<u>Recovery of Consequential Damages for Insurer's Breach of Contract</u>

By James T. Nyeste

Two things this summer caused me to think about the recovery of consequential damages for an insurance company's breach of its policy obligations. I use the term "consequential damages" in the ordinary contract law sense – those contract damages beyond the policy coverage which might not flow immediately and directly from the breach but which nevertheless were the foreseeable and probable result of the breach. See Restatement [Second] of Contracts § 351; Illinois Pattern Jury Instructions – Civil (2000) 700.13 Contracts – Damages – Breach of Contract. The consequential damages that are most often claimed are lost profits and borrowing costs.[1]

The first thing that caused me to think about consequential damages was a property insurance case where the potential client, the insured, asked me to substitute-in as her counsel. There, the insured's historic four-flat was nearly a total loss due to a fire. The brick walls and limestone façade were standing but badly damaged, and the interior was completely destroyed. Over the course of three years after the fire, the insurance company repeatedly re-estimated and increased the amount of the loss as it grudgingly acknowledged the quality of materials and craftsmanship in the historic building. Payments for "actual cash value" were dribbled to the insured, and reconstruction had to proceed slowly. The insurance company held back the depreciation amount and refused to advance the building's full replacement cost, despite substantial rebuilding by the insured. Nearly four years after the fire, the building still could not be occupied, and the insured's lost rentals, additional living expenses, and other consequential damages from the insurance company's delay were more than the available coverage. In reviewing this case, my thinking was that the insurance company's breach of contract in under-estimating and delaying the "actual cash value" payments may have exposed it to contract damages greater than just the coverage under its policy. Nevertheless, for reasons that are not relevant to this issue and which are confidential, I declined the representation of the potential client.

The second thing that caused me to think about consequential damages was a mailing I received for a CLE program examining the New York case of *Bi-Economy Market v. Harleysville Ins. Co.*, 10 N.Y.3d 187, 886 N.E.2d 127, 856 N.Y.S.2d 505 (2008), and how it might lead to increased consequential damages recoveries in all types of insurance claims around the country, possibly even without bad faith on the part of the insurance company. In *Bi-Economy*, the insured's meat market was destroyed by a major fire, resulting in heavy structural damage, damage to business equipment, complete loss of the food inventory, and business interruption. The amount of the loss was disputed. Initially, Harleysville paid only $163,000. More than a year later, after alternative dispute resolution, Harleysville paid an additional $244,000. During this time, Harleysville offered to pay for only seven months of lost business income, despite the fact that the policy provided for a full twelve months of business interruption coverage. Bi-Economy never resumed business operations. Two years after the fire, Bi-Economy filed suit asserting various causes of action, including bad faith claims handling and breach of contract. Bi-

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[1] I differentiate this meaning from the concept of "consequential damage" as part of the *coverage* provided by a liability policy. See *Universal Underwriters Ins. Co. v. LKQ Smart Parts, Inc.*, 2011 IL App (1st) 101723 (holding that liability insurer had duty to defend insured against a spoliation of evidence claim as consequential damage flowing from covered property damage).

Economy 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 the policy was issued. The trial court dismissed Bi-Economy's consequential damages claim, and the appellate court affirmed. The New York Court of Appeals granted leave to appeal and reversed the dismissal of the insured's claim for consequential damages. The Court of Appeals held that the purpose of the insurance 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. According to the court, this is not to punish the insurer, but to give the insured its bargained-for benefit under traditional contract law, regardless of the alleged bad faith.

After reading the *Bi-Economy* case, I didn't think it was so ground-breaking. I was pretty sure that there was Illinois precedent for allowing the recovery of consequential damages in insurance cases. My research, which I do not claim was exhaustive or even very thorough, quickly turned up a handful of cases where consequential damages were allowed under a breach of contract theory, or at least were allowed to be pleaded, regardless whether bad faith was also alleged. Further, these consequential damages are not preempted by Section 155 of the Insurance Code.

