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NEW DEVELOPMENTS IN THE NEW YORK LAW OF GOOD FAITH AND BAD FAITH: *Bi-Economy Market, Inc. v. Harleysville Insurance Company* 10 N.Y. 3d 187 (Feb. 19, 2008) and *Panasia Estates, Inc. v. Hudson Insurance Company* 10 N.Y.3d 200(Feb. 19, 2008)

By: Charles Platto, Rachel Lebejko Priester, and Sujata Gadkar-Wilcox[1]

On February 19, 2008, the New York Court of Appeals issued decisions in *Bi-Economy Market, Inc. v. Harleysville Insurance Company*, 10 N.Y.3d 187, and *Panasia Estates, Inc. v. Hudson Insurance Company*, 10N.Y.3d 200. In these decisions, the Court of Appeals held that the insurers violated their contractual obligations of good faith and fair dealing with respect to first-party claims and were liable for consequential damages in excess of policy limits. As pointed out in a strong dissent, in *Bi-Economy* and *Panasia*, the Court of Appeals did not follow its long-standing precedents and effectively established a new standard with little or no guidance as to how it was to be applied.

Previously, in a series of cases in the mid-1990s—*Pavia v. State Farm Mutual Automobile Insurance Company*,[2] *Soto v. State Farm InsuranceCompany*,[3] *Rocanova v. Equitable Life Assurance Society*,[4] and *New York University v. Continental Insurance Company*[5]—the New York Court of.....*continued on next page*

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[1]Mr. Platto is a partner with *Wiggin and Dana LLP* and heads the firm's national Insurance Practice Group. He is Adjunct Professor of Insurance Law and Litigation at Fordham Law School. Ms. Priester and Ms. Gadkar-Wilcox are associates with *Wiggin and Dana LLP*. Mr. Platto submitted amicus briefs on behalf of the American Insurance Association and other insurance trade associations in the *Soto, Rocanova*, and *NYU v. Continentalcases*. The views expressed in this article are those of the authors and not of the institutions with which they are affiliated. This article is adapted from the authors' article that appeared in the April 2008 issue of the Insurance Litigation Reporter.

[2]82 N.Y.2d 445 (1993) (setting bad faith standard of "gross disregard").

[3]83 N.Y.2d 718 (1994) (holding that "punitive damages awarded against an insured in a civil suit are not a proper element of the compensatory damages recoverable in a suit against an insurer for a bad-faith refusal to settle").

[4]83 N.Y.2d 603, 615 (1994) ("A complaint does not state a claim for compensatory or punitive damages by alleging merely that the insurer engaged in a pattern of bad-faith conduct. The complaint must first state a claim of egregious tortious conduct directed at the insured claimant.").

[5]87 N.Y.2d 308 (1995) (following *Rocanova*).

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Appeals set forth clear, well-defined standards for compensatory damages for bad faith in connection with third-party claims and for punitive damages. The principles enunciated in those decisions have been applied and followed in New York for the last decade.[6] New York has never had an independent tort for first-party bad faith. *See, e.g., Acquista v. New York Life Insurance Company*.[7]

Until February 19, 2008, the rules were clear. Now, it's a whole new ball game and there aren't any rules.

NEW YORK'S SETTLED BAD-FAITH STANDARD: *PAVIA* AND *PROGENY*

In *Pavia v. State Farm Mutual Automobile Insurance Company*, 82 N.Y.2d 445 (1993), the Court of Appeals held that the standard for bad faith is the insurer's "'gross disregard' of the insured's interests—that is, a deliberate or reckless failure to place on equal footing the interests of its insureds with its own interests when considering a settlement offer. . . . In other words, a bad-faith plaintiff must establish that the defendant insurer engaged in a pattern of behavior evincing a conscious or knowing indifference to the probability that an insured would be held personally accountable for a large judgment if a settlement offer within policy limits were not accepted." *Id*. at 453-54. The *Pavia* Court acknowledged the need to require insurers to act in the insured's best interests in light of the control an insurer has over claims against its insured, but it also reiterated New York courts' "understandable reluctance to expose insurance carriers to liability far beyond the bargained-for policy limits for conduct amounting to a mere mistake in judgment. Thus, established precedent clearly bars a 'bad faith' prosecution for conduct amounting to ordinary negligence." *Id*. at 453. *Pavia* underscored that the court must consider all of the facts and circumstances of an insurer's alleged failure to discharge its duties, and it concluded that under the facts of that case, plaintiffs had failed to make out a claim for bad faith. "That defendant could have acted more expeditiously does not convert inattention into gross disregard for the insured's rights, particularly where, as here, there is no contention that the insurer failed to carry out an investigation, to evaluate the feasibility of settlement . . . or to offer the policy limits before trial after the weakness of the insured's litigation position was clearly and fully assessed." *Id*. at 455.

