

New York Allows Consequential Damages Claims Against Commercial Insurers Outside Of Policy Limits

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In two decisions that will have significant implications for breach of contract suits against commercial insurers, the New York Court of Appeals (New York's highest court) ruled on February 19, 2008, that commercial property owners can assert claims for consequential damages in excess of policy limits where insurers have breached their contracts. *Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York*, 4 No. 14, (N.Y. Ct. App. Dec. February 19, 2008) ("Bi-Economy Decision"); *Panasia Estates, Inc. v. Hudson Insurance Company*, 1 No. 15, (N.Y. Ct. App. Dec. February 19, 2008) ("Panasia Decision"). In *Bi-Economy*, the Court of Appeals reversed the grant of partial summary judgment affirmed by the Appellate Division, holding that the courts below erred in dismissing the consequential damages claims, and held that insurers may be liable for such damages in excess of the stated policy limits if those damages are a natural and probable consequence of the breach. In *Panasia*, relying on the reasoning set forth in *Bi-Economy*, the Court of Appeals upheld the decisions below which denied the insurer's motion to dismiss the claims for consequential damages.

This memorandum briefly summarizes these important decisions.

BACKGROUND

Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York

Bi-Economy Market was a wholesale and retail meat market located in Rochester, New York. Under a "Deluxe Business Owner's" policy, *Harleysville Insurance Company* insured *Bi-Economy* for replacement cost coverage on the building and business property and contents, as well as for lost business income for up to one year. *Bi-Economy Decision* at 2.

In October 2002, *Bi-Economy* suffered a fire which resulted in the loss of inventory and equipment, and caused structural damage to the building itself. *Id.* After submitting a claim for damages under the terms of its insurance policy with *Harleysville*, the insurer advanced *Bi-Economy* the sum of \$163,161.92. *Id.* Alternative dispute resolution ultimately awarded *Bi-Economy*, over a year later, damages in the amount of \$407,181. *Id.* Concurrent with the alternative dispute resolution, *Harleysville* offered to pay seven months of lost business income, as opposed to the 12 months specified in the policy. *Id.*

Bi-Economy failed to resume business and filed suit against *Harleysville* in October 2004, seeking consequential damages for "the complete demise of its business operation in an amount to be proved at trial" resulting from *Harleysville's* breach of contract. *Id.* at 3. The suit asserted that *Harleysville* improperly delayed full payment on the claims submitted and as a result of this

breach, Bi-Economy's business collapsed. Bi-Economy claimed that these damages were reasonably foreseeable and contemplated by the parties at the time of contracting. *Id.*

Harleysville subsequently moved for and received partial summary judgment dismissing the breach of contract claims seeking consequential damages. *Id.* The Appellate Division, Fourth Department, affirmed, holding that the Supreme Court properly granted summary judgment dismissing the cause of action for breach of contract, as it sought "consequential damages only, and such unusual or extraordinary damages must have been brought within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting." *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N. Y.*, 2007 NY Slip Op 933, 1 (N.Y. App. Div. 2007) (internal citations omitted). "Here, the insurance policy expressly excludes coverage for consequential losses, and thus it cannot be said that such damages were contemplated by the parties when the contract was formed." *Id.*

Following the Appellate Division's affirmance, Bi-Economy sought leave to appeal, which the Court of Appeals granted.

Panasia Estates, Inc. v. Hudson Insurance Company

Panasia Estates owned a six-story commercial building on West 19th Street in Manhattan, and held a commercial property insurance policy with Hudson Insurance Company. *Panasia* Decision at 1. The policy included "Builders Risk Coverage," which covered damage to the property during renovations. *Id.*

The dispute arose over water damage to the building; Panasia claimed the damage resulted from rain entering the building while the roof was opened during renovations, while Hudson argued that the damage occurred over a long period due to wear and tear. *Id.* at 2. Hudson consequently denied Panasia's claim, and Panasia filed suit asserting that Hudson failed to timely and properly investigate the claim. *Id.* As a result, according to Panasia, Hudson breached the policy and should be liable for both direct and consequential damages. *Id.*