In *Clark v. Standard Life and Accident Ins. Co.*, 68 Ill.App.3d 977 (1st Dist. 1979), the insured claimed that the insurance company breached his mortgage disability insurance policy by denying that he had become disabled and by failing to pay the benefits and that, as a result, he was unable to pay his mortgage and, ultimately, had to quit-claim his home to the lender. The trial court dismissed the insured's count requesting compensation for the loss of his home. The appellate court reversed, stating:

> Contracts of insurance are to be judged by the same legal principles as any other contract. In Illinois, when a breach of contract, without more, is alleged, the injured party is to be put in as good a position as he would have been had the contract been fully performed. And where, as here, it is claimed that an insurer has refused to comply with the provisions of an insurance policy, the measure of damages is usually limited to the contractual amount. In select cases, consequential damages may be recovered when they "were reasonably foreseeable and were within the contemplation of the parties at the time the contract was executed" [quoting *Kalal v. Goldblatt Brothers, Inc.*, 53 Ill.App.3d 109, 112 (1977)], arising out of special circumstances communicated and known to both parties.

68 Ill.App.3d at 986 (other internal citations omitted). Although the insured's complaint did not allege that that the loss of the house or his exclusive reliance on the policy for mortgage payments in case of disability were within the contemplation of the parties – or foreseeable as a probable result of a breach – at the time the contract was entered into, the appellate court instructed the trial court on remand to grant the insured leave to amend.

Clark was followed by *Mohr v. Dix Mut. County Fire Ins. Co.*, 143 Ill.App.3d 989 (4th Dist. 1986). In *Mohr*, the insured, a farmer, lost a tractor and several other pieces of farm equipment in a fire. The insurance company offered a payment for the damaged equipment, but the insured rejected the offer as inadequate and refused to sign the proof-of-loss form tendered by the company. After multiple attempts to resolve the dispute, the insured realized that his loss would not be settled, and he gave up the lease on the land that he was farming and did not plant his crops. He sued the insurer in contract, fraud, and under Section 155 of the Insurance Code for the insurer's vexatious delay in settling his claim. On the contract claim, the jury awarded the insured $120,000 for the damaged equipment and $105,000 for his consequential damages, that is, the insured's lost profits for being unable to plant his crops. On the fraud claim, the jury found for the insurer. On the Section 155 claim, the trial court found that the insurer's conduct amounted to vexatious delay and awarded attorney fees and the statutory damages. The insurer appealed, arguing, among other things, that Section 155 preempted the consequential damages claim. The appellate court disagreed. The court relied on *Clark* for the recoverability of consequential damages where "where they were reasonably foreseeable, were within the contemplation of the parties at the time the contract was entered, or arose out of special circumstances known to the parties." Id. at 996. In rejecting the preemption claim, the court explained that Section 155 nowhere limits recovery for breach of contract but affords an additional recovery plus attorney fees as a sanction for vexatious and unreasonable delay.

In *Heller International Corp. v. Sharp*, 857 F.Supp. 627 (N.D. Ill. 1994), the insured sued its insurers who refused to indemnify it under a fidelity bond for losses sustained due to an employee's dishonest and fraudulent acts. As a result of the insurers' refusal to honor the bond, the insured alleged in its breach of contract complaint that it was forced to borrow $10 million to cover the loss and pay more than $10 million in interest. The insurers moved for summary judgment to the extent the insured's claim exceeded the bond's $10 million limit, arguing that the insured's consequential damages were preempted by Section 155. The court denied the motion, holding that neither the language of Section 155 nor the cases interpreting it indicate that the statute should result in limits on an insured's recovery for breach of contract. Because breaches of contract are neither inherently wrongful nor tortious, an action alleging a breach of contract does not involve conduct proscribed by Section 155. Instead of Section 155, insurers have to look to principles of contract law on the insured's recovery of damages in excess of the policy or bond limits where the claim or count does not allege vexatious conduct.

