HUNTON& WILLIAMS

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Contacts

McLean Office
1751 Pinnacle Drive, Suite 1700
McLean, VA 22102

Walter J. Andrews
(703) 714-7642
wandrews@hunton.com

Lon A. Berk
(703) 714-7555
lberk@hunton.com

Edward J. Grass
(703) 714-7649
egrass@hunton.com

Paul E. Janaskie
(703) 714-7538
pjanaskie@hunton.com

Washington DC Office
1900 K Street, NW
Washington, DC 20006

Neil K. Gilman
(202) 955-1674
ngilman@hunton.com

John W. Woods
(202) 955-1513
jwoods@hunton.com

Atlanta Office
Bank of America Plaza, Suite 4100
600 Peachtree Street, NE
Atlanta, GA 30308

Lawrence J. Bracken II
(404) 888-4035
lbracken@hunton.com

New York Office
200 Park Avenue
New York, NY 10166

Robert J. Morrow
(212) 309-1275
rmorrow@hunton.com

Charlotte Office
Bank of America Plaza, Suite 3500
101 South Tryon Street
Charlotte, NC 28280

Dana C. Lumsden
(704) 378-4711
dlumsden@hunton.com

Sergio Oehninger of the firm's McLean office authored this Alert.

New York Court of Appeals Rules That Policyholders Can Seek Consequential Damages in First-party Bad Faith Claims

In two separate opinions, a five to two majority of the New York Court of Appeals ruled that an insured can assert a claim for consequential damages for an insurer's alleged bad faith breach of a first-party insurance contract. *Bi-Economy Market, Inc. v. Harleysville Insurance Company of New York*, No. 14 (N.Y. February 19, 2008); *Panasia Estates, Inc. v. Hudson Insurance Company*, No. 15 (N.Y. February 19, 2008).

Background of *Bi-Economy*

The policyholder, a wholesale and retail meat market, was insured under a "Deluxe Business Owner's" insurance contract, which provided coverage for business property and lost business income. When the market suffered a major fire, the policyholder submitted a claim to its insurer pursuant to the terms of the contract. After the insurer refused to pay the full claim, the parties submitted their dispute to alternative dispute resolution. During all of this time, the insurer offered to pay only seven months of the policyholder's claim for lost business income, despite the fact that the policy provided for a full twelve months. The policyholder never resumed operations.

The policyholder sued the insurer for bad faith claims handling, breach of contract, and tortious interference with business relationships, seeking consequential damages for the loss of its business operations. The policyholder alleged that due to the insurer's improper delay in paying the claim, the policyholder's business collapsed, and liability for such consequential damages was reasonably foreseeable and contemplated by the parties at the time of contracting. The insurer countered that the insurance contract's "consequential loss" exclusions precluded coverage for consequential damages. The trial court ruled in favor of the insurer, and the New York Appellate Division affirmed. The policyholder petitioned for review by the New York Court of Appeals, which reversed the Appellate Division's ruling.

The Majority's Decision in *Bi-Economy*

A majority of the New York Court of Appeals held that a claim for consequential damages resulting from a breach of the covenant of good faith and fair dealing implicit in contracts of insurance may be asserted, so long as such damages resulting from a breach were within the reasonable contemplation of the parties at the time of or prior to contracting. Addressing a concern raised by the dissent, the majority explained that this is *not to punish* the insurer, but to give the policyholder its bargained-for benefit. As the majority reasoned, the purpose of the policyholder's business interruption coverage was to ensure that, in the event of a calamity, the policyholder promptly would receive the financial support necessary to sustain its business operations. It was reasonably foreseeable that if the insurer breached its obligations under the contract to investigate in good faith and promptly pay covered claims it would have to respond to the policyholder's business losses as a result of the breach. Consequently, the majority ruled that the consequential damages sought by the policyholder, specifically for the demise of its business, were reasonably foreseeable and contemplated by the parties, and thus could not be dismissed on summary judgment.

Background of *Panasia*

In *Panasia*, the policyholder owned commercial real estate and had a commercial property insurance policy that included "Builders Risk Coverage," covering damage to the policyholder's property while undergoing renovation. During renovation, rain entered the building through an opening in the roof, which had been created to perform the construction work. The policyholder claimed it promptly notified its insurer of the loss but the insurer failed to investigate or adjust the claim until several weeks later. Then, three months later, the insurer denied the claim, stating that the policyholder's loss was the result of repeated water infiltration over time rather than from a risk covered under the insurance contract.

The policyholder commenced an action against the insurer, seeking direct and consequential damages for the insurer's alleged breach of the insurance contract by failing to properly investigate the loss and wrongfully denying the claim. The insurer moved for partial summary judgment, contending that consequential damages are not recoverable in a claim for breach of an insurance contract. The insurer also argued that a contractual exclusion for "consequential loss" precluded the policyholder's request for consequential damages. The trial court denied the insurer's motion and the Appellate Division affirmed, stating that "[a]n 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." The Appellate Division also ruled that the contractual exclusion for consequential loss does not bar the recovery of consequential damages. The insurer appealed to the New York Court of Appeals, and the same majority as in *Bi-Economy* affirmed the Appellate Divisions' ruling.

The Majority's Decision in *Panasia*

Citing *Bi-Economy*, the majority explained that consequential damages are recoverable in a claim for a breach of an insurance contract, so long as the damages were within the reasonable contemplation of the parties as the probable result of a breach at the time of or prior to contracting. Because the record on appeal was not fully developed on the issue of whether the specific damages sought by the policyholder were foreseeable, the majority affirmed the lower court's order denying the insurer's motion for partial summary judgment. Additionally, the majority noted that the Appellate Division had correctly concluded that the contractual exclusion for consequential loss does not bar the recovery of consequential damages.

The Dissenting Judges' Opinion

The same two Judges dissented in both *Bi-Economy* and *Panasia*. The dissenters argued that the majority ignored New York precedent prohibiting punitive damages for a breach of a contract for insurance (except where a plaintiff could show "egregious tortious conduct" by defendants and a "pattern of similar conduct directed at the public generally") by simply changing labels--labeling punitive damages as "consequential damages" and a bad faith failure to pay a claim as a "breach of the covenant of good faith and fair dealing." Additionally, the dissenters concluded that "consequential damages" have no place in a case involving an insurance contract where the obligation breached is merely one to pay money, reasoning that an insurance contract itself identifies the damages contemplated by the parties, i.e., payment equal to the losses covered by the policy, up to the policy limits. Finally, the dissenters called the majority's decision a "bad policy choice," arguing the majority's "attempt to punish unscrupulous insurers will undoubtedly lead to the punishment of many honest ones" and will generate an increase in insurance premiums.

Implications

The holdings of New York's high court in *Bi-Economy* and *Panasia* demonstrate that, under New York law, a claim for consequential damages resulting from a breach of a first-party insurance contract for business interruption or builder's risk coverage may be allowed where the damages were within the reasonable contemplation of the parties as the probable result of a breach at the time of or prior to contracting. Given the purpose of business interruption and builder's risk coverage, it may be that the effect of this holding will be limited and not be applied in other contexts. Furthermore, according to the majority, its rulings does affect New York's prohibition against punitive damages for a breach of an insurance contract. Nonetheless, insurers operating in New York must consider whether the rulings in *Bi-Economy* and *Panasia* will expose them to increased litigation and judgments.