Soto v. State Farm Insurance Company, 83 N.Y.2d 718 (1994), reiterated *Pavia*'s "gross disregard" standard and added that punitive damages against an insured are not recoverable as compensatory damages in a subsequent bad faith action. The *Soto* Court based its holding on the public policy against indemnification for such conduct by the insured, "since punitive damages are not designed to compensate an injured plaintiff for the actual injury that that person may have suffered, [and] their only real purpose is to punish and deter the wrongdoer. . . . Regardless of how egregious the insurer's conduct has been [in failing to settle the case], the fact remains that any award of punitive damages that might ensue [against the insured] is still directly attributable to the insured's immoral and blameworthy behavior." 83 N.Y.2d at 724-25.

Rocanova v. Equitable Life Assurance Society, 83 N.Y.2d 603 (1994), emphasized that "[p]unitive damages are not recoverable for an ordinary breach of contract as their purpose is not to remedy private wrongs but to vindicate public rights." 83 N.Y.2d at 613. The *Rocanova* Court further emphasized that "the standard for awarding punitive damages in first-party insurance actions is 'a strict one' and this extraordinary remedy will be available 'only in a limited number of instances.'" *Id*. (internal citations omitted). As *Rocanova* noted, to prove entitlement to punitive damages, the plaintiff must "state a claim to the effect that he was personally the victim of a cognizable tort arising out of his contractual relationship with [the insurer], and to demonstrate that the wrong to him not only rose to the level of 'such wanton dishonesty as to imply a criminal indifference to civil obligations' but was also part of a pattern of similar, publicly directed misconduct." *Id*. at 614 (citation omitted). Ultimately, *Rocanova* stands for the proposition that "[a] complaint does not state a claim for compensatory or punitive damages by alleging merely that the insurer engaged in a pattern of bad-faith conduct." *Id*. at 615.

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[6] *See, e.g.*, Smith v. Gen. Accident Ins. Co., 91 N.Y 2d 648, 653 (1998) (citing and applying *Pavia* and *Soto*); Lavaud v. Country-Wide Ins. Co., 29 A.D.3d 745, 746 (2d Dept. 2006) (citing and applying *Pavia*'s "gross disregard" standard); Redcross v. Aetna Cas. & Sur. Co., 260 A D.2d 908, 911 (3d Dept. 1999) (same); Vecchione v. Amica Mut. Ins. Co., 274 A.D.2d 576, 576 (2d Dept. 2000) (citing and applying *Pavia* and *Soto*); Bennion v. Allstate Ins. Co., 284 A.D.2d 924, 925 (4th Dept. 2001) (citing and applying *Pavia*'s "gross disregard" standard and *Rocanova* standard for punitive damages); Bettan v. Geico Gen. Ins. Co., 296 A D.2d 469, 470 (2d Dept. 2002) (citing and applying *Rocanova* and *NYU*).

[7] 285 A D.2d 73, 81 (1st Dep't 2001) ("We are unwilling to adopt the widely accepted tort cause of action for 'bad faith' in the context of a first-party claim, because we recognize that to do so would constitute an extreme change in the law of this State. Essentially, we accept the more conservative approach adopted by the minority of jurisdictions that the duties and obligations of the parties to an insurance policy are contractual rather than fiduciary.") (internal alteration, quotation, and citation omitted).

New York University v. Continental Insurance Co., 87 N.Y.2d 308 (1995), followed *Rocanova* and underscored the high burden for showing entitlement to punitive damages:

> To the extent that plaintiff alleges that defendants engaged in a "sham" investigation to perpetuate their allegedly fraudulent scheme [to deny insurance benefits], those allegations merely evidence plaintiff's dissatisfaction with defendants' performance of the contract obligations. Indeed, plaintiff conceded that defendants conducted an investigation, but argues that it provided an inadequate basis for defendants to deny plaintiff's claim. That allegation does not state a tort claim, it merely raises a question for the fact finder determining the breach of contract claim.

