PROOF OF DAMAGES IN SUBROGATION ACTIONS:
PROBLEMS AND SOLUTIONS

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I. INTRODUCTION

While there are some minor variations from state to state in the applicable law regarding property damages, the basic principles are universal, to a greater extent than in many other areas of the law. Because of this, and because of the relatively limited amount of case law addressing specific issues regarding the measure and proof of property damages in most jurisdictions, lawyers who handle property damage cases often have the need or occasion to cite and rely upon pertinent precedent from foreign jurisdictions.

A favorite among subrogation practitioners is Lakewood Engineering & Manufacturing v. Quinn, 604 A.2d 535, 539 (Md. App. 1992). In Lakewood, a claim for damages resulting from a fire caused by a defective electric fan, the Maryland Court of Special Appeals not only held that the trial court properly accepted the plaintiff's insurer's estimate of the property damages into evidence, but also upheld the trial court's action in throwing out the jury's damages verdict as inadequate, because the amount of the award represented only a fraction of the insurer's damage estimate. Those who regard the insurance profession as a service industry might be startled by the Lakewood court's statement that "it is the nature of an insurer to pay as little as possible on any given claim", and by the characterization of the insurance company's adjuster as "one whose interests are diametrically opposed" to those of the insured. The Lakewood court concluded:

> In light of the adversarial relationship that generally exists between an insurer and a claimant/insured, an inference may properly be drawn that the amount of damages to which the insurer concedes is, at the very least, the lower boundary of the damage actually suffered.

604 A.2d at 539.

Upon reading the Lakewood decision for the first time, most attorneys who routinely pursue subrogation claims probably pause for a moment and wistfully imagine that the task of proving damages were truly so simple. Lakewood is the only case specifically adopting the notion that subrogating insurance carriers routinely strong-arm their insureds to the point that any amount the carrier ultimately agrees to pay must, of necessity, be regarded as a solid reflection of the minimum damages recoverable from a tortfeasor. In practice, the Lakewood argument must be employed sparingly and selectively, since most liability claims personnel, defense attorneys, judges and jurors will either know intuitively or will readily recognize that, while the amount paid out on a first-party property insurance policy may accurately reflect the amount owed under the policy, the amount of such a payment may bear no relationship - or only an incidental relationship - to the amount recoverable from a third party tortfeasor. In Interested Underwriters at Lloyd's v. Third Holdings, 88 A.D. 2d 863, 451 NYS 2d 759 (First Dept. 1982) the court threw out a property damage award that was based exclusively on the damage documentation and estimates used to establish the amount of the subrogated insurer's payment to its insured, on the grounds that this information failed to establish the amount recoverable from the tortfeasor under the applicable legal standard. In theory, an insured with a contractual right to recover its damages under a property insurance policy would be expected to extract from the insurer every penny to which the insured is legitimately entitled. Thus, representatives of defense interests can often make a cogent argument that the first-party insurance payment is more meaningful as an indication of the maximum amount that could ever be recovered, rather than serving as the lower limit of the damages that should be recoverable.

This article will discuss the legal standards for proving the amounts recoverable from a tortfeasor for the kinds of damages that are most frequently involved in subrogation claims, and the practical implications of the differences in the legal standards applicable to the measure and proof of damages recoverable in tort and under the first-party property insurance contract.

II. LEGAL STANDARDS REGARDING THE MEASURE AND PROOF OF THE AMOUNTS RECOVERABLE FROM A TORTFEASOR FOR PROPERTY DAMAGES

A. The Basic Measure of Damages to Real Property

1. Pennsylvania Law

In Pennsylvania, "the measure of damages for injury to property is the cost of repairs where the injury is repairable; however, where the injury is characterized as permanent, the measure of damages becomes the decrease in the fair market value of the property". Wade v. S.J.Groves & Sons Co., 283 Pa. Super. 464, 483, 424 A.2d 902, 911 (1981).

The Pennsylvania Supreme Court has defined "market value" as "what a purchaser willing to buy feels justified in paying for property which one is willing but not required to sell". Fedas v. Insurance Company of the State of Pennsylvania, 300 Pa. 555, 562, 151 A. 285 (1930). This is typical of the definition of "market value" that is applied in other jurisdictions. See e.g., Elberon Bathing Company, Inc. v. Ambassador Insurance Company, Inc., 77 N.J. 1, 9, 389 A.2d 439, 443 (1978).

