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New York Court of Appeals Allows Consequential Claims to Proceed

By Abbie Havkins, Esq., and Matthew Kraus, Esq.

The New York Court of Appeals, in two dramatic but divided opinions, has allowed an insured to assert consequential damages claims in a breach-of-contract action against its insurer.

These holdings, which abandon 20 years of settled jurisprudence in the Court of Appeals, could potentially increase an insurer's ultimate liability in breach-of-contract actions, provided that the insurance policy does not outright preclude such a recovery in the first place.

The Court of Appeals has historically refused to allow an insured to recover extra-contractual damages arising out of the insurer's purported breach of contract. *See Rocanova v. Equitable Life Assur. Soc'y,* 83 N.Y.2d 603, 615, 612 N.Y.S.2d 339, 344 (1994).

The underlying rationale was that an insurer could only be liable for extra-contractual damages if it was also liable for a tort independent of the contract. *New York Univ. v. Continental Ins. Co.,* 87 N.Y.2d 308, 662 N.E.2d 763, 639 N.Y.S.2d 283 (1995). In other words, extra-contractual damages were unavailable in breach-of-contract claims absent a claim that the insurer engaged in tortious conduct.

Nevertheless, in *Panasia Estates, Inc. v. Hudson Ins. Co.,* 2008 NY Slip Op 1419 (2008) and *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y.,* 2008 NY Slip Op 1418 (2008), the Court of Appeals abandoned its reliance on its prior holdings and refused to dismiss an insured's consequential damages claim even though the insured failed to allege a tort independent of the contract.

Bi-Economy Mkt., Inc. involved the insurer's breach of a business-interruption policy following a fire on the insured's premises. After the insured's breach-of-contract claims were sustained in alternative dispute resolution, the insured commenced an action for bad faith claims handling, tortious interference with business relations and consequential damages.

The insurer moved to dismiss the consequential damages claim on the basis that the policy excluded consequential losses.

The Court, in overturning the Supreme Court and the Appellate Division, reinstated the consequential damages claim. The Court noted that under New York law, the non-breaching party may recover consequential damages which are the natural and probable consequences of the breach.

Since the policy at issue was a business-interruption policy, the Court held that the insurer should have been aware that it would have to respond in damages to the insured for the loss of the insured's business if it breached the policy. The Court stated as follows:

> 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. This is not to punish the insurer, but to give the insured the bargained-for-benefit.

Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y., supra at 12.

The Court rejected the insured's reliance on the consequential "loss" exclusion. It held that the consequential losses refer to delay caused by third parties or by the suspension, lapse or cancellation of any license, lease or contract. Consequential damages are in addition to the losses caused by a calamitous event and include damages caused by a carrier's injurious conduct.

The Court states that its decision follows long established New York law to justify its decision. However, it primarily relies on case law from Utah, Hawaii, Arizona, Nevada and Mississippi, in noting that that insured bargains "for peace of mind, or comfort, of knowing that it will be protected in the event of a catastrophe."

In *Panasia,* the Court affirmed the Supreme Court and the Appellate Division's denial of the insurer's motion to dismiss the insured's consequential damages claim. The *Panasia* Court similarly rejected the insurer's reliance on the policy's consequential loss exclusion.

For the first time, the Court also expressly stated that an insured *could* recover consequential damages for the insurer's breach of the implied covenant of good faith and fair dealing. The Court held as follows:

> [C]onsequential 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 Estates, Inc. v. Hudson Ins. Co., supra at 2,3.

There was a vigorous dissent in both decisions.

The dissent argued that *Panasia* and *Bi-Economy* essentially abandon the Court's previous holdings which prevented insureds from asserting bad faith claims and seeking punitive damages against insurance carriers absent "egregious tortious conduct."

The dissent asserts that consequential damages authorized by the majority are punitive in nature since they are not triggered by a simple breach of contract, but only by a breach committed in bad faith. The dissent warned as follows:

> The majority's bad policy choice is more important than the flaws in its reasoning. This attempt to punish unscrupulous insurers will undoubtedly lead to the punishment of many honest ones. Under today's opinions, juries will decide whether claims should have been paid more promptly, or in larger amounts; whether an insurer who failed to pay a claim did so to put pressure on the insured, or from legitimate motives, or from simple inefficiency; and whether, and to what extent, the insurer's slowness and stinginess had consequences harmful to the insured.

