there was no coverage for McDermott's claims, the District Court did not reach each distinct basis for denial. The District Court concluded the loss was *not* accidental.[3] In determining whether the loss was "accidental" "the question is not whether a reasonable person would have expected the consequences, but whether the *insured reasonably should have expected the consequences.*" *Allstate Ins Co v McCarn,* 466 Mich 227, 645 NW2d 20, 23 (2000). In this case there is no question Mathews' "intentional acts created a direct risk of harm which lead to the loss of the residence" and, further, that Mathews "should have expected an open flame near copious amounts of liquid butane and butane vapor to cause a fire." *McDermott,* 2013 U.S. Dist. LEXIS 98514 at *23. The District Court held Mathews, as an insured, should reasonably have expected his use of an open flame near liquid butane would have caused the fire. That he did not intend to burn down the house is not determinative, rather it is whether his acts created a direct risk he should have been aware of.

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[1] "The process involves drawing liquid butane through chopped marijuana leaves. The butane absorbs the THC from the marijuana and is then poured into a container. As the butane evaporates, a sticky, THC-rich substance is left behind. That substance commonly referred to as 'honey oil' (or 'ear wax'), is then heated and the intoxicating fumes are inhaled." *Nationwide Mutual. Fire Ins. Co. v McDermott,* 2013 U.S. Dist. LEXIS 98514 (E.D. Mich. July 15, 2013) at *25

[2] The denial correspondence also listed as other reasons there was no coverage include "(d) Even if there was coverage, any coverage would be excluded by the Intentional Acts exclusion…(f) There was a failure to comply with the General Policy Conditions pertaining to Concealment, Fraud or Misrepresentation by misrepresenting the use of the premises, and by concealing, misrepresenting and omitting material facts in regard to the premises, and the loss; (9g) By the wrongful conduct rule per *Orzal v Scott Drug Co,* 449 Mich 550, 537 N.W.2d 208 1995), by operating an illegal marijuana, butane honey oil and THC manufacturing facility; and (h) Any Loss of Use coverage does not apply to an insured's business."

[3] "Accidental" is not defined in the Policy. "Accidental" has been defined as "an undersigned contingency, a casualty, a happening by chance, something out of the usual course of things, unusual, fortuitous, not anticipated and not naturally to be expected." *Id.* Citing *Allstate Ins Co v McCarn,* 466 Mich 227, 645 NW2d 20, 22 (2000).

The only other bar to coverage the District Court analyzed, assuming *arguendo* there was coverage, was whether the Increased Hazard exclusion barred coverage. The Increased Hazard exclusion precludes recovery resulting from hazards that "are increased by means within the control and knowledge of the insured." The District Court recognized the hazard of fire damage was undoubtedly increased when Mathews emptied 24 cans of butane into an enclosed area and ignited a flame–events that were within the knowledge and control of an insured. The District Court reasoned Nationwide only agreed to provide coverage for risks an insured was aware of and were within their control, as in that situation an insured would mitigate those risks. To provide coverage where Mathews so clearly increased the hazards is at odds with the principle an insurance company cannot be held liable for a risk it did not assume.

Subsequent to the District Court's grant of Nationwide's Motion for Partial Summary Judgment, it ordered additional briefing on whether Nationwide was entitled to subrogate against its own insured. Initially the District Court denied Nationwide's Motion for Summary Judgment as to recovery of the payments issued to McDermott on the basis there was a genuine issue of material fact as to whether said payments were voluntary.[4] The parties were granted the opportunity to file additional motions as to whether Nationwide was entitled to subrogate against its insured. The Nationwide policy contained a Standard Mortgage Clause which created an independent contract between the mortgagee and insurer. The second portion of the Mortgage Clause contained a subrogation provision providing for subrogation if Nationwide paid the mortgagee for the loss but denied the claim to the insured. Once Nationwide paid the principal on the mortgage to Chase as mortgagee, the District Court held it was entitled to subrogate against McDermott. McDermott argued, citing *Prestige Ins Co v Michigan Mutual Ins Co,* 99 F3d 1340, 1352 (6th Cir 1996), an insurer is not entitled to subrogate against its own insured. Acknowledging this is the general rule and not the norm, the District Court distinguished *Prestige* on the basis there was a valid subrogation agreement in the instant case. Finding that subrogation was appropriate against McDermott, the District Court granted Summary Judgment in favor of Nationwide awarding it $139,841.04.

McDermott appealed the ruling to the Sixth Circuit on the basis she was an innocent co-insured and was not only entitled to coverage but should not be liable to Nationwide. The Sixth Circuit upheld the grant of Summary Judgment not on the basis the District Court discussed as barring coverage, rather holding McDermott violated the Michigan Amendatory Endorsement's Policy Conditions when she breached her duty to notify Nationwide of "any change which may affect the premium risk under th[e] policy," specifically the change in its use from a residence premises to a marijuana growing operation center. *Nationwide Mutual Fire Ins. Co. v McDermott,* __F3d___(6th Cir 2015) (released February 24, 2015, not recommended for publication) at *6. Harkening back to the bedrock principal an insurer cannot be held liable for a risk it did not assume, while recognizing this Condition did not contemplate reporting every "change" to a carrier the Sixth Circuit held McDermott's argument–that turning the basement of the insured premises into a marijuana manufacturing facility with 28 marijuana plants was somehow equal to buying a houseplant–constituted a gross mischaracterization of the issue. In support, Nationwide indicated had McDermott reported the change and the marijuana growing operation, it would have "declined coverage altogether, because such an operation is an increased hazard and 'an unacceptable risk.'" *Id.* at *8. Once the Sixth Circuit determined there was no coverage for the loss, it adopted the reasoning of the District Court with respect to Nationwide's ability to subrogate against McDermott under the Mortgage Clause.

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[4] *Nationwide Mutual Fire Ins. Co. v McDermott,* 2013 U.S. Dist. LEXIS 128764 (E.D. Mich. September 10, 2013).

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