87 N.Y.2d at 319.

In 2001, the First Department issued its decision in *Acquista v. New York Life Insurance Company*, 285 A.D.2d 73 (2001), where the court recognized that allowing a first-party tort claim for bad faith "would constitute an extreme change in the law of this State." *Id*. at 81. Nevertheless, the *Acquista* Court, apparently troubled by the allegations that the insurer "undertook a conscious campaign calculated to delay and avoid payment on [its insured's] claims, while having determined at the outset that it would deny coverage," *id*. at 78, concluded that "some sort of remedy" for "dilatory tactics by insurance companies seeking to delay and avoid payment of proper claims" was needed. *Id*. at 81. The *Acquista* Court then claimed to find a middle ground, holding that "while plaintiff's cause of action alleging bad faith conduct on the part of the insurer cannot stand as a distinct tort cause of action, we conclude that allegations may be employed to interpose a claim for consequential damages beyond the limits of the policy for the claimed breach of contract." *Id*. at 82. Although *Acquista* claimed it was not allowing a first-party bad faith claim, it nevertheless decided to allow a breach of contract claim to seek damages above the policy limits under a "consequential damages" rubric. Despite *Acquista*'s facially cautious language, it appeared to conflict directly with the precedent set by the Court of Appeals, and several courts have rejected *Acquista*. *See*, *e.g*., *Paterra v. Nationwide Mutual Fire Insurance Company*, 38 A.D.3d 511 (2d Dep't 2007) ("The plaintiffs' claim predicated on the breach of the implied covenant of good faith is duplicative of the breach of contract claim. Since there is no separate tort for bad faith refusal to comply with an insurance contract, this claim should have been dismissed. . . . Contrary to the plaintiffs' contentions, they do not have a claim for consequential damages beyond the limits of the policy for the claimed breach of contract.") (citing, *inter alia*, *NYU*); *see also,* 1 Ostrager & Newman, Handbook on Insurance Coverage Disputes § 12.;12[a] (13th ed. 2006) ("A number of New York courts have rejected the reasoning in *Acquista*, finding that it conflicts with the holdings of [*NYU*] and [*Rocanova*].") (collecting cases).[8]

NEW YORK'S NEW APPROACH: *BI-ECONOMY* AND *PANASIA*

In February 2008, over vigorous dissents, the Court of Appeals issued companion decisions in *Bi-Economy Market, Inc. v. Harleysville Insurance Company* and *Panasia Estates, Inc. v. Hudson Insurance Company*, concluding that a first-party claim against an insurer for breach of contract could give rise to a claim for consequential damages against the insurer in excess of the policy limits. *Bi-Economy* involved a claim under a commercial property insurance contract, which included 12 months' business interruption insurance, where the property was to be restored "with reasonable speed and similar quality." Slip Op. at 3. The market's premises "suffered a major fire" which involved losses to the inventory and the building. The insurer refused to pay the entire claim submitted as "actual damages"; after more than a year, alternate dispute resolution resulted in a large additional award. The market never resumed operations and sued the insurer, claiming bad faith claims handling, tortious interference with business relations, and breach of contract, and seeking "consequential damages for 'the complete demise of its business operation.'" *Id*. The insured's theory was that the insurer

> improperly delayed payment for its building and contents damage and failed to timely pay the full amount of its lost business income claim. Bi-Economy further alleged that, as a result of Harleysville's breach of contract, its business collapsed, and that liability for such consequential damages was reasonably foreseeable and contemplated by the parties at the time of contracting.

[8] Lower courts within the First Department struggled to reconcile *Acquista* with *Rocanova*. *E.g*., Weisel v. Provident Life & Cas. Ins. Co., 11 Misc. 3d 1062(A) (Sup. Ct. N.Y. Co. Feb. 14, 2006) (dismissing claim for consequential damages for emotional distress due to insurer's alleged breach of its obligations because "*Acquista* only clarifies that consequential damages are available under a contract theory. Thus, plaintiff cannot recover damages generally reserved for torts (e g., emotional distress) as consequential contract damages.") (citing Wehringer v. Standard Sec. Home Ins., 57 N.Y.2d 757 (1982); *Rocanova*; *NYU*; and *Acquista*).

Id. Notably, the policy included "several contractual provisions excluding coverage for 'consequential loss.'" *Id*. at 4. The Fourth Department entered summary judgment for the insurer on the grounds that consequential damages were not recoverable. 37 A.D.3d 1184 (4th Dep't 2007).

