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New York Court Of Appeals Permits Potential Recovery of Consequential Damages Against First-Party Property Insurer

By **EVAN H. KRINICK** and **MICHAEL A. TROISI**

On February 19, 2008, the State of New York Court of Appeals, the state's highest court, decided Bi-Economy Market v. Harleysville Insurance Company, (2008 N.Y. Slip Op 1418). In reversing the Order of the Appellate Division, Fourth Department, the Court held that a policyholder alleging breach of contract against its property insurer for failure to pay a claim for business interruption can seek recovery of the policy limits and consequential damages.

Rivkin Radler submitted an Amici Curiae brief to the Court on behalf of the New York Insurance Association, the National Association of Mutual Insurance companies, the American Insurance Association and the Property Casualty Insurers Association of America.

FACTS

Bi-Economy Market was a family owned wholesale and retail meat market located in Rochester, New York. A fire occurred at the market in October 2002, which resulted in the complete loss of plaintiff's inventory and damage to the building and its contents. Bi-Economy submitted a claim to Harleysville. The policy provided coverage for the building, as well as the business property. The policy also provided coverage for Loss of Business Income ("Business Interruption") for a period of one year from the date of loss. During the adjustment process, there was a dispute regarding the actual damages sustained to the building and business property. Additionally, there was a dispute as to the amount of "Business Interruption," with Harleysville contending that it should only be liable for seven months and Bi-Economy contending that they were entitled to the full one-year period. Bi-Economy never resumed its business operations after the fire.

Bi-Economy commenced an action against Harleysville asserting causes of action for bad faith claims handling, tortious interference with business relations and breach of contract, and sought consequential damages for "the complete demise of its business operation in an amount to be proved at trial." Specifically, Bi-Economy alleged that Harleysville delayed payments for its building and contents damage and failed to timely pay the full amount of its Loss of Business Income claim.

THE DECISION

In a 5-2 ruling for the policyholder, the majority relied on traditional contract analysis enunciated in Kenford Co. v. County of Erie, 73 N.Y.2d 312, 319 (1989). In Kenford, the Court held that a non-breaching party may recover consequential damages so long as such damages were within the contemplation of the parties as the probable result of the breach at the time of or prior to contracting. Kenford directs that in order to determine whether consequential damages were reasonably contemplated by the parties, the Courts must look to "the nature, purpose and particular circumstances of the contract known by the parties . . . as well as what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made."

Applying this analysis to the facts of Bi-Economy, the Court found that the consequential damages allegedly sustained by Bi-Economy were foreseeable because the purpose served by business interruption coverage was to insure that Bi-Economy had the financial support necessary to sustain its business operations in the event a disaster occurred. The Court reasoned that "the very purpose of business interruption coverage would have made Harleysville aware that if it breached its obligation 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.

Contrary to the traditional breach of contract prin-

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ciples, the Court added a "bad faith" component to the recovery of consequential damages. The Court relies on the implied covenant of good faith and fair dealing inherent in all contracts to specifically find that insurance contracts contain an implied agreement by the insurer to evaluate a claim "…honestly, adequately and--most importantly—promptly." Here, the Court interpreted plaintiff's claim that Harleysville failed to promptly adjust and pay the loss as a breach of the implied covenant. The Court holds that when an insured in such a situation suffers additional damages as a result of an insurer's excessive delay or improper denial, the insurance company should stand liable for these damages.

THE DISSENT

In dissent, Judge Smith argued that the Kenford analysis did not apply to insurance policies because insurance policies contain agreed upon monetary limits, and are thus quite different from performance-based contracts, (like the one at issue in Kenford) that do not address the amount to be paid in the event of a breach. Regarding insurance contracts, Justice Smith wrote "the parties have already told us what damages they contemplated" (payment for covered losses up to the policy limits) and that the Kenford analysis is only appropriate in those cases "where there is no agreement on what money will be paid in the event of a breach" and the court is left to decide what damages the parties contemplated.

Judge Smith criticizes the majority for making "bad faith" a predicate for the recovery of consequential damages and for abandoning, without discussion or explanation, the Court's well-established precedents in Rocanova v. Equitable Life Assurance Society of the U.S., 83 N.Y.2d 603 (1994) and New York University v. Continental Insurance Company, 87 N.Y.2d 308 (1995). Rocanova and New York University held that punitive damages are not available for breach of an insurance contract unless the plaintiff shows both "egregious tortious conduct" directed at the insured claimant and "a pattern of similar conduct directed at the public generally." Judge Smith accuses the majority of simply changing labels: "punitive damages are now called 'consequential' damages, and a bad faith failure to pay a claim is called a 'breach of the covenant of good faith and fair dealing.'" He further opines that the "consequential" damages authorized by the majority are "punitive in fact" and such damages "are not triggered, as true consequential damages are, simply by a breach of contract, but only by a breach committed in bad faith." In recognizing the serious harm associated with exposing insurers to such liability, Judge Smith laments that the majority's opinion will lead to the punishment of many honest insurers, more litigation and an inevitable increase in insurance premiums.

THE "CONSEQUENCES" OF THE DECISION

The Court's decision in Bi-Economy will undoubtedly expand the scope of potential liability for insurers, as it opens the door for policyholders to seek recovery beyond the limits of the policy. The stringent standards for pleading a claim for punitive damages, as set forth in Rocanova and New York University, remain undisturbed. As Judge Smith predicts, however, insurers should anticipate that claims formerly brought seeking "punitive damages" will now be couched as claims for "consequential damages."

The Court's holding appears to be narrow and limited to a breach of the particular type of coverage at issue in Bi-Economy (business interruption insurance) and will be permitted only in cases where the breach was in "bad faith." Indeed, the Panasia case was remanded to the Supreme Court for a determination of whether the types of consequential damages sought were within the contemplation of the parties at the time the contract was formed. Outside the context of business interruption insurance, such proof may be more difficult for the policy holder to establish. While the Bi-Economy Court was persuaded, at the pleading stage, that the alleged consequential damages (the demise of the business) were foreseeable in light of the nature of business interruption coverage, there is no strong indication that the court will sustain more speculative or remote claims arising out of other species of first party coverage. As Panasia and other cases wind their way through the courts, we should gain an even better understanding of the scope of the Bi-Economy ruling and its implications for New York insurers.

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ENDNOTES:

1. On the same day, the Court decided Panasia Estates, Inc. v. Hudson Insurance Company (2008 N.Y. Slip Op 1419). In Panasia, the court held that an exclusion for "consequential loss" had no impact on a claim for consequential damages. The Court found that the record was insufficiently developed to rule on the viability of the claim for consequential damages.

2. Under settled New York law, a breach of the implied covenant can only be established by a finding of conduct amounting to "gross disregard" of the policyholder's rights. Negligence or an error in judgment are insufficient. See, Pavia v. State Farm, 82 N.Y.2d 445 (1993).

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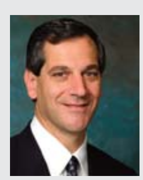

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