

Risky Business: Contractual Versus Equitable Rights of Subrogation

Kyle Rice
11.8.23

In *Zurich Am. Ins. Co. v. Infrastructure Eng'g. Inc.*, 2023 Ill. App. LEXIS 383, the insurer, Zurich American Insurance Company (Insurer) proceeded as subrogee of Community College District No. 508 d/b/a City Colleges of Chicago and CMO, a Joint Venture. The Appellate Court of Illinois, First District (Appellate Court) addressed whether Insurer – who issued a builder's risk policy to insure a building during construction – could subrogate on behalf of the building owner, City Colleges of Chicago (City Colleges), who was part of the joint venture and an additional named insured, but who had not been directly paid for the underlying loss. The Appellate Court determined that the policy language established that the carrier was contractually permitted to subrogate on behalf of all additional named insureds on the policy, including the building owner.

Zurich Am. Ins. Co. involved a subrogation claim arising from a water loss that occurred during the construction of a new academic building at Malcom X College in Chicago (the Project). Malcom X College is owned and operated by City Colleges. City Colleges contracted with CMO to serve as the general contractor on the Project and required CMO to "purchase and maintain a builder's risk property insurance policy during the period of construction." CMO purchased a builder's risk policy (the Policy) from Insurer. The Policy listed CMO as the "named insured" and City Colleges as an "additional named insured." CMO was also listed as the agent for all other insureds on the Policy.

City Colleges contracted with Moody Nolan for portions of the project, who in turn subcontracted with Infrastructure Engineering, Incorporated (Infrastructure Engineering) to install the stormwater detention system for the Project. A rainstorm occurred on August 17, 2015, as the Project was ongoing and before the stormwater detention system was fully installed. The property flooded during the storm, causing damage to the building and equipment on site (the Loss). CMO submitted a claim to Insurer arising out of the Loss, for which Insurer made payments just under \$3 million to CMO. Following making its payments, Insurer filed suit against Infrastructure Engineering alleging the defective design of the stormwater management system caused the Loss.

Infrastructure Engineering moved for summary judgment, arguing that: a) neither CMO nor City Colleges were third-party beneficiaries to its subcontract with Moody Nolan, and b) that Insurer "could not establish the necessary elements to entitle it to a right of subrogation because there was no contractual relationship between CMO and Infrastructure Engineering and because City Colleges suffered no loss and received no loss payment under the insurance policy." Infrastructure Engineering argued that subrogation required that: "(1) a third party must be primarily liable to the insured for the loss; (2) the insurer must be secondarily liable to the insured for loss under an insurance policy, and (3) the insurer must have paid the insured under that policy, thereby extinguishing the debt of the third party." Since Insurer paid CMO and not City Colleges, Infrastructure Engineering argued Zurich could not meet the third element required to establish a subrogation claim for City Colleges. Insurer responded that the matter was governed by contractual subrogation, not equitable subrogation. Insurer pointed to the subrogation provision of the policy, which stated:

"If [Insurer] pays a claim under this Policy, they will be subrogated, to the extent of such payment, to all the Insured's rights of recovery from other persons, organization and entities."

The trial court rejected Infrastructure Engineering's first argument, finding that City Colleges was a third-party beneficiary of the subcontract. However, the trial court found that since City Colleges suffered no loss and was not paid by Insurer, Insurer had failed to establish two of the necessary elements of subrogation and thus was not entitled to subrogate on behalf of City Colleges. Insurer filed a

motion to reconsider, arguing that the subrogation provision absolved Insurer of the need to satisfy the three requirements of equitable subrogation. The trial court denied the motion for reconsideration, citing a line of cases that the three elements were required for both equitable and contractual subrogation. Insurer appealed the finding that it had no right to subrogate for City Colleges.

On appeal, the Appellate Court reversed, finding that contractual provision in the policy established Insurer's right to subrogate on behalf of City Colleges. The Appellate Court found "[w]here the right of subrogation is created by the terms of an enforceable contract, the contract terms control, rather than common law or equitable principles." Here, the terms of the policy explicitly provided Insurer with a right to subrogation to the extent of its claim payments.

The Appellate Court determined that policy established a right of subrogation for both the Named Insured (CMO) and the Additional Named Insured (City Colleges), and that "both the owner and the general contractor have insurable interests in the property until construction is complete." Further, the Appellate Court found City Colleges did suffer a loss due to the incident, CMO purchased the Policy for the benefit of City Colleges, City Colleges reimbursed CMO for its share of the premiums, and that CMO was City Colleges' agent and was required to be the party to receive the claim payments. As a result, the Appellate Court determined City Colleges was an "Insured" under the policy and that Insurer acquired City Colleges' rights to recovery against third parties for the loss even though payments were not made directly to City Colleges.

Subrogation professionals practicing in Illinois must always be mindful of how subrogation rights manifest when pursuing a subrogation claim. While the elements of equitable subrogation may not always be met, the specific policy language may provide a contractual right of subrogation allowing you to move forward with a claim.

Editor's Note: On September 19, 2024, the Supreme Court of Illinois (Supreme Court) affirmed the Appellate Court's judgment. *Zurich Am. Ins. Co. v. Infrastructure Eng'g, Inc.*, 2024 IL 130242, 2024 Ill. LEXIS 468. The court stated that although the three elements discussed above were recited in the context of equitable subrogation, they still applied to contractual subrogation provisions because they involve the definition of subrogation itself. In this case, however, the elements were satisfied because both the owner and the general contractor suffered a loss and CMO, as agent for the property owner, submitted the loss to Zurich.

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.