The Court of Appeals reversed the entry of judgment for Harleysville, concluding that the insured could, through its breach of contract claim, seek "damages for the collapse of its business resulting from a failure to fulfill [the insurer's] obligations under the contract of insurance." Slip Op. at 4. Using a breach of contract analysis, the court held that the insured could recover damages "which are the natural and probable consequence of the breach," including, "in limited circumstances," consequential damages. *Id*. at 4-5. The Court noted that consequential damages were recoverable only if "reasonably contemplated by the parties," *id*. at 5, which requires an examination of the nature and purpose of the particular contract. "In the present case . . . the purpose of the agreement—what the insured planned to do with its payment—was at the very core of the contract itself." *Id*. at 6. The *Bi-Economy* Court distinguished punitive damages from the consequential damages at issue here, *id*., and based its holding on the implied covenant of good faith and fair dealing. *See id*. at 7 ("As in all contracts, implicit in contracts of insurance is a covenant of good faith and fair dealing, such that 'a reasonable insured would understand that the insurer promises to investigate in good faith and pay covered claims.'") (citing *NYU*).

Having concluded that consequential damages could be sought in "limited circumstances" the court emphasized that the Bi-Economy policy involved business interruption coverage:

> The purpose served by business interruption coverage cannot be clearer—to ensure that Bi-Economy had the financial support necessary to sustain its business operation in the event disaster occurred. . . . Accordingly, limiting an insured's damages to the amount of the policy, i.e., money which would have been paid by the insurer in the first place, plus interest, does not place the insured in the position it would have been had the contract been performed. . . . . Thus, the very purpose of business interruption coverage 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.

Id. at 8-9 (citations omitted). The court also noted that "this insurance included an additional performance-based component: the insurer agreed to evaluate a claim, and to do so honestly, adequately, and—most importantly—promptly." *Id*. at 10. The court disregarded the contractual exclusions for "consequential loss" on the basis that those related to damages caused by a third-party, not damages related to the insurer's conduct ("consequential damages").[9]

Panasia, decided on the same day as *Bi-Economy*, involved commercial property insurance without business interruption insurance. The property at issue was damaged while it was undergoing renovation. According to the insured, insurer Hudson "failed to investigate or adjust the claim until several weeks later. Hudson then denied the claim three months after that, stating that Panasia's loss was the result of repeated water infiltration over time and wear and tear rather than from a risk covered under the builder's risk policy provision." Slip Op. at 2. Panasia filed suit, alleging that the insurer breached its contract by failing to properly investigate and to pay for the loss, and sought direct and consequential damages from the breach. *Id*.

Relying on *Acquista*, the First Department allowed Panasia to state a claim for consequential damages, 39 A.D.3d 343 (1st Dep't 2007), and the Court of Appeals, on the basis of its *Bi-Economy* ruling, held that consequential damages may be recoverable "so long as the damages were 'within the contemplation of the parties as the probable result of the breach at the time of or prior to contracting.'" Slip Op. at 3 (quoting *Bi-Economy*). The court then remanded *Panasia* so that the Supreme Court could "consider whether the specific damages sought by Panasia were foreseeable damages as the result of Hudson's breach." *Id*. at 4.

A strong, comprehensive dissent was filed in *Bi-Economy*, and the dissenting opinion was appended in full to *Panasia*. The dissenters argued that the majority effectively abandoned the rule set forth by *Rocanova* and *NYU* that punitive damages were not recoverable absent "egregious tortious conduct" against the insured and the general public. *Bi-Economy*, slip op. at dissent 1 (Smith, J., dissenting op.). The dissent argued that

[9] It is not clear on what basis the court so held, as the court neither provided the language of the relevant exclusions nor cited to any authority for its discussion.

> The "consequential" damages authorized by the majority, though remedial in form, are obviously punitive in fact. They are not triggered, as true consequential damages are, simply by a breach of contract, but only by a breach committed in bad faith. The majority never explains why this should be true, but the explanation is self-evident: the purpose of the damages the majority authorizes can only be to punish wrongdoers and deter future wrongdoing. They have nothing to do with consequential damages, or with the covenant of good faith and fair dealing, as those terms are ordinarily understood. . .
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> . . . In insurance contracts or other contracts for payment of money, the parties have already told us what damages they contemplated; in the case of insurance, it is payment equal to the losses covered by the policy, up to the policy limits.

