LJN LAW JOURNAL NEWSLETTERS

The Insurance Coverage Law Bulletin®

An ALM Publication

Volume 10, Number 2 • March 2011

Extra-Contractual Damages in New York

How Much Has Changed?

By Robert D. Goodman and Katherine L. Kriegman

It has been three years since the New York Court of Appeals issued its decisions in *Bi-Economy Market, Inc. v. Harleysville Ins. Co.*, 10 N.Y.3d 187, 886 N.E.2d 127 (2008), and *Panasia Estates, Inc. v. Hudson Ins. Co.*, 10 N.Y.3d 200, 886 N.E.2d 135 (2008), permitting policyholders to recover consequential damages, at least in certain circumstances, in cases involving insurer bad faith. *Bi-Economy* and *Panasia* were each decided over a strong dissent that warned that the cases represented a sharp break from prior New York law imposing stringent standards for the recovery of extra-contractual damages in insurance cases. *See Bi-Economy*, 10 N.Y. 3d at 196-197, 886 N.E. 2d at 133 (Smith, J., dissenting).

In the three years since *Bi-Economy* and *Panasia* were decided, courts in a number of subsequent cases have been called upon to apply the reasoning of *Bi-Economy* and *Panasia*, reaching, at times, markedly differing outcomes. Although these subsequent decisions have shed some light on the question of how much has changed in the law of extra-contractual damages in New York, a number of important questions remain unsettled.

Robert D. Goodman, a member of this newsletter's Board of Editors, is a partner in the New York office of Debevoise & Plimpton LLP, where he represents and advises insurers in complex coverage and other policyholder and regulatory litigation. **Katherine L. Kriegman** is an associate in the New York office of Debevoise & Plimpton.

After taking a closer look at the Court of Appeals' decisions in *Bi-Economy* and *Panasia*, we summarize the current state of the law relating to a variety of issues regarding the availability of extra-contractual damages in New York that were arguably left open by the Court of Appeals.

The *Bi-Economy* and *Panasia* Decisions

Companion cases decided on the same day, *Bi-Economy* and *Panasia* concerned the availability of consequential damages in the setting of first-party property insurance where the policyholder has alleged bad faith on the part of the insurer. In *Bi-Economy*, the court held that consequential damages could be awarded for foreseeable damages when an insurer improperly delayed payment and failed to timely pay the full amount of the insured's lost business income claim. The court found that the loss of the plaintiff's business was foreseeable since "the very purpose of business interruption coverage would have made [the insurer] 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 [the insured] for the loss of its business as a result of the breach." *Bi-Economy*, 10 N.Y.3d at 195, 886 N.E.2d at 132. The court explained that: "To determine whether consequential damages were reasonably contemplated by the parties, 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 is assumed, when the contract was made.'" *Id*. at 193, 866 N.E.2d at 130 (*citing Kenford Co. v. County of Erie*, 73 N.Y.2d 312, 319, 537 N.E.2d 176, 179 (1989) (internal citations omitted)).

The *Bi-Economy* court specifically distinguished between consequential and punitive damages, explaining that consequential damages are "designed to compensate a party for reasonably foreseeable damages" and "must be proximately caused by the breach and must be proven by the party seeking them," while punitive damages "are not measured by the pecuniary loss or injury of the plaintiff as compensation but are assessed by way of punishment to the wrongdoer and example to others." *Id*. at 193, 866 N.E.2d at 131 (internal quotation marks omitted).

The court explained that, in *Bi-Economy*, "the purpose of the contract was not just to receive money, but to receive it promptly so that in the aftermath of a calamitous event … the business could avoid collapse and get back on its feet as soon as possible. … 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 its bargained-for benefit." *Id*. at 195, 866 N.E.2d at 132.

Although a major part of the court's rationale for permitting consequential damages in the *Bi-Economy* case had appeared to be the nature and purpose of business interruption insurance, the Court of Appeals made clear in *Panasia* that the *Bi-Economy* rule was not limited

to business interruption cases. *Panasia* involved a commercial property insurance policy, which included "builder's risk" coverage, issued by Hudson Insurance Company. The policyholder claimed that Hudson improperly delayed investigating a claim for damage to the policyholder's property allegedly caused by inclement weather when the roof of the building was open in order to permit construction work. Hudson sought summary judgment dismissing the policyholder's claims for consequential and other extra-contractual damages. The Court of Appeals affirmed the lower courts' rulings that Hudson was not entitled to a judgment as a matter of law that consequential damages are not recoverable in a claim for breach of an insurance contract. The court stated 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*, 10 N.Y.3d 200, 203, 886 N.E.2d 135, 137 (*quoting Kenford*, 73 N.Y.2d at 319, 537 N.E.2d at 178).