In Babich v. Pittsburgh & New England Trucking Co., 563 A.2d 168, 170 (Pa. Super. 1989), the Pennsylvania Superior Court held that evidence of the cost to repair or replace property was inadmissible where the damage was "permanent" or irreparable. Older Pennsylvania cases, reflecting a more agrarian approach to property valuations, suggested that even the complete destruction of a building or other structure would not be regarded as "permanent" damage to real property. See e.g. Kosco v. Hachmeister, 396 Pa. 288, 152 A.2d 673 (1959); Showers v. U.S., 113 F. Supp. 350, 352 (M.D. Pa. 1953). The rationale of such an approach is that a building is a mere "improvement" to real property, which can always be restored or replaced, and that "permanent" damage occurs only when the property's natural elements become polluted or depleted or otherwise irreparably destroyed.

This approach may have made sense in the days when income from real property ownership was derived primarily from the production of crops, livestock, timber or other natural and renewable resources. It makes considerably less sense in modern times, when the potential income to be derived from property ownership, and the resultant value of the property, increases with the intensity of the development of the property. In line with the more modern and realistic approach to property valuation, and without even discussing the older line of cases, more recent Pennsylvania Superior Court cases like Babich characterize the complete destruction of a building as "permanent" damage, resulting in the prohibition of consideration of evidence of the cost to repair or replace the property.

Babich leaves a question unanswered that is often of vital importance to subrogating carriers claiming damages to real property in Pennsylvania: in those cases where enough remains of the original structure that it is theoretically and technically possible to "repair" the damaged property, but it is economically infeasible to do so because the cost of repair would exceed the property's pre-loss market value, is evidence of the repair cost admissible as proof of the damages recoverable? In other words, is the "repairability" or "permanence" of real property damage determined on the basis of theoretical possibility or economic reality? As noted previously, repair costs are admissible as proof of the amount of damages recoverable, but only where the property is repairable. Wade v. J.Groves, supra; Babich, supra. Further, even where repair costs are recoverable, the costs of repair may not exceed the pre-loss value of the property. Jones v. Monroe Electric Co., 350 Pa. 539, 39 A.2d 569 (1944). However, if repair costs have properly been admitted as proof of the damages recoverable, the defendant bears the burden of proving that the cost of repair exceeds the property's value. Watsontown Brick Co. v. Hercules Powder Co., 265 F. Supp. 268, 275 (M.D. Pa. 1967) affirmed 387 F.2d 99 (3rd Cir. 1967).

Thus, in a typical subrogation action, where the only information as to the amount of damages to real property that is developed in the course of the first-party adjustment is based upon the costs of repairing or replacing the damaged property, a great deal can ride upon the determination of whether the damage was permanent or repairable. If the damage is deemed repairable, then the subrogating carrier may properly rely upon the repair cost information as proof of the damages recoverable, subject to whatever rebuttal evidence the defense may offer, including evidence that the repair costs exceeded the property's value.

However, if the property is deemed "permanently" or "irreparably" damaged, and the subrogating carrier has offered no evidence of market value in its case-in-chief, then, at least in Pennsylvania, the carrier may well have failed to meet its burden of proof under the Babich rule. See, e.g. Millers Mutual Fire Ins. Co. v. Wildish Const. Co., 306 Or. 102, 758 P.2d 836 (1988), where the Oregon Supreme Court stated that the plaintiffs had "put all their eggs in one basket" by relying exclusively on evidence of replacement cost in a claim involving the complete destruction of their home and, therefore, failed to make out a case that could be submitted to the jury under the applicable "market value" standard.

Where there is any doubt as to the repairability or permanence of the damage, the safest course is to develop and introduce evidence as to the pre-loss market value of the property, with the recognition that this evidence will serve to "cap" the amount recoverable. One source of such evidence would be a qualified real estate appraisal. Another source that may be available in an appropriate case would be a representative of the insured, because the insured is normally presumed qualified to testify regarding the value of his or her own property. (See Section III. A., below).

The risk that the subrogating carrier may fail to meet its burden of proof may not be all that great in a case where the "repairability" of the damages is legitimately in dispute. Because a defendant bears the burden of proving that repair costs exceed the pre-loss value of the property, the plaintiff should theoretically be permitted to make out its case-in-chief with proof of repair costs alone. The defendant is then free to attempt to prove that the damage is "irreparable" from a practical standpoint, by offering proof that the property's pre-loss market value was less than the estimated repair costs. At that point, there will be evidence in the record supporting an award of damages under either the permanent or repairable approach. This was essentially the ruling made by The Honorable Mark Bernstein of the Philadelphia Court of Common Pleas in the attached Order in USA One BV et al. v. Delmont Fire Protection et al. (the One Meridian Plaza Fire litigation).