Id. at 3. The dissent further argued that the majority misused the implied covenant of good faith: "this is the first time, as far as I know, that we have relied on that implied covenant to condemn the bad faith breach of an express promise." *Id*. at 5. The dissent noted that although the *Bi-Economy* majority appeared to rely in part on the purpose of business interruption insurance, that discussion was "apparently extraneous to its holding [because] [t]he *Panasia* case involves no business interruption coverage." *Id*.

IMPLICATIONS OF THE COURT'S DECISIONS

Until *Bi-Economy* and *Panasia* were decided, New York state law had a clear standard for compensatory damages for bad faith as well as for imposition of the extraordinary additional remedy of punitive damages. New York also had rejected a tort cause of action for first-party bad faith claims. Now, the Court has issued opinions which establish what appears to be a very new and different test without adequate explanation. The dissent states that the majority have ignored *Rocanova* and *NYU*. While that may be true, what is also true, and perhaps of even greater concern, is what the majority really has done: it has ignored *Pavia* and *Soto*. Although the dissent suggests that punitive damages are now replaced by consequential damages, we hope the decision does not actually go so far. Consequential damages should be viewed as compensatory, requiring a showing of direct harm and actual damages. Therefore, we do not think the punitive rule is abolished. Our concern is that the bad faith rule is expanded without standards or limits.

Neither *Bi-Economy* nor *Panasia* discuss the "gross disregard" standard for bad faith liability and damages in excess of policy limits set forth in *Pavia*. Instead, the court elevates one aspect of an insurance contract, the implied covenant of good faith and fair dealing, over another aspect: the policy limits for which the parties contracted. What the decisions appear to do is to hold that the flip side of good faith is bad faith, without explicitly so stating. Notably there is no discussion of what is required to show a breach of the implied covenant of good faith, or whether the "gross disregard" required for "bad faith" is applicable.

The new decisions embrace *Acquista* at the cost of *Pavia*. *Bi-Economy* and *Panasia* have not only established a de facto bad faith scheme for first-party actions which, uniquely, is contract-based instead of the traditional tort-based scheme, but they pronounce no standards for satisfying entitlement to consequential damages. The majorities do not refer to the longtime standards for showing bad faith in New York that the insurer must act in "gross disregard" of the insured's interest. Contrary to *Pavia*, which emphasized that all insurer errors are not necessarily bad faith,[10] the *Bi-Economy* court engages in no discussion as to the bad faith standard, nor does the *Panasia* court set forth a test for the lower court to consider on remand. The Court of Appeals, therefore, appears to have implicitly rejected *Pavia*'s emphasis on courts' "reluctance to expose insurance carriers to liability far beyond the bargained-for policy limits for conduct amounting to a mere mistake in judgment," *id*. at 453, in favor of a breach of contract analysis without regard for the policy limits.

Fundamentally, if *Bi-Economy* and *Panasia* represent the majority's attempt to establish a cause of action for first-party bad faith, we are perplexed, because the Court did not explain or acknowledge that was what it was doing. But even if the Court wanted to do so, through the *Acquista* back door, the court has not set forth clear standards for such a claim. The new decisions have raised more questions than they have answered. These decisions should not be a change from what has been the standard for bad faith, and if the Court intends to apply the bad faith standard to first-party claims, it should be the standard that is tried and true in New York.

[10] Specifically, the *Pavia* court stated: "[t]hat [the insurer] could have acted more expeditiously does not convert inattention into gross disregard for the insured's rights," *Pavia*, 82 N.Y.2d at 455

The question has been raised as to what implications these decisions have as to the law of third-party bad faith, since they arise in the first-party context. The answer is that there would not appear to be any apparent difference. The Court has now utilized a contract based theory to extend liability in the first-party context. The same theory would appear to apply to third-party claims, where contractual principles have always been applied. The key point in both situations is that previously the imposition of extra contractual liability in excess of policy limits required a showing of a greater wrong, i.e., bad faith, whereas now, whether in the first-party context or presumably in the third-party context, the majority would be willing to ignore contractual policy limitations and not require an additional showing of bad faith in order to impose additional contract based "consequential" damages. Our criticism of this approach in the first-party context would apply equally in the third-party context.

These cases raise serious concerns with regard to the sanctity of policy terms and limits, and the standards for applying or, in exceptional cases, overriding those terms and limits. We are concerned that the decisions may open a floodgate of litigation and as a practical matter will create confusion and uncertainty for insurers, policyholders, and courts. We hope that lower courts, and ultimately the Court of Appeals will interpret, clarify, narrow, and limit the new decisions in a way that is consistent with the precedent from the last 15 years. ⚖