Hudson moved for partial summary judgment dismissing all claims relating to consequential damages, arguing, similar to Harleysville, that the contractual exclusion of "consequential loss" precluded recovery of consequential damages. *Id.* The Supreme Court disagreed with Hudson, and the Appellate Division, First Department, affirmed, holding that "an insured may recover foreseeable damages, beyond the limits of its policy, for breach of a duty to investigate, bargain for and settle claims in good faith." *Panasia Estates, Inc. v. Hudson Ins. Co.*, 2007 NY Slip Op 3196, 1 (N.Y. App. Div. 2007) (internal citations omitted). Furthermore, the Appellate Division rejected Hudson's contention that "consequential loss" and "consequential damages" are synonymous terms. *Id.*

Following the Appellate Division's affirmance, Hudson sought leave to appeal, which the Court of Appeals granted.

SUMMARY OF THE DECISIONS

Writing for the 5-2 majority in both Court of Appeals decisions, Judge Eugene F. Pigott concluded that “consequential damages resulting from a breach of the covenant of good faith and fair dealing may be asserted in an insurance contract context, so long as the damages were ‘within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting’” *Panasia Decision* at 3 (quoting *Kenford Co. v County of Erie*, 73 NY2d 312, 319 (1989)).

In *Bi-Economy*, the Court of Appeals began its analysis with *Kenford*, stating that it is well settled that a nonbreaching party in a breach of contract action “may recover general damages which are the natural and probable consequence of the breach.” *Bi-Economy Decision* at 4 (quoting *Kenford* at 319). Furthermore, “[t]he party breaching the contract is liable for those risks foreseen or which should have been foreseen at the time the contract was made.” *Id.* at 5 (quoting *Ashland Mgt. v. Janien*, 82 NY2d 395, 403 (1993)). The breaching party need not have foreseen either the breach or the particular damage incurred, only “that loss from a breach is foreseeable and probable.” *Id.* (citing Restatement [Second] of Contracts § 351; 3 Farnsworth, Contracts § 12.14 [2d ed 1990]).

Additionally, the Court of Appeals in *Bi-Economy* found particularly relevant the implicit covenant of good faith and fair dealing, which includes the understanding that “the insurer promises to investigate in good faith and pay covered claims.” *Bi-Economy Decision* at 7 (quoting *New York Univ. v. Continental Ins. Co.*, 87 NY2d 308, 318 (1995)). According to the Court of Appeals, this also includes the idea that an insured purchases more than the provision of funds in the event of a loss, specifically peace of mind, comfort, and security. *Id.* at 7-8.

Concluding that “[t]he purpose served by business interruption coverage cannot be clearer -- to ensure that *Bi-Economy* had the financial support necessary to sustain its business operation in the event disaster occurred,” Judge Pigott found that limiting *Bi-Economy*’s damages to the money originally owed under the policy would not place *Bi-Economy* in the same position as if *Harleysville* had performed in accordance with the policy. *Id.* at 8-9. “Thus, the very purpose of business interruption coverage would have made *Harleysville* aware that if it breached its obligations under the contract to investigate in good faith and pay covered claims it would have to respond in damages to *Bi-Economy* for the loss of its business as a result of the breach.” *Id.* at 9.

The majority dismissed the dissent’s assertion that *Kenford* and its progeny are inapplicable to the facts of *Bi-Economy*, noting that because the purpose for which the insured intended to use the insurance proceeds was “at the very core of the contract itself,” it can not be characterized as a pure agreement to pay money only. *Bi-Economy Decision* at 6. Rather, Judge Pigott agreed with *Bi-Economy* that the purpose of the policy was to receive money in a timely fashion such that business could continue with as little interruption as possible. *Id.* at 10.