In What Kinds of Insurance Cases Are Consequential Damages Available?

Although the policies at issue in *Bi-Economy* and *Panasia* each provided first-party property insurance, subsequent New York decisions have made clear that consequential damages may be available in a variety of contexts other than first-party property cases. *See Woodworth v. Erie Ins. Co.*, No. 05-CV-6344CJS, 2009 U.S. Dist. LEXIS 49379 (W.D.N.Y. June 12, 2009) (applying *Bi-Economy* to a homeowner's insurance policy and stating that "nothing in [*Bi-Economy*] suggests that it applies only to cases involving business interruption insurance policies or commercial insurance policies"); *Savino v. Hartford*, 23 Misc. 3d 1116(A), 886 N.Y.S.2d 69 (Sup. Ct., Suffolk Cty. 2009) (applying *Bi-Economy* to auto insurance); *Handy & Harman v. AIG*, Index No. 115666/07, 2008 N.Y. Misc. LEXIS 7522 (Sup. Ct. New York Cty, Aug. 26, 2008) (applying *Bi-Economy* to environmental pollution insurance).

Much less clear is whether consequential damages may be available in insurance cases absent a showing of bad faith. Both *Bi-Economy* and *Panasia* involved allegations of bad faith, and there is language in each of the decisions suggesting that bad faith is a prerequisite to recovery of consequential damages. *Bi-Economy*, 10 N.Y.3d at 196, 886 N.E.2d at 133; *Panasia*, 10 N.Y.3d at 203, 886 N.E.2d at 137. Indeed, this is how the dissent read the majority's ruling, stating that, unlike "true consequential damages," which are triggered "simply by a breach of contract," the "consequential' damages authorized by the majority" were triggered "only by a breach committed in bad faith." *Bi-Economy*, 10 N.Y.3d at 197, 886 N.E.2d at 133 (Smith, J., dissenting). However, much of the Court of Appeals' rationale for permitting consequential damages seemed to be grounded in an application of contract law principles — what was "within the contemplation of the parties" — as to which the bad faith issue seems to be essentially irrelevant. This appears to have been the view of New York's Appellate Division, First Department, in a subsequent ruling in the *Panasia* case itself. In an unpublished decision issued the year after the Court of Appeals' decision, the First Department stated that "Plaintiff is correct in arguing that the motion court erred by stating that consequential damages do not lie for breach of an insurance contract absent bad faith, since the determinative issue is whether such damages were 'within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting.'" 2009 N.Y. Slip. Op. 09284 (1st Dep't 2009) (*citing Bi-Economy*, 10 N.Y.3d at 192, 886 N.E.2d at 129).

Other courts, however, have not adopted this view, and have instead required a showing of bad faith before granting an award of consequential damages. The Southern District of New York explained that to succeed on a consequential damages claim, the plaintiff "must have suffered damages resulting directly from a breach of the implied covenant of good faith and fair dealing." *Simon v. Unum Group*, No. 07 Civ. 11426 (SAS), 2009 WL 2596618, at *7 (S.D.N.Y. Aug. 21, 2009) (granting defendants' summary judgment motion to dismiss consequential damages claim because plaintiff "failed to offer any evidence to show that defendants acted in bad faith when they denied his claim for benefits"). Despite the plaintiff's arguments that consequential damages are available in breach of contract actions absent a showing of bad faith, the court explained that "there is no support for this view … *Bi-Economy v. Harleysville Insurance Co. of New York* … held that consequential damages are payable for breach of the implied covenant of good faith and fair dealing. [Plaintiff] cannot sustain a claim for consequential damages without showing that defendants lacked good faith in processing his claim." *Id.* at *8. *See also In re Axis Reinsurance Co.*, No. 07-CV-07924-JSR, 2010 U.S. Dist. LEXIS 33377, at *19 (S.D.N.Y. March 7, 2010) (holding that *Bi-Economy* and *Panasia* "reinforce the proposition that damages in excess of the policy limit are available only in situations where the insurer acts in bad faith").

