

## **SOUTH DAKOTA FINALLY TAKES POSITION ON LANDLORD/TENANT SUBROGATION AND SUTTON RULE**

*American Family Mut. Ins. Co. v. Auto-Owners Ins. Co.*, 2008 WL 4816666 (S.D. 2008)

For those of you who handle property subrogation and utilize our Landlord/Tenant Subrogation Chart contained on our website, you may have noticed that South Dakota remained one of the last states which remained undecided with regard to the application of the "Sutton Rule" when it comes to a landlord's property insurer subrogating against one of the landlord's tenants for property damage (e.g., fire or water damage) caused by the tenant to the landlord's property. That has changed. On November 5, 2008, the South Dakota Supreme Court officially rejected the blanket application of the "Sutton Rule" and adopted a "case by case" approach which looks at the terms of the applicable lease and under which subrogation may be denied if the lease expressly requires the landlord to maintain fire insurance or the lease exonerates a tenant from losses caused by a fire.

In *American Family Mutual Ins. Co. v. Auto-Owners Insurance Co.*, Donald Babinski owned a rental duplex located at 1026 North Menlo Avenue in Sioux Falls, South Dakota. Babinski purchased a business owners' policy of insurance from American Family to provide coverage for property damage to the rental dwelling on Menlo Avenue. Under the insurance policy, American Family was granted the right of subrogation in order to recover any amounts paid under the policy from those responsible for causing the loss. On January 28, 2005, tenants signed a lease agreement to rent one unit of the duplex owned by Babinski. The lease agreement contained the following provisions:

*(2) MAINTENANCE, REPAIRS, AND ALTERATIONS. Resident agrees: ... (b) to be responsible for, at Resident's own cost, any and all breakage or damage done to any part of the premises, including damages or theft by Resident's guests to the apartment and common areas of the building ...*

\* \* \*

*(H) LIABILITY OF RESIDENT AND MANAGEMENT.*

*(1) NON-LIABILITY OF LESSOR.... Resident is required to maintain liability and personal property insurance during the term of the lease or any subsequent leases. Proof of insurance is required at the time the lease is signed.*

*(3) RESIDENT SHALL REIMBURSE MANAGEMENT FOR (a) any loss, property damage, or cost of repair or service (including plumbing problems and freezer punctures) cause[d] by negligence or improper use by Resident, his/her agents, family or guests ... The lease did not contain any provision reserving a right of subrogation in favor of the landlord's insurer, American Family, nor did it specifically address damage to the dwelling caused by fire.*

In accordance with the lease, the tenants purchased a homeowners' insurance policy from Auto-Owners for the rental duplex. The term of the policy provided coverage from February 28, 2005 to February 28, 2006. All three tenants were covered under the policy.

On March 1, 2005, an accidental fire occurred when one of the tenants, Ashley Deiss, took ashes from the fireplace and moved them to a cardboard box inside a closet in the residence. As a result of the fire, American Family paid insurance proceeds to Babinski in the amount of \$96,959.42 for the damage caused by the fire. American Family then sought subrogation in this amount against Auto-Owners on the tenants' homeowners' insurance policy. Auto-Owners denied American Family's subrogation claim. American Family subsequently filed a declaratory judgment action seeking a determination of whether it had a subrogated interest against the Auto-Owners policy held by tenants.

The circuit court granted Auto-Owners' motion for summary judgment and issued a memorandum decision. The circuit court concluded that the South Dakota Supreme Court would adopt the rule first pronounced in *Sutton v. Jondahl*, 532 P.2d 478 (Okla. App. 1975). The *Sutton* rule precludes a landlord's insurer from asserting a subrogation claim against a tenant absent an express agreement to the contrary. The circuit court found that public policy reasons supported the *Sutton* approach including the legal certainty provided by the rule and the fact that it avoids gamesmanship over the manner in which landlords craft lease provisions. Additionally, the circuit court held that even if it adopted the alternative case-by-case approach, American Family did not have a subrogation right. This was because the tenants could not reasonably anticipate that the landlord's insurer could assert a subrogation claim against them if the rental property was destroyed by a fire caused by their negligence.

On appeal, the Supreme Court was asked to decide a matter of first impression for this state. The issue was whether, for subrogation purposes, a tenant is co-insured under his or her landlord's insurance policy absent an express provision in the parties' lease to the contrary. If the Court decides that the tenant is co-insured under the landlord's policy, an insurer could not bring a subrogation action against a tenant who caused damage to the landlords' insured premises because the right of subrogation cannot arise in favor of an insurer against its own insured.

The court noted that other states applying the *Sutton* rule have found that the rule protects the reasonable expectations of the tenant. They also noted that although some treatises acknowledge *Sutton* as a modern trend, at least one criticizes the holding and the trend:

*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 policy provides such coverage.* 6A, J.A. Appleman, Insurance Law and Practice § 4055 at 78 (2005).

Several jurisdictions have rejected *Sutton's* categorical rule and instead have applied a flexible case-by-case approach. Under the case-by-case approach, the court 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."

The case-by-case approach was attractive to the South Dakota Supreme Court because it was consistent with the public policy of South Dakota. Section 20-9-1 of the South Dakota Statutes provides for the general proposition that "[e]very person is responsible for injury to the person, property, or rights of another caused by his willful acts or caused by his want of ordinary care or skill, subject in the latter cases to the defense of contributory negligence." Also, § 43-32-10 specifically addresses damages caused by a lessee's negligence in the context of a lease:

*In every hiring of residential premises, whether in writing or parol, the lessee shall preserve the premises, appliances, appurtenances, and other leased personalty in good condition, and repair all deteriorations or damage thereto occasioned by his negligent, willful or malicious conduct or such conduct of persons acting under his direction or control.*

The Supreme Court concluded that the case-by-case approach is the best approach to employ in the landlord-tenant context because it applies basic contract principles. Subrogation may be denied under the case-by-case approach if the lease expressly requires the landlord to maintain fire insurance or the lease exonerates a tenant from losses caused by a fire. They rejected the notion that a tenant is implied to be a co-insured under a landlord's insurance policy. Therefore, they officially adopted the case-by-case approach

as a better reasoned rule that recognizes the intent of the parties under contract law and the equitable underpinning of subrogation.

This significant and well-reasoned decision leaves West Virginia as the only state left which has not committed itself to a particular approach to handling landlord/tenant subrogation claims. For information and an explanation as to how each state approaches this area of subrogation law, please see our Landlord/Tenant Subrogation Chart at <http://www.mwl-law.com/CM/Resources/Landlord-Tenant-Subrogation-070308.pdf>.