2. Other Jurisdictions

Other jurisdictions are generally in accord with Pennsylvania damages law as outlined above, so that similar issues and considerations will arise wherever the claim is being pursued. Many jurisdictions are not as restrictive as Pennsylvania regarding the admissibility of repair costs in cases of total destruction of a building or structure, and instead treat repair costs and market value as equally acceptable alternative means of proving the damages recoverable. Bastian v. Laffin, 54 Md. App. 703, 460 A.2d 203 (1983); Withers v. Ferraro Construction Co., 21 Md. App. 550, 320 A.2d 576 (1974); Regal Construction Co. v. West Lanham Hills Citizen's Association, 256 Md. 302, 260 A.2d 82, 84 (1970); Jacklitch v. Finnerty 96 A.D.2d 960, 466 N.Y.S.2d 774 (1983); Restatement (Second) Torts, § 929. However, subject to the various exceptions noted below, the repair costs recoverable will almost always be limited to the pre-loss fair market value of the property. Bastian v. Laffin, supra. As in Pennsylvania, the burden is normally on the defendant to prove that repair costs exceed pre-loss market value. Kruvant v. Dickerman, 18 Md. App. 1, 305 A.2d 227, 231 (1973); Bastian v. Laffin, supra; City of Oakland v. Pacific Gas & Electric, 118 P.2d 328, 333 (Cal. App. 1941); Jacklitch v. Finnerty, 96 A.D.2d 690, 691, 466 N.Y.S.2d 774, 776 (1983). Thus, in Huff v. Thornton, 287 N.C.1, 231 S.E. 2d 198, 203 (1974) the court stated that the fact that a building repair estimate failed to take any depreciation into account was a matter for cross-examination and might affect the weight, but not the admissibility, of the evidence.

Some jurisdictions treat proof of repair costs as merely an alternative means of proving the diminution in market value resulting from property damage. Colangeli v. Construction Service Company, 233 N.E. 2d 192, 194 (Mass. 1968); Carolina Power & Light Co. v. Paul, 261 N.C. 710, 136 S.E.2d 103 (1964); Jenkins v. Eplinger, 55 N.Y.2d 35, 432 N.E.2d 589 (1982); Fuller v. Martin, 41 Ala. App. 160, 125 So. 2d 4 (1961). "The law recognizes that the cost of repairs has a logical tendency to shed light upon the question of the difference in market value." Richard W. Cooper Agency v. Irwin Yacht & Marine Corporation, 264 S.E. 2d 768, 771 (N.C. App. 198). From a practical standpoint, a prospective buyer of damaged property would presumably deduct repair costs from the price that would have been offered for the property if it were not damaged. In Huff v. Thornton, 23 N.C. App. 388, 209 S.E. 2d 401, 404 (1974) affirmed 287 N.C.1 231 S.E. 2d 198 (1975), the court suggested that repair costs were a more realistic reflection of damages than a market value appraisal, which is inherently hypothetical and imprecise.

B. Issues Arising From the Proof of Repair Costs

1. Treatment of Depreciation

Where repair costs are presented in support of a property damage claim, liability insurers and defense counsel invariably assert that they only owe for "ACV", or the repair costs minus depreciation. Before conceding this point, the subrogating insurer's representatives should carefully consider the elements of the repairs that are claimed to be subjected to depreciation, and whether those repairs truly enhance the pre-loss value of the property. Certainly, installation of new carpeting and roofing and fresh paint are likely to enhance the value of a property. See e.g. Medford Housing Authority v. Marinucci Bros. & Co., 241 N.E. 2d 834, 837 (Mass 1968), where the court held that the plaintiffs could not recover the full cost of repainting buildings that were blackened as the result of the defendant's release of hydrogen sulfide gas, where the buildings had not been repainted for several years prior to the incident.

On the other hand, replacement of a masonry wall or steel framing with new materials of like kind and quality, while perhaps a theoretical "betterment" to the existing structure, are not likely to materially increase the property's value. There is authority for the recovery of the full cost of repairs without reduction for depreciation or betterment, where the repairs do not materially increase the value of the property over its pre-loss value, even though the new materials may increase the life expectancy of the property or its components. U.S. v. Ebinger, 386 F.2d 557, 560-561 (2nd Cir. 1967). The rationale of the Ebinger decision was that the injured claimant should not be forced to finance a part of the cost of prematurely replacing equipment that will not add to the property's value. Note that the Ebinger argument will only apply in cases of partial loss, where the damaged property is a necessary part of a larger whole, such that the claimant could not "cut its losses" by abandoning the property in exchange for a payment of the property's pre-loss market value. The Ebinger court also stated that it would be "clearly inequitable" to allow recovery of the full replacement cost of components that were scheduled for early replacement.