The Foreseeability Requirement for Consequential Damages

Both *Bi-Economy* and *Panasia* reaffirmed the traditional foreseeability requirement for consequential damages. *Bi-Economy*, 10 N.Y.3d at 193, 886 N.E.2d at 130; *Panasia*, 10 N.Y.3d at 203, 886 N.E.2d at 137. In determining foreseeability, courts look to whether "the parties' reasonable contemplation should include '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.'" *Whiteface Real Estate Dev.*, No. 08-cv-24 (GLS/DRH), 2010 WL 2521794, at *5 (*citing Kenford*, 73 N.Y.2d at 319, 537 N.E.2d at 179). *See also Simon*, 2009 WL 2596618, at *5.

Courts have differed, however, as to whether foreseeability must be shown

at the pleading stage. In *Quick Response Commercial Div., LLC v. Travelers Property & Casualty Co.*, No. 1:09-cv-00651 (GLS/RFT), 2009 U.S. Dist. LEXIS 95438, at *2 (N.D.N.Y. Oct. 14, 2009), the court denied a motion to dismiss a bad faith claim, holding that the policyholder was not required to make a showing of the foreseeability of consequential damages at the pleading stage. By contrast, in *Third Equities Corp. v. Commonwealth Land Title Ins. Co.*, No. 010254-10, 2010 N.Y. Misc. LEXIS 61113, (N.Y. Sup. Ct. Dec. 9, 2010), the insurer moved to dismiss, and for summary judgment, with respect to plaintiff's consequential damages claim. The court granted the motion, in part because "the record did not support the inference that consequential damages were reasonably contemplated by the parties … " *Id.* at *8.

Presumably, summary judgment should be available where, following discovery, an insured cannot show a genuine issue of fact concerning the foreseeability of consequential damages. *See East Coast Resources, LLC v. Town of Hempstead*, 707 F. Supp. 2d 401 (E.D.N.Y. 2010) (in a non-insurance case, defendants obtained summary judgment dismissing consequential damages claims based on a lack of foreseeability). Relying on *Bi-Economy*, the court in *East Coast Resources* held that the plaintiff's lost profits "were not reasonably foreseeable or within the parties' contemplation at the time of contracting." *Id.* at 412. *But see 30-40 East Main Street Bayshore, Inc. v. Republic Franklin Ins. Co.*, 74 A.D.3d 1330, 1333, 904 N.Y.S.2d 740, 742 (Sup. Ct. App. Div. 2010) (affirming denial of summary judgment where insurer failed to make a "prima facie showing that the disputed [damages] was a type of damage not within the contemplation of the parties when they executed the insurance policy containing coverage for loss of business income").

Availability of Punitive Damages After *Bi-Economy* And *Panasia*

As noted, *Bi-Economy* and *Panasia* were decided over a strongly worded dissent. The main thrust of the dissent was that the majority had, *sub silentio*, abandoned New York's former rule rejecting the argument insurer bad faith "without more" could "justify a punitive damages award." *Bi-Economy*, 10 N.Y.3d at 196, 886 N.E.2d at 133 (Smith, J., dissenting). "The majority achieves this result simply by changing labels: Punitive damages are now called 'consequential damages,' and bad faith failure to pay a claim is called a breach of the 'covenant of good faith and fair dealing.'" *Id.* at 196, 886 N.E.2d at 133 (Smith, J., dissenting). In the dissent's view, the type of consequential damages approved by the majority, "though remedial in form, are obviously punitive in fact." *Id.* at 197, 886 N.E.2d at 133 (Smith, J., dissenting).

A central premise of Judge Smith's dissent is the view that the majority had "largely nullif[ied]" the Court of Appeals' earlier decision in *Rocanova v. Equitable Life Assur. Soc.*, 83 N.Y.2d 603, 634 N.E.2d 940 (1994) and *New York Univ. v. Continental Ins. Co.*, 87 N.Y.2d 308, 662 N.E.2d 763 (1995). *See Bi-Economy*, 10 N.Y.3d at 196-97, 886 N.E.2d at 133 (Smith, J., dissenting). In *Rocanova* and *NYU*, the Court of Appeals had held that punitive damages were only available in insurance cases where the policyholder could prove both "egregious tortious conduct by which he or she was aggrieved" and "that such conduct was part of a pattern of similar conduct directed at the public generally." *Rocanova*, 83 N.Y.2d at 613, 634 N.E.2d at 944; *see also NYU*, 87 N.Y.2d at 316, 662 N.E.2d at 767 (in order to state a claim for punitive damages, a policyholder must allege that: 1) the insurer's conduct "must be actionable as an independent tort"; 2) the tortious conduct must be "egregious" in nature; 3) "the egregious conduct must be directed to plaintiff"; and 4) "it must be part of a pattern directed at the public generally").

