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New York's New "Good Faith" Standard—What Does it Mean for "Bad Faith"?

Bi-Economy Market, Inc. v. Harleysville Ins. Co. (N.Y.) *Panasia Estates, Inc. v Hudson Ins. Co.* (N.Y.)

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On February 19, 2008, with little fanfare or advance warning, and over a vigorous dissent, the New York Court of Appeals issued decisions in *Bi-Economy Market, Inc. v. Harleysville Ins. Co.*, __ N.Y.2d ___, and *Panasia Estates, Inc. v. Hudson Ins. Co.*, ___ N.Y.2d ___, which have sent a shockwave through the New York and national insurance community. In these decisions, the Court of Appeals held that insurers violating their contractual obligations of good faith and fair dealing with respect to first party claims were liable for consequential damages in excess of policy limits. In rendering its decisions, the Court did not apply its long established standard for "bad faith" breach of contract, but at the same time did not explain or articulate a standard for contractual "good faith." It nevertheless applied the contractual principle of good faith, but ignored the contractual policy provisions on consequential damages and policy limits. In doing so, the Court ignored without explanation or analysis more than a decade of its own precedents on bad faith and punitive damages.

In a series of cases in the mid-1990s—*Pavia v. State Farm Mutual Auto. Ins. Co.*,[2] *Soto v. State Farm Ins. Co.*,[3] *Rocanova v. Equitable Life Assurance Soc.*,[4] and *New York Univ. v. Continental Ins. Co.*[5]—the New York Court of 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 Ins. Co.*[7]

The rules were clear. Now, it's a whole new ball game and there aren't any rules.

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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*).

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's Settled Bad-Faith Standard: *Pavia* and Progeny

In *Pavia v. State Farm Mutual Automobile Insurance Co.*, 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 Co., 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.

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 Ins. Co.*, 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 is 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 Mut. Fire Ins. Co.*, 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 court have rejected the reasoning in *Acquista*, finding that it conflicts with the holdings of [*NYU*] and [*Rocanova*].") (collecting cases).[8]

Thus, as of the mid-1990s, the Court of Appeals had clarified that the standard for sustaining a claim of bad faith in New York was the "gross disregard" of the insured's interest. *See, e.g.*, *Smith v. General Accident Ins. Co.*, 91 N.Y.2d 648, 652-53 (1998) (citing and applying *Pavia* and *Soto*); *see also* nn.1-5, *supra*. The Court also had held that punitive damages were to be awarded only in the exceptional circumstance, to punish and deter wrongful conduct and vindicate public rights, not to compensate an individual claimant for a mistaken coverage decision. The First Department, more recently, in *Acquista*, appeared to strike a different path, extending the law and in effect providing for a first party bad-faith claim, even as the court understood that to do so would change existing law. But prior to the decisions just issued by the Court of Appeals, it had not accepted the *Acquista* approach.

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 Co.* and *Panasia Estates, Inc. v. Hudson Insurance Co.*, 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

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*).

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.

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 concluded 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.

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.

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 Panaisa 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

> 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. . .
>
> . . . 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 Change of Heart

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, without thorough analysis, the Court has issued opinions which establish what appears to be a very new and different test which the Court has failed to adequately explain. 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.

Nowhere in *Bi-Economy* or *Panasia* is there any discussion of 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: "[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 *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 consideration of the policy involved in 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," *id.* at 453, in favor of a simple breach of contract analysis and an invitation to disregard 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.

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.