SANDBERG PHOENIX

BAD FAITH BLOG

Breach of Contract Claims Survived (Barely), But All Bad Faith Claims Dismissed

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The Sapienza's purchased a home in an historic district in Sioux Falls, South Dakota, tore it down, and built a new home which the historic preservation board approved. However, the new house upset the neighbors who sued for injunctive relief (to include having the house torn down) arguing that the new structure violated certain height and setback restrictions. Liberty Mutual defended the Sapienza's under a reservation of rights. The trial court in the underlying case granted injunctive relief after finding that "compensation would not provide adequate relief," a ruling affirmed by the Supreme Court of South Dakota. The Sapienza's were given 30 days to demolish their home which they did at the cost of more than $60,000.00. They then sued Liberty Mutual for breach of contract, both for failing to provide an adequate defense and for refusing to indemnify them for their out of pocket "damages". They also filed three counts described as "bad faith" claims. The U.S. District judge granted Liberty Mutual' s motion to dismiss the three bad faith claims, but denied the motion to dismiss the breach of contract claims. The judge gave plaintiffs 14 days to file a motion for leave to amend their complaint if they had a factual basis for alleging a breach of the duty to defend and certified a question to the South Dakota Supreme Court to decide whether "the costs the Sapienzas incurred to comply with the injunction constitute covered 'damages' under the Policies."

The Sapienzas had retained their own attorney to defend the suit their neighbors filed before tendering the case to Liberty Mutual. Liberty Mutual allowed the same attorney to defend the Sapienzas throughout. The judge found that under the Restatement of the Law of Liability Insurance § 12 that there were two grounds under which an insurer could be liable for providing an inadequate defense. The second of those grounds is whenever the defense attorney negligently defends the case "when the insurer directs the conduct of the counsel with respect to the negligent act or omission in a manner that overrides the duty of the counsel to exercise independent professional judgment." *Id*. After carefully reviewing the facts and noting that the facts alleged in the complaint failed to state a claim, the judge gave the Sapienzas an opportunity to amend to state a claim, if they could. (Slip op. at 10)

Regarding whether there were covered damages, the parties cited conflicting cases, none of which had been decided by the Supreme Court of South Dakota. The cases upon which Liberty Mutual relied "held that the term 'damages' in an insurance contract refers to legal damages rather than claims for equitable relief." (*Id.* at 11) The Sapienzas cited several non-South Dakota cases which had allowed the insureds to recover under the policy and found that the case law upon which Liberty Mutual relied was too "technical." (*Id.*) Because there was no South Dakota case on point to which the court could point, the court certified a question to the Supreme Court of South Dakota: "do the costs incurred by the Sapienzas to comply with the injunction constitute covered 'damages' under the policies such that Liberty Mutual must indemnify the Sapienzas for these costs?"

The court's ruling on the breach of contract issues was important to the court's ultimate ruling on the bad faith claims. The court carefully reviewed South Dakota bad faith law and noted that South Dakota "recognizes first and third-party bad faith claims." (*Id.* at 16) In South Dakota third-party bad faith law is a negligence type of claim which "arises when an insurer wrongfully refuses to settle a case brought against its insured by a third-party." On the other hand, South Dakota first-party bad faith "is an intentional tort and typically occurs when an insurance company consciously engages in wrongdoing during its processing or paying a policy benefit to its insured." (*Id.* at 16) In order to establish a first-party bad faith claim the plaintiff had to show "(1) an absence of a reasonable basis for denial of policy benefits, and (2) the insurer's knowledge of the lack of a reasonable basis for denial." (*Id.*)

The Sapienzas claimed that Liberty Mutual committed bad faith when it failed "to give their interests equal consideration." However, that "duty of equal consideration" arises in South Dakota only in third-party bad faith cases. The court further noted comments a and c of the Restatement of the Law of Liability Insurance § 24, like South Dakota law, limited the "equal consideration standard to situations where the insurer has made an unreasonable settlement decision." (*Id.* at 18) Because this was not a third-party bad faith case, (a breach of the duty to settle was not the Sapienza's theory for recovery), the court had to evaluate whether the Sapienzas had stated a claim for first-party bad faith.

The district judge ruled that the Sapienzas failed to "meet the first party bad faith test for essentially the same reasons they failed to state a claim for breach of the duty to defend." (*Id.*) The court considered Plaintiffs' counts 2 and 3 allegations together and found that even when considered together, they failed to allege "sufficient detail to support the reasonable inference that Liberty Mutual breached any duty it owed to the Sapienzas" in the way that Liberty Mutual defended the case. The allegations made "failed to link Liberty Mutual's conduct to the supposedly deficient defense the Sapienzas received." (*Id.*) For those reasons the court dismissed the counts 2 and 3 bad faith claims.

The court also dismissed the count alleging that Liberty Mutual "engaged in bad faith because it did not have a reasonable basis for refusing to indemnify them for damages caused by the [neighbors'] lawsuit." (*Id.* at 18) After noting that under South Dakota law an insurance company "has a reasonable basis for denying benefits if the claim is 'fairly debatable' in fact or law," the court noted that the issue was fairly debatable. Since the court had to certify "a question to the Supreme Court of South Dakota because there are no controlling cases whether expenses associated with an injunction qualify as damages in the insurance context," the issue was "fully debatable." (*Id.*) Applying the fairly debatable standard made count 4, the only remaining bad faith claim, subject to dismissal.

The Sapienza case is important to insurance law and bad faith attorneys and claims professionals for several reasons. First, it demonstrates that the recent Restatement of the Law of Liability Insurance is being recognized by courts all across the country. The judge stated that the Restatement had been relied upon by other courts. (*I.d* at 7, n.1) In addition, the federal court made it clear that it was going to adhere to the federal court pleading standards set forth by the United States Supreme Court in *Ashcroft v. Iqbal* and *Bell Atlantic Corp v. Twombly*. The court was going to require plaintiffs to allege facts that would support a claim "plausible on its face." Furthermore, the federal judge was not going to allow the third-party equal consideration standard to apply in what was, at best, a first party bad faith claim asserting both duties to defend and to indemnify. Because the plaintiffs had problems alleging a plausible breach of the duty to defend, the judge was not going to allow that claim to go forward. Additionally, since South Dakota law did not clearly establish a duty to indemnify (and was uncertain enough to certify a question to the Supreme Court of South Dakota to resolve the issue), the question of Liberty Mutual's duty to indemnify was fairly debatable. Finally, although Liberty Mutual's decision to defend under a reservation of rights was expensive on the one hand, by undertaking that expense it likely demonstrated its good faith to the court. The court was not inclined to punish the insurer for acting in good faith toward its insured by providing a defense where it was questionable whether it had a duty to defend. The insureds did themselves no favors by filing and seeking to prosecute breach of contract and bad faith claims which were tenuous at best.

Case citation: *Sapienza v. Liberty Mutual Fire Insurance Company*, 2019 WL 2162723 (D. S.D. May 17, 2019).