In accordance with this understanding, the Court of Appeals read into the insurance contract an additional requirement that “the insurer agreed to evaluate a claim, and to do so honestly, adequately, and -- most importantly -- promptly.” *Id.* Because *Harleysville* knew or should have

known that its delay or improper denial would result in additional damages, the Court of Appeals found that “the insurance company should stand liable for these damages.” *Id.*

Responding to the dissent’s accusation that this decision represents an imposition of punitive damages on the insurer, Judge Pigott asserted simply that the effect of this decision is “not to punish the insurer, but to give the insured its bargained-for-benefit.” *Id.*

Finally, the Court of Appeals rejected Harleysville’s contention that the contractual exclusion of “consequential losses” precludes the recovery of “consequential damages” resulting from breach of contract. *Id.* According to Judge Pigott, consequential losses “clearly refer to delay caused by third party actors or by the [s]uspension, lapse or cancellation of any license, lease or contract” and that “[c]onsequential damages, on the other hand, are in addition to the losses caused by a calamitous event.” *Id.*

In *Panasia*, the Court of Appeals relied wholly on the reasoning set forth in the *Bi-Economy* Decision in finding that the courts below properly denied summary judgment dismissing the claims for consequential damages, and remanding the case to the Supreme Court to determine whether the specific damages sought were foreseeable as a result of the breach. *Panasia* Decision at 4-5.

Judge Robert S. Smith, joined by Judge Susan Phillips Read, dissented in both cases, appending the same dissenting opinion (the “Dissent”) to both decisions. Asserting that the Court of Appeals was merely imposing punitive damages on the insurer under the guise of consequential damages, Judge Smith argued that the majority overturned the precedent set by *Rocanova v Equitable Life Assur. Socy. of U.S.*, 83 NY2d 603 (1994) and *New York Univ. v Continental Ins. Co.*, 87 NY2d 308 (1995), which preclude punitive damages for a bad faith failure to pay a claim unless a plaintiff can show both “egregious tortious conduct” directed at the insured and “a pattern of similar conduct directed at the public generally.” *Dissent* at 1 (internal citations omitted). According to the dissent, the Court of Appeals misused both the terms “consequential damages” and “covenant of good faith,” and while the damages authorized may be remedial in form, they are punitive in fact. *Id.* at 3. Furthermore, in dismissing the *Kenford* analysis undertaken by the Court of Appeals, Judge Smith rejected the idea that the Court’s result is one that the parties would have contracted and posed the following hypothetical conversation by way of example:

Applicant for insurance: “Suppose you refuse, in bad faith, to pay a claim. Will you agree to be liable for the consequences, including lost business, without regard to the policy limits?”

Insurance company: “Oh, sure. Sorry, we forgot to put that in the policy.”

Id. at 4

Judge Smith additionally warned of the serious damage that can result from allowing punitive damage awards, in particular that:

[i]nsurers will fear that juries will view even legitimate claim denials unsympathetically, and that insurers will thus be exposed to damages without any

predictable limit. This fear will inevitably lead insurers to increase their premiums -- and so will inflict a burden on every New Yorker who buys insurance.

Id. at 2.

As such, Judge Smith concluded that the majority's decision represented poor policy choice, and will result in juries deciding whether claims were paid promptly, whether the delays were justified, and whether the claims should have been paid in larger amounts. Id. at 6. "All these very difficult, often nearly unanswerable, questions will be put to jurors who will usually know little of the realities of either the insured's or the insurer's business. The jurors will no doubt do their best, but it is not hard to predict where their sympathies will lie." Id.

CONCLUSION

The Court of Appeals' decisions in Bi-Economy and Panasia open the door for potential insurer liability above and beyond stated policy limits. Insurers should be aware when investigating and handling claims that policyholders may now seek to hold insurers liable for consequential damages allegedly flowing from improper and/or unreasonably delayed coverage determinations without regard to policy limits.

If you have any questions concerning these decisions, please contact Barry Ostrager (212-455-2655), Mary Kay Vyskocil (212-455-3093) or Andrew Amer (212-455-2953).

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