Similarly, in New Jersey Power & Light Co. v. Mabee, 41 N.J. 439, 197 A.2d 194 (1964), the New Jersey Supreme Court held that the plaintiff electric utility was entitled to recover the full cost of replacing a 20 year old power pole that had an estimated life expectancy of 36 years for accounting purposes. The court noted that there was no basis upon which to conclude that the damaged pole would only have lasted 36 years, or that the new pole would necessarily last that long, and therefore no basis upon which to conclude that the plaintiff was truly deriving any benefit in replacing the pole as a result of the defendant's tortious conduct.

Depreciated "book values" for property as set forth in the insured's tax schedules and other accounting records rarely bear any real world relationship to the actual value or useful life of the property. Because an insured business owner will normally (and properly) depreciate property at the maximum rate permitted under applicable accounting principles and tax law, defense attorneys frequently attempt to seek out depreciation schedules and other tax and accounting records to undermine the values claimed for damaged property. It is questionable whether such records should even be admissible for this purpose. In Olson & French, Inc. v. Commonwealth, 399 Pa. 266, 160 A.2d 401, 403 (1960), the Pennsylvania Supreme Court stated that "depreciated book value is an arbitrary accounting figure, unrelated to market value, and therefore irrelevant and immaterial to the issue of fair market value."

2. Code Upgrades

A troublesome issue in the first-party context that is beyond the scope of this article relates to whether and under what circumstances upgrades in construction that are required to meet current building codes are recoverable under a property insurance policy. Assuming that a determination is made that such costs are covered in a particular case, the next question may well be whether those costs can then be recovered from the tortfeasor who caused the loss. The obvious argument against such a recovery is that it did not merely put the claimant in the same position as prior to the loss, but in a "better" position.

However, there is authority for the recovery of such costs. Peluso v. Singer General Precision, Inc., 47 Ill. App. 3d 842, 8 Ill. Dec. 152, 365 N.E.2d 390 (1st Dist. 1977). In Peluso, the court suggested that allowing recovery of such expenses would discourage cutting corners in meeting code requirements in connection with property damage repairs. Another argument for recovery of such costs is that such costs normally would not have been incurred at all, but for the loss. Further, in each case, the particular code upgrades should be critically scrutinized to determine whether or not they truly enhance the value of the property.

3. Admissibility of Repair Cost Estimates When Repairs Are Not Actually Performed

There are a few cases which hold that the "diminution in value" standard is the exclusive measure of damages available when the claimant never actually repairs the damaged property, and that repair cost estimates are therefore inadmissible under such circumstances. Wentworth v. Air Line Pilot Association, 336 A.2d 542 (D.C. App. 1975); Lucas v. Bowman Dairy Company, 50 Ill. App. 2d 413, 200 N.E.2d 374 (1st Dist. 1964); Maryland Casualty Co. v. Rittiner, 133 S.2d 172 (La. App. 1961).

Other courts have rejected this arbitrary and illogical rule, recognizing that the law should be concerned with the appropriate measure of damages only, and not with the manner in which the injured party elects to use the monetary damages awarded. General Outdoor Advertising Co. v. LaSalle Realty Co., 141 Ind. App. 247, 218 N.E.2d 141, 152 (1966); Bates v. Warrick, 77 N.J.L. 387, 71 A.1116 (1909). If there is any doubt that repair estimates will be deemed admissible in a particular case, it is imperative that some evidence be presented to satisfy the "diminution in market value" standard.

C. The Measure and Proof of the Amount Recoverable for Damages to Personal Property

As a general rule, the same basic principles and considerations apply to the measure and proof of damages to personal property as apply to damages to real property. Restatement (Second) Torts, §928(a); Guido v. Hudson Transit Lines, 178 F.2d 740, 742 (3rd Cir. 1950) (applying New Jersey law); Williams-Bowman Rubber Co. v. Industrial Maintenance, Welding & Machining Co., 667 F.Supp. 539, 546-47 (N.D. Ill. 1987); Wambles v. Davis, 405 So. 2d 945 (Ala. Civ. App. 1981); Babbitt v. Maraia, 157 A.D. 2d 691, 549 NYS 2d.

