Federal Court Asks South Dakota Supreme Court to Decide Whether Injunction Costs Are "Damages," Adopts Restatement's Position on Providing "Inadequate" Defense

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Do costs associated with complying with an injunction constitute covered "damages?" The U.S. District Court for the District of South Dakota recently certified that question to the South Dakota Supreme Court, in *Sapienza v. Liberty Mutual Fire Insurance Company*, No. 3:18-CV-03015-RAL, 2019 U.S. Dist. LEXIS 84973 (D.S.D. May 17, 2019). If the South Dakota Supreme Court takes on the question, it will become one of the few highest state courts to do so.[1] The *Sapienza* case is also notable because the court adopted § 12 of the Restatement of the Law of Liability Insurance (Restatement) regarding an insurer's potential liability for providing an "inadequate" defense. In doing so, the *Sapienza* court joins a growing list of courts to rely upon or cite to the Restatement.

The *Sapienza* case arose out of an underlying dispute between residential neighbors over the size and location of the Sapienzas' new house they built in a historic district in Sioux Falls, SD. The newly-built house allegedly prevented the neighbors from using their fireplace, blocked natural light the neighbors previously enjoyed, and decreased the value of the neighbors' house. The neighbors sought a permanent injunction requiring the Sapienzas to modify or relocate the house. The Sapienzas' homeowners' insurer provided them with defense counsel, but the insurer instructed the Sapienzas that it would not cover any costs associated with an injunction as such costs did not constitute covered "damages."

The neighbors prevailed at trial, obtaining an order granting their injunction against the Sapienzas. The order required the Sapienzas to either bring the house into compliance with federal and state regulations for homes in historic districts, or rebuild it. After unsuccessfully appealing the injunction order (eventually affirmed by the South Dakota Supreme Court) and unsuccessfully seeking approval for new plans from the Sioux Falls Board of Historic Preservation, the injunction order forced the Sapienzas to demolish their house, at the cost of over $60,000. The Sapienzas sued their insurer to recover those costs as well as damages for allegedly mishandling their defense.

As for whether injunction-related costs constitute covered "damages," the Sapienzas and their insurer cited cases from other jurisdictions in which the courts either held that "damages" refer only to "legal damages" (not equitable relief), or rejected the "technical definition of damages as inconsistent with the rule that terms in an insurance contract be given their plain and ordinary meaning." Finding no controlling South Dakota precedent, the court in *Sapienza* certified the question to the South Dakota Supreme Court. A decision from the South Dakota Supreme Court, assuming it accepts the certified question, could impact similar claims in other jurisdictions, especially those in which the "damages" question remains unresolved.

As for whether the Sapienzas' homeowners' insurer breached its duty to defend by providing an "inadequate" defense, the court in *Sapienza* likewise found no controlling South Dakota precedent. However, the court attempted to "predict" how the Supreme Court would decide the issue, and in doing so turned to the Restatement of the Law of Liability Insurance (Am. Law Inst., Revised Proposed Final Draft No. 2, Sept. 7, 2018). Observing that the "draft Restatement [(§ 12)] follows the well-reasoned majority rule and because the Supreme Court of South Dakota has found the Restatements 'persuasive in many instances,'" the *Sapienza* court predicted that "the Supreme Court of South Dakota would adopt the Restatement's position on insurer liability for an improper defense."

Under § 12, the *Sapienza* court observed, an insurer may be liable if it either (1) "fails to take reasonable care" in undertaking the insured's defense, or (2) negligently "directs the conduct of counsel . . . in a manner that overrides the duty of the counsel to exercise independent professional judgment." In other words, the court explained, "the insurer itself must have engaged in some misconduct," and will not be held vicariously liable for defense counsel's conduct. The court dismissed the Sapienzas' complaint because they failed to allege sufficient facts about their insurer's alleged negligent misconduct. By adopting and applying a section of the Restatement, the *Sapienza* court joins a chorus of other courts which have similarly done so in various other contexts.[2]

If you have questions or need more information, contact Anthony L. Miscioscia (miscioscia@whiteandwilliams.com; 215.864.6356) or Timothy A. Carroll (carrollt@whiteandwilliams.com; 215.864.6218).

[1] The South Dakota Supreme Court is not required to do so. *See* S.D. Codified Laws § 15-24A-1 (providing that the court "***may*** answer questions of law certified to it by . . . a United States district court").

[2] *See, e.g., Marcus v. Allied World Ins. Co.*, No. 2:18-CV-253-DBH, 2019 U.S. Dist. LEXIS 69203, at *11-12, 18 n.22 (D. Me. Apr. 23, 2019) (citing § 32 regarding interpretation and burden of proving application of exclusion, and § 21 regarding insurer's right of reimbursement of defense costs); *Country Mut. Ins. Co. v. Martinez*, No. CV-17-02974-PHX-ROS, 2019 U.S. Dist. LEXIS 69283, at *41 n.15 (D. Ariz. Apr. 23, 2019) (citing § 12 regarding potential liability of insurer for mishandling insured's defense); *Webcor Constr., LP v. Zurich Am. Ins. Co.*, No. 17-cv-2220 YGR, 2019 U.S. Dist. LEXIS 39834, at *12-13 (N.D. Cal. Mar. 12, 2019) (citing § 13 regarding conditions under which insurer must defend insured); *Cannon Elec. v. Ace Prop. & Cas. Co.*, 2019 Cal. Super. LEXIS 8, *23 (Los Angeles Co. Super. Ct. Jan. 9, 2019) (citing § 23); *Century Sur. Co. v. Andrew*, 432 P.3d 180, 186 (Nev. 2018) (citing § 48 regarding insured's entitlement to consequential damages resulting from insurer's breach of duty to defend).