Contrary to the concerns expressed in the dissent, the strict standards for the imposition of punitive damages announced in *Rocanova* and *NYU* do not seem to have been eroded following the *Bi-Economy* and *Panasia* decisions. Instead, courts have continued to reject punitive damages under the standards outlined in *Rocanova* and *NYU*. In *Silverman v. State Farm Fire & Cas. Co.*, 22 Misc. 3d 591, 594-95, 867 N.Y.S.2d 881, 883 (N.Y. Sup. Ct. 2008), the Supreme Court, Nassau County dismissed the plaintiff's claim for punitive damages, noting that, after *Bi-Economy*, a claim for consequential damages "does not serve to bolster a claim for punitive damages. Indeed, the Court of Appeals [in *Bi-Economy*] itself expressly distinguished the two and indicated no intent to change the law in that regard." *Id.* at 595, 867 N.Y.S.2d at 883. *See also Savino v. Hartford*, No. 31088-2008, 2009 WL 1110632, at *4 (N.Y. Sup. Ct. Mar. 25, 2009) (denying motion for summary judgment with respect to compensatory damages where there was a potential breach of good faith and fair dealing, but dismissing claim for punitive damages).

Other cases decided after *Bi-Economy* and *Panasia* have also upheld the strict punitive damages standards outlined in the *Rocanova* and *NYU* decisions. *See Commerce and Industry Ins. Co. v. U.S. Bank Nat'l Assoc.*, No. 07 Civ. 5731 (JGK), 2008 WL 4178474 (S.D.N.Y. Sept. 3, 2008) ("Under New York law, the failure to pay a claim cannot provide the basis for an award of punitive damages in the absence of egregious conduct on the part of the defendant that is actionable as an independent tort, that is directed to the plaintiff, and that is part of a pattern of behavior aimed at the public generally."); *Haym Solomon Home for the Aged, LLC v. HSB Group, Inc.*, No. 06-CV-3266 (JG), 2010 U.S. Dist. LEXIS 4255, at *15 (E.D.N.Y. Jan. 20, 2010) (dismissing claim for punitive damages under *Rocanova* and *NYU*); *Whiteface Real Estate Dev. and Construction, LLC v. Selective Ins. Co. of Am.*, No. 08-cv-24 (GLS/DRH), 2010 WL 252179 (N.D.N.Y. June 16, 2010) (dismissing plaintiff's punitive damages claim and holding that claims for intentional and willful breach of contract do not allege conduct sufficient to establish an actionable independent tort or to warrant punitive damages under *Rocanova* or *NYU*).

Post-*Bi-Economy*, New York courts have continued to recognize a difference between the "gross disregard" standard for bad faith articulated in *Pavia v. State Farm Mutual Auto Ins. Co.*, 82 N.Y.2d 445, 626 N.E.2d 24 (1993) and the more stringent "egregious tortious conduct standard" necessary for punitive damages cited in *Rocanova* and *NYU*. *See Silverman*, 22 Misc. 3d at 594, 867 N.Y.S.2d at 883 ("Under New York law, punitive damages would be available in this case only where the plaintiffs could demonstrate that they were victims of a tort independent of the insurance contract … [and] a claim for consequential damages … does not serve to bolster a claim for punitive damages.") Contrary to the fears underlying the *Bi-Economy* dissent, courts have continued to distinguish the appropriate standards for bad faith and punitive damages under New York law. *Compare In re Axis Reinsurance*, No. 07-CV-07924-JSR, 2010 U.S. Dist. LEXIS 33377, at *25 (S.D.N.Y. March 7, 2010) (insured "must establish that the insurer demonstrated a gross disregard of its policyholder's interests" to make a showing of bad faith) (citing *Federal Ins. Co. v. Liberty Mut. Ins. Co.*, 158 F. Supp. 2d 290, 294-5 (S.D.N.Y. 2001) with *In re Delta Financial Corp., et al.*, 398 B.R. 382, 404 (Bankr. D. Del. 2008) (applying New York law) ("Punitive damages are available only in those limited circumstances where it is necessary to deter defendant and others like it from engaging in conduct that may be characterized as 'morally reprehensible,' and of 'such wanton dishonesty to imply a criminal indifference to civil obligations.'" (citing *New York Univ. v. Continental Ins. Co.*, 87 N.Y.2d 308, 315-16, 662 N.E.2d 763, 767 (1995))).