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.

Future Impact

This is the rare decision that has claims and underwriting perspectives. Both decisions strongly suggest that had the insurance policies included a provision excluding "consequential damages" that the consequential damages claim would have been dismissed.[1]

As such, insurers seeking to avoid consequential damages should include a provision that explicitly excludes "consequential damages" resulting from any breach, whether negligent, intentional or in bad faith. Of course, the marketing impact of including such a provision must be considered.

From a claims' perspective, coverage disputes involving insurance policies that exclude "consequential damages" should not be affected by the decision. However, in assessing coverage issues involving policies without such language, some additional factors have been added to the mix of variables that must be considered in assessing whether to disclaim coverage.

We are not suggesting that when an insurer believes that coverage does not exist it should simply raise the "white flag" and surrender and provide coverage.

Naturally, under New York law, and that of virtually every jurisdiction, the benefit of the doubt must go to the insured. However, even after the insured is given the benefit of the doubt, there are situations where a close question arises as to whether a claim should be covered or declined.

For example, an insurer may believe, based on its own analysis and/or the advice of coverage counsel, that a claim is not covered and its chances of prevailing are 80:20. Prior to those two decisions, given the 80 percent chance of success, disclaiming would be the logical decision.

However, after these decisions, in situations involving insurance policies lacking the exclusion for "consequential damage," a prudent insurer must also consider the potential impact of an award of consequential damages.

For example, assume that an insurer insures a small but very profitable bakery (netting $300,000 in annual profit) that sustains a $50,000 fire loss but failed to provide notice until three months after the fire. Assume that the question of whether the notice was untimely has approximately an 80 percent chance of being resolving in the insurer's favor.

From the claims/coverage perspective the prudent insurer must now weigh whether paying a $50,000 fire loss is a better course then disclaiming coverage and having a 20 percent chance of paying the $50,000 plus the consequential damages that may result if the failure to pay the $50,000 puts the bakery out of business and the bakery seeks lost profit (consequential damages) of $300,000 per year.

There is a third approach. As many of you know from our previous advice, until these two decisions we had suggested that an insurer that did not believe a claim was covered disclaim.

We generally recommended against commencing a declaratory judgment action because if the insurer commences the declaratory judgment action and lose it must pay the insured's legal fees in the declaratory judgment action under New York law. As such, it was preferable to let the insured commence the action.

That approach may no longer be the preferred one.

Using the example set forth earlier, the choices are not limited to paying the $50,000 claim that the insurer believes is not covered or disclaim and have a 20 percent risk of paying hundreds of thousands of dollars of consequential damages. Now the preferred approach might be to commence a declaratory judgment action (in federal court if possible for an even faster decision) and by means of a summary judgment motion prior to any discovery obtain a judicial declaration as to whether the disclaimer is appropriate or not.

Unless there are factual questions involved, most insurance coverage declaratory judgment actions can be resolved quickly. If the court decides there is coverage, pay the claim and the insurer may be able to avoid or reduce the consequential damages.[2]

In a third party liability situation take over the defense and agree to indemnify the insured for the damages. If the court rules in the insurer's favor then it will have the comfort of knowing that it will not face consequential damages in the future.

The key to this strategy is speed, speed in commencing the action and speed in obtaining a judicial decision. Only in such circumstances will this strategy succeed.

Notes

[1] We use the phrase "strongly suggest" because the insurance policies at issue excluded damages for "consequential losses" which the majority struggled to distinguish from "consequential damages." As the dissent notes that distinction is one largely without a difference. Nonetheless, since the majority expressly distinguished provisions regarding "consequential damages" from "consequential losses" rather then either ignoring the distinction or holding that neither provision would be an effective bar to consequential damages, it appears that the Court would deny consequential damages if a provision in the insurance policy explicitly so provided.

[2] Not because the insurer has shown "good faith" by starting an action to test its position, but because it has cut off the time period that the insured lacks its insurance proceeds. Of course, as noted earlier the downside is that the insured will be entitled to its legal fees in defending the insurer-initiated action.

Abbie Havkins, *a partner with* ***Havkins, Rosenfeld, Ritzert & Varriale*** *in New York, litigates coverage disputes and counsels insurance professionals on E&O, D&O, commercial general liability, environmental, professional liability and fidelity policies.* ***Matthew Kraus*** *is an associate with the firm.*