791 (2d Dept. 1992). However, in practice, the "general rule" is often subsumed by various exceptions that apply to much of the damaged property that is frequently involved in subrogation claims. The following is a discussion of the two exceptions that apply with greatest frequency in subrogation actions.

1. Household Effects

Household furnishings, appliances, and clothes are components of virtually any significant homeowner's claim. Strictly speaking, there is a "market value" for such goods, which is best reflected by what a sale of the goods might bring in a yard sale, estate sale, or at a consignment shop. The imposition of a "market value" measure of damages would obviously impose a severe hardship on tort victims who must reestablish their households by purchasing new goods at much higher prices than the market value of the used, but otherwise perfectly serviceable, goods they are being forced to replace. In recognition of this hardship, there is authority in Pennsylvania, New Jersey and most other jurisdictions which rejects a strict "market value" measure of damages with respect to household effects. Instead, the courts favor a more flexible "actual value to the owner" approach that takes into account both the original and replacement cost of the goods, the likelihood and feasibility of replacing the property with comparable equivalents, and other considerations that would affect the property's value to its owner. See e.g., Lloyd v. Haugh & Keenan Storage & Transfer Co., 72 A. 516 (Pa. 1909); Lane v. Oil Delivery, Inc., 216 N.J. Super. 413, 524 A.2d 405 (App. Div. 1987); Jacklitch v. Finnerty, 96 A.D.2d 690, 466 N.Y.S.2d 774 (1983); Holme v. Freeman, 185 A.2d 88, 91 (Conn. App. 1962); Muller v. Sinclair Refining Co., 32 A.D.2d 1000, 301 N.Y.S.2d 716, 718 (1969); DeSpirito v. Bristol County Water Co., 102 R.I. 50, 227 A.2d 782 (1967); Kates Transfer & Warehouse Co. v. Klassen, 6 Ala App. 301, 59 So. 355 (1912). "The rationale for such a rule is consonant with the goal of tort damages to fully compensate the injured party, thereby making it possible to replace the lost property with a comparable substitute." Lane v. Oil Delivery, supra, 524 A.2d at 409.

While the original and replacement cost of the goods may be considered as evidence under the "actual value" standard, the amount recoverable under the standard does not necessarily, or even usually, equate with the full replacement cost of the damaged goods. Muller v. Sinclair Refining Co., supra, 301 N.Y.S.2d at 718. Particularly in the case of property that has a finite useful life, it would not necessarily be any more equitable to require the defendant to pay the full replacement cost than it would be to force the plaintiff to accept the liquidation value of the household effects. This may be one of the rare instances in which "ACV" actually reflects at least a roughly accurate measure of the amount recoverable.

2. Inventory

The measure of damages to an inventory of merchandise is one of the few situations in which the full replacement cost generally equates with the recoverable "market value", particularly where the inventory is the stock of a wholesaler or retailer. Kaplan v. City of Winston-Salem, 286 N.C. 80 (1974). From a practical standpoint, in order to replace damaged stock, the retailer or wholesaler would normally be expected to turn to its suppliers and pay the then-current price in that market for substitute goods. To the extent that the injured merchant must also pay any expediting expenses or other costs in order to maintain or properly restore normal business operations, those costs, if reasonable, should be recoverable as consequential damages. Restatement (Second) Torts, §§ 927 and 928.

There is authority for a manufacturer to recover the wholesale selling price for damaged products. Simmons, Inc. v. Pinkerton's, Inc., 762 F.2d 591, 606-607 (7th Cir. 1985) (applying Indiana law); H.K. Porter Co. v. Halperin, 297 F.2d 442 (7th Cir. 1961) (applying Illinois law); Restatement (Second) Torts, §911, comment (d). The best rationale for such a recovery is that the only "market" that is theoretically available for the manufacturer to procure replacement goods would be competing manufacturers of the same goods, who would presumably charge at least their wholesale selling price. The subrogating insurer that has been required under its policy to pay its insured manufacturer's selling price will most often benefit from this doctrine in spite of its logical flaw: the rule allows a potential windfall recovery of the "profit" element of the selling price even where the manufacturer was able to procure replacement goods from its own production or inventory without incurring any actual loss of sales or profits. However, unincurred costs associated with the sale of the goods, such as salesmen's commissions, will have to be deducted from the wholesale selling price. Simmons, Inc. v. Pinkerton, supra.

