ATTORNEY ADVERTISING FEBRUARY 2008

Developments in New York Law on the Recovery of Consequential Damages

In two decisions handed down last week, the New York Court of Appeals held 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." *Bi-Economy Market, Inc. v. Harleysville Insurance Co. of New York*, 2008 WL 423451 (N.Y. Feb. 19, 2008) and *Panasia Estates, Inc. v. Hudson Insurance Co*., 2008 WL 420014 (N.Y. Feb. 19, 2008). Consequential damages are those "unusual and extraordinary damages" that "do not so directly flow" from a breach of contract, and because of their indirectness, the courts of New York and elsewhere have traditionally limited the circumstances under which they are recoverable. Although *Bi-Economy* and *Panasia* do not represent a radical change in New York law, they do represent a dramatic and expansive application of existing law, which set a new high-water mark for the recovery of consequential damages in first-party insurance disputes.

Prior to these decisions, claims by first-party insureds in New York seeking recovery beyond unpaid insurance proceeds plus interest, including claims for consequential damages, were almost uniformly rejected. Based on a fair but broad reading of the Court of Appeals' holdings in *New York Univ. v. Continental Ins. Co*., 87 N.Y. 2d 308 (1995) and *Rocanova v. Equitable Life Assur. Soc*., 83 N.Y.2d 603 (1994), the lower courts had significantly limited what a first-party insured can recover for a breach of the insurance contract, including the breach of the implied covenant of good faith and fair dealing. The rulings in *Bi-Economy* and *Panasia* may signal the end of this approach.

Notably, the claims asserted in *Bi-Economy Market* and *Panasia Estates* are not novel. In *Bi-Economy* , the insured, a family-owned wholesale and retail meat market, sustained a fire loss that destroyed its inventory and caused major structural damage to its facility. Harleysville had issued to Bi-Economy a "Deluxe Business Owner's" policy that provided commercial property and business interruption coverage. Bi-Economy alleged that Harleysville's failure to pay promptly the full claim under the policy caused its business to fail. Bi-Economy asserted causes of action for bad faith, tortious interference with business relations, and breach of contract, seeking consequential damages for the going-concern value of the business. Bi-Economy further alleged that its business collapse was reasonably foreseeable and contemplated by the parties at the time of contracting.

In expanding the relief previously available to insureds, the Court of Appeals in *Bi-Economy* distinguished a claim for breach of an insurance policy from an action for breach of a contract to pay money only – where the only recoverable damage for breach is interest. The Court observed that insureds "bargain for the peace of mind, or comfort, of knowing that [they] will be protected in the event of a catastrophe." The Court reasoned that the purpose served by business interruption coverage was "to ensure that Bi-Economy had the financial support necessary to sustain its business operation in the event disaster occurred." This purpose "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." Thus, Harleysville's failure to promptly adjust and pay the loss, resulting in the failure of the insured's business, resulted in the insurance

company's liability for these consequential damages. The Court explained that "[t]his is not to punish the insurer, but to give the insured its bargained-for-benefit."

In *Panasia Estates*, Hudson Insurance issued a builders risk policy to Panasia Estates while it was undergoing renovations. Notably, and unlike the policy at issue in *Bi-Economy Market*, Panasia's policy did not provide business interruption coverage. After the insured property sustained extensive water damage, Panasia submitted a claim, which was not paid. Panasia Estates then filed suit, alleging that Hudson failed to investigate or adjust the claim until several weeks after the claim was reported, and then improperly denied the claim three months later on the grounds that the damage was caused by repeated infiltration over time and wear and tear.

Relying on its holding in *Bi-Economy Market*, the Court of Appeals in *Panasia Estates* held 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." The Court remanded the case to the trial court, with a direction to develop the record further as to whether the specific damages sought by Panasia Estates were foreseeable as a result of Hudson's breach.

The *Bi-Economy* and *Panasia* decisions were the first time that the Court of Appeals applied the rule in *Kenford v. County of Erie*, 73 N.Y.2d 312 (1989), the controlling test in New York for the recovery of consequential damages for a breach of contract, to a first-party insurance dispute. Closely following the rule set out in *Kenford* , the Court held that consequential damages are recoverable where "the nature, purpose and particular circumstances of the contract" and its negotiation demonstrate that the insurer assumed liability for such damages consciously or that the policyholder reasonably supposed that such liability was assumed. Because the Court of Appeals expressly applied the *Kenford* rule in *Bi-Economy* and *Panasia*, the two decisions are on sounder legal footing than the First Department's decision in *Acquista v. New York Life Insurance Co* ., 285 A.D.2d 73 (N.Y. App. Div. 2001), which allowed consequential damages against a first-party insurer without ever mentioning, let alone applying, the controlling legal test for consequential damages under New York law.

The dissents in *Bi-Economy Market* and *Panasia* questioned the appropriateness of consequential damages that were "obviously punitive in fact." The dissents also recognized that attempting to punish unscrupulous insurers would undoubtedly lead to the punishment of many honest ones, stating, "The result of the uncertainty and error that the majority's opinions will generate can only be an increase in insurance premiums. That is the real 'consequential damage' flowing from today's holdings."

Although it is not exactly clear what the practical impact of these rulings will be on insurance coverage and claim-handling litigation in New York, it seems likely that claims by an insured for consequential damages will now survive dispositive motions and will generally receive greater consideration by the same courts that had previously disposed of such claims under the one-two punch of *New York Univ.* and *Rocanova*. Moreover, the *Bi-Economy Market* and *Panasia Estates* decisions will inevitably result in additional and more intrusive litigation against insurers by an emboldened policyholders' bar seeking to capitalize on a perceived tectonic shift in New York law. Insurers should brace for new and creatively pled cases.

For more information, please contact Gerald P. Dwyer, Jr. (gdwyer@rc.com) at (860) 275-8331 or Gregory P. Varga (gvarga@rc.com) at (860) 275-8230.