Property and liability insurance policies explicitly promise to protect a business from catastrophe. When a business suffers a fire in the manufacturing plant, or a series of lawsuits from a defective product, it counts upon its insurance company to pay to repair or replace the plant, or to defend, settle or pay the judgments in the underlying claims. Without insurance protection, forced to devote its own resources to rebuilding or defense, a policyholder’s business may suffer; indeed, it may fail.

Insurance Promises Protection

Insurance companies market their insurance products as armor against catastrophe. For instance, CIGNA Worldwide, Inc. has boasted that it “has a very controversial way of handling claims”:

We pay them. . . . [W]e believe the primary goal of an insurance company should be to provide insurance. So we don’t use hidden loopholes or prolonged ‘investigations’ to keep your money in our account. . . . It’s not our practice to avoid paying a claim to improve our cash flow at the expense of yours.

Even a textbook used for training at Lloyd’s of London acknowledges that “[t]he right to a claim is the commodity the insured is purchasing, and an insurer who does not pay a proven claim promptly is selling shoddy goods”:

In business, particularly small businesses, the ability to earn a living may be suspended until money is available to replace lost or damaged equipment. Prompt payment of claims is an essential element in insurance protection. . . . The prime reason that an individual or company buys an insurance policy is that he or it identifies the possibility of pecuniary loss or liability. Should such a loss or liability occur, a claim will normally ensue and the insured can expect a prompt indemnification of this loss to avoid any further financial suffering.

Promises Broken

When catastrophe strikes, however, many policyholders are abandoned by their insurance companies which deny coverage by arguing that various exclusions or conditions relieve them from any duty. Abandoned policyholders then face not only the costs of paying to replace or repair damaged property, or paying judgments, settlements or defense costs in actions brought against them, but the prospect of financing insurance coverage litigation to recover their expenditures.

This double catastrophe is enough to force many policyholders into bankruptcy. Even if not “killed,” a policyholder typically forgoes opportunities and suffers lost profits on account of the insurance company’s breach. Moreover, in a subsequent insurance coverage action, the insurance company typically argues that, whatever the consequences to the policyholder of its breach, its liability is capped by its policy limits.

Insurance companies thus have a perverse incentive to deny claims. Even if coverage is clear, an insurance company can expect to extract significant concessions if it denies coverage. The policyholder may not contest the denial, either because it does not understand the coverage provided under
its insurance policy, or because it does not have the resources to bring an insurance coverage action. Even if the policyholder does bring an action, it likely will settle for an amount less than that to which it is entitled, given its litigation costs, its urge to get back into business quickly and the fact that, even if it wins, it can expect only to recover what it originally was owed. Moreover, the threat of extra-contractual recovery for the insurance company’s “bad faith” may be of little use to the policyholder, because bad faith awards of damages are not permitted in many states and because they are difficult and costly to recover.

**Relief Available: Consequential Damages**

There is, however, an often-overlooked remedy, which the policyholder can bring to the bargaining table or into the courtroom: consequential damages. Under established law, a policyholder is entitled to recover all damages incurred by the policyholder as a consequence of a breach of an insurance policy under the rule announced in the venerable English decision, *Hadley v. Baxendale* (1854). Hadley held the damages recoverable for breach of contract are those that arise naturally from the breach, or those that were in the contemplation of the parties at the time the contract was made. Consequential damages can include lost profits, damages for the loss of the business as a going concern, and even the costs of the bankruptcy or liquidation proceedings, all without regard to insurance policy limits.

**Hadley Applied in Insurance Coverage Litigation**

*Hadley* has been accepted and applied by U.S. courts in insurance coverage actions. For instance, in *Royal College Shop, Inc. v. Northern Insurance Co.*, (10th Cir. 1990), a fire insurance company breached its insurance policy by failing to pay the policyholder’s losses when a fire damaged the policyholder’s shoe store, resulting in the permanent closure of the store. In the policyholder’s insurance coverage action, the jury awarded the losses explicitly covered by the policy and “$175,000 in consequential damages for loss of the business as a going concern.” On appeal to the Tenth Circuit, the insurance company argued both (i) that consequential damages were not recoverable for breach of an insurance policy, and (ii) that the policyholder had not proved that damages for loss of the business as a going concern were the proximate result of the breach and were in the contemplation of the parties.

Disposing of the first point quickly, the court in *Royal College Shop* held that consequential damages were recoverable in insurance coverage disputes. As to the second point, the court first found that a policyholder may recover consequential damages for the breach of an insurance policy if it demonstrates either that (i) they “may fairly be considered as arising, in the usual course of things, from the breach itself,” or (ii) they “may reasonably be assumed to have been within the contemplation of both parties as the probable result of the breach.” The Tenth Circuit found both of these requirements were satisfied:

It is elementary that a business obtains insurance against fire loss for protection and to restore itself to the status quo, i.e., the status before the fire. If a fire should occur, and the insurance company should refuse to pay under the policy, a business could be forced to close down for lack of finances. Furthermore, as the district court stated, it was reasonable for the jury in this case to conclude that the parties to the insurance contract reasonably anticipated that the failure to pay upon the contract following a fire would prevent the plaintiffs from restarting their business. Accordingly, it was proper to permit the jury to award damages for loss of business if it fairly arose from the failure to pay on the insurance policy.

This case is not an aberration: courts throughout the country have granted policyholders consequential damages for insurance company breaches of insurance policies as contract damages, distinct from any bad faith recovery, and without regard to policy limits. Thus, under general principles of law extant since *Hadley*, a policyholder may recover as consequential damages for a breach of an insurance policy any losses that either (i) arose from the breach itself, or (ii) were in the contemplation of the parties.

**Advice for Policyholders: Include Demand for Consequential Damages**

Under *Hadley*, a policyholder might prove a loss of profits or opportunities on account of the strain upon its resources worked by an insurance company’s failure to comply with its promise to defend and indemnify third-party claims, or to repair or
replace damaged property. Alternatively, a policyholder could demonstrate that it was foreseeable that an insurance company’s delay in complying, or failure to comply, with its obligations in the face of catastrophe would cause the policyholder to lose profits or opportunities.

It is clear that a policyholder has a remedy for all consequential damages from an insurance company’s breach, including lost profits. There is virtually no limit as to what may constitute consequential damages, as long as it falls within one of the wings of Hadley. Putting the threat of consequential damages on the bargaining table is an often-overlooked way for policyholders to ensure they get the benefits of the insurance coverage they purchased.

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