Availability of Attorneys' Fees Under *Bi-Economy* and *Panasia*

One of the most controversial, and unsettled, issues following the *Bi-Economy* and *Panasia* decisions is whether attorneys' fees incurred by a policyholder in obtaining coverage — including fees incurred in a litigation brought against the insurer — should be recoverable as consequential damages. In one of the first decisions to confront this question following the *Bi-Economy* and *Panasia* decisions, the court in *Chernish v. Massachusetts Mutual Life Ins. Co.*, No. 5:08-CV-0957, 2009 WL 38548 (N.D.N.Y. Feb. 10, 2009), stated that "*Bi-Economy* had changed the landscape" with regard to the policyholder's claim for attorneys' fees. *Id.* at *4. However, the court did not reach a conclusion with respect to the issue, holding instead that "[t]he pleading stage is too early in the litigation to resolve the Plaintiff's entitlement to attorney's fees." *Id.* On that basis, the *Chernish* court denied the insurer's motion to dismiss the policyholder's claim for attorneys' fees. *Id.*

Other cases have continued to reject the recovery of attorneys' fees post-*Bi-Economy*. For instance, the court in *Woodworth v. Erie Ins. Co.*, No. 05-CV-6344CJS, 2009 U.S. Dist. LEXIS 49379 (W.D.N.Y. June 12, 2009), observed: "Nothing in *Bi-Economy* or any post-*Bi-Economy* authority cited by the parties suggests that the New York Court of Appeals intended through its *Bi-Economy* decision to alter in the insurance context the traditional American rule that each party should bear its own attorneys' fees." *Id.* at *13. In *Autholet v. Nationwide Mutual Ins. Co.*, 2008 N.Y. Misc. LEXIS 752, at *4 (Sup. Ct., Suffolk Cty. Oct. 24, 2008), the court stated that: "The Court further notes, to the extent that the plaintiff seeks consequential damages for having been compelled to retain legal counsel to seek redress, that an insured may not recover attorney's fees or other legal expenses incurred in bringing an action against an insurer, as here, to determine its rights under a policy. Hence, any consequential damages to which the plaintiff may ultimately be entitled shall be exclusive of such expenses." (internal citations and quotation marks omitted); *see also Handy & Harman*, Index No. 115666/07, 2008 N.Y. Misc. LEXIS 7522, at *12 (dismissing plaintiff's claim for attorneys' fees because "[i]t is well-settled that an insured may not recover the expenses incurred in bringing an affirmative action against an insurer to settle its rights under the policy") (internal citations and quotation marks omitted).

A few cases decided after *Bi-Economy* have permitted policyholders to pursue attorneys' fees in bad faith cases, but not as consequential damages. Instead, these decisions have relied on *Sukop v. State of New York*, 19 N.Y.2d 519, 227 N.E.2d 842 (1967), a Court of Appeals decision pre-dating *Rocanova* and *NYU* that had permitted a policyholder to seek recovery of attorneys' fees in cases involving allegations of insurer bad faith. For instance, in *Grinshpun v. Travelers Cas. Co.*, No. 6702/2008, 2009 WL 1025747, at *4 (N.Y. Sup. Ct. March 11, 2009), the New York Supreme Court, King's County, stated that costs associated with having to commence a legal action to support a claim "are not consequential damages that were contemplated by the policy as in the situations in *Bi-Economy* and *Panasia*," but held that *Bi-Economy* and *Panasia* "did not disturb the Court's recognition … of a cause of action for the costs of a suit to enforce a claim by an insured where its insurer denies a claim in bad faith." *See also Haym Salomon Home*, No. 06-CV-3266(JG), 2010 U.S. Dist. LEXIS 4225, at *15 (E.D.N.Y. Jan. 20, 2010).

Conclusion

Although recent cases have helped to answer some of the questions that have followed the New York Court of Appeals' decisions in *Bi-Economy* and *Panasia*, much remains to be resolved. As lower courts continue to reach sometimes conflicting outcomes with respect to New York's law of consequential damages, it may be that the Court of Appeals will again be asked to address this important area of the law for both insurers and policyholders.