While there are no Pennsylvania or New Jersey decisions to this effect, some courts have even allowed a retailer or wholesaler to recover the selling price of destroyed goods. Tozzi v. Testa, 97 Ill.App.3d 832, 53 Ill. Dec. 379, 423 N.E.2d 948 (3d Dist. 1981); Winfield Design Associates, Inc. v. Quincy Jefferson, 581 F. Supp. 21 (N.D. Ill. 1984). Such a ruling is even more difficult to support from a logical standpoint, since a retailer or wholesaler can, in many, if not most instances, avoid a loss of sales from destroyed inventory by drawing upon other available inventory or through the purchase of replacement goods. In those cases where the particular nature of the goods involved or customer requirements or other circumstances result in an actual loss of sales, there should be independent evidence to establish that the loss of sales occurred. Where an actual loss of sales occurs, full selling price should be recoverable to reflect the loss of profits, minus any costs of sales that were not incurred.

D. Unique Property and the "Peculiar Value" Doctrine

Another broad exception to the market value measure of damages applies where property — real or personal — has no market value, or where the "fair" market value does not accurately reflect the true value of the property to its owner. Examples of circumstances in which the unique property or "peculiar value" exception has been applied includes cases involving damage to bridges (Commonwealth v. Crea, 483 A.2d 996 (Pa. Cmwlth. 1977)), churches (Trinity Church v. John Hancock Mutual Life Ins. Co., 399 Mass. 43, 502 N.E.2d 532 (1987)) and historically or architecturally unique structures (Klair v. Day, 1988 W.L. 4756 (Del.Super. 1988)). Electrical utility poles are likely candidates for property damage and are also a fertile source of case law regarding the proper measure of damage to property with no "fair" market value. See e.g., Duquesne Light & Power Co. v. Rippel, 478 A.2d 472 (Pa. Super. 1984); Carolina Power & Light Co. v. Paul, 261 N.C. 710, 136 S.E.2d 103 (1964).

A slightly different articulation of a similar principle provides that where an injured property owner demonstrates a "reason personal" for restoring the damaged property to its original condition, the property owner may recover the full cost of restoration, even though this cost may exceed the pre-loss value of the property. Heninger v. Dunn, 101 Cal. App. 3d 858, 162 Cal Rptr. 104 (1980); Regal Construction Co. v. West Lanham Hills Citizen's Association, 256 Md. 302, 260 A.2d 82, 84 (1970); Restatement (Second) Torts, §929, comment (b). For example, in State v. Rice, 24 Md. App. 631, 332 A.2d 296 (1975), the court held that a property owner's desire to replace wrongly felled trees for the purpose of providing privacy to the land was sufficient "reason personal" to affirm the judgment of $17,500 for replacement of the trees, even though an appraiser had testified that the diminution in property value was only $100.

Thus, by persuading a court that the "unique property" or "peculiar value" or "reason personal" doctrines should be applied, many potential problems in proving damages in subrogation actions may be solved, because the doctrine opens the door to proof of damages by way of the cost of repair or replacement estimates that are typically developed in the course of the first-party adjustment. However, the doctrine is truly an exception to the general rule, and will not be applied in cases involving typical residential or commercial properties, for which a fair market value is presumed to exist.

E. Business Interruption and Lost Rentals

1. The Basic Standards for Measuring and Proving Loss of Income

The phrase "business interruption" is virtually exclusively an insurance concept. The tort law analogue to a claim for "business interruption" is a claim for "lost profits" or "loss of income." Such damages fall within the broader category of "consequential damages." An action for loss of income or for the loss of use of property is allowed where such loss is caused by the claimant's inability to use property due to the defendant's wrongful conduct. Kosco v. Hachmeister, Inc., 396 Pa. 288, 152 A.2d 673 (1959); Neville Chemical Co. v. Union Carbide Corp., 422 F.2d 1205, 1226 (3d Cir. 1970). To recover, the claimant's profits must have been lost as a result of the defendant's tortious conduct. Cromartie v. Carteret Savings & Loan, 277 N.J. Super. 88, 103, 649 A.2d 76, 83 (App. Div. 1994). "Lost profits" are defined as the difference between gross income and the cost or expenses which would have had to be expended to produce that income. Cromartie, supra. The party claiming the damages must prove the relevant expenses or show that the inability to produce the proof is a consequence of the defendant's actions. Cromartie, supra.

Lost profits must be computed on a reasonably accurate and fair basis. J.L. Davis & Associates v. Heidler, 263 N.J. Super. 264, 276, 622 A.2d 923, 929 (App. Div. 1993). Thus, a claim for lost profits may be rejected as speculative and unrecoverable where made in