The foregoing cases were decided before *Cramer v. Insurance Exchange Agency*, 174 Ill.2d 513 (1996), which was a watershed decision concerning Section 155. Prior to *Cramer*, there was substantial confusion concerning whether there existed a general tort of insurer bad faith under Illinois law and concerning the preemptive effect of Section 155 on other causes of action. In *Cramer*, the Illinois Supreme Court cleared up much of this uncertainty, holding that there is no independent tort of bad faith and unfair dealing in Illinois and that Section 155 provides the exclusive remedy for vexatious and unreasonable conduct by insurers. The court further held, however, that Section 155 does not preempt well-established torts like common law fraud when the insured can actually allege and prove the required elements. The court explained:

> [A]n insurer's conduct may give rise to both a breach of contract action and a separate and independent tort action. Mere allegations of bad faith or

> unreasonable and vexatious conduct, without more, however, do not constitute such a tort. Courts therefore should look beyond the legal theory asserted to the conduct forming the basis for the claim. In cases where a plaintiff actually alleges and proves the elements of a separate tort, a plaintiff may bring an independent tort action, such as common law fraud, for insurer misconduct.

174 Ill.2d at 528 (internal citations omitted).

Given that *Cramer* did not purport to limit the insured's contractual remedies (or even the insured's well-established tort remedies), one would expect post-*Cramer* cases to hold that consequential damages may still be recoverable under a breach of contract theory. Indeed, in *Chicago Motor Club v. Robinson*, 316 Ill.App.3d 1163 (1st Dist. 2000), the court reversed the dismissal of the insured's contract claims, stating:

> [W]e find merit in Safeway's argument that *Cramer v. Insurance Exchange Agency* requires dismissal of many of Robinson's claims, but do not agree that all of Robinson's claims must be dismissed. The issue in *Cramer* was whether an insured's tort claim against his insurer for its breach of the duty of good faith and fair dealing in denying coverage could constitute a cause of action. The supreme court determined that it could not because the General Assembly intended section 155 of the Insurance Code to provide the only available extra-contractual remedy for such a plaintiff. The court emphasized that it would not endorse a common-law tort where the legislature had acted to provide an exclusive and limited remedy and where that remedy had been regularly updated by the legislature.
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> Part of the complaint brought by Robinson alleges breach of contract claims, and section 155 of the Code allows the court to make certain other damage awards beyond contract damages to Robinson if it is found that Safeway is guilty of vexatious and unreasonable conduct in how it handled Robinson's claims. We agree with Safeway, however, that Robinson's tort-based claims relating to Safeway's handling of Robinson's coverage are superseded by section 155 and the court's holding in *Cramer*. * * * Accordingly, on remand, Robinson is limited in her recovery to contractual damages, and those extra-contractual damages consistent with the provisions of section 155 of the Insurance Code.

Id. at 1173-74 (citations omitted). See also *Hartford Steam Boiler Inspection and Ins. Co. v. Quantum Chemical Corp.*, 1966 U.S. Dist. LEXIS 17551 (N.D. Ill. 1996) (holding that insured chemical company's claim for consequential damages, including lost business opportunities and increased capital costs, was not preempted by Section 155); *Perez v. AMCO Ins. Co.*, 2010 U.S. Dist. LEXIS 38568 (N.D. Ill. 2010) (denying motion to dismiss insured's separate count for consequential damages arising from insurers' breach).

In sum, you can take a pass on attending the CLE program concerning *Bi-Economy Market v. Harleysville Ins. Co.*, 10 N.Y.3d 187, 886 N.E.2d 127, 856 N.Y.S.2d 505 (2008), if your interest was how it might affect Illinois law. There already is a solid basis in Illinois law for the insured's recovery of consequential damages in addition to the policy coverage when the insurance

company breaches its contract, so long as the consequential damages were reasonably foreseeable, were within the contemplation of the parties at the time the policy was issued, or arose out of special circumstances known to the parties. These consequential damages are recoverable under traditional principles of contract law and are in addition to, and not preempted by, the extracontractual remedy available under Section 155 for insurer conduct that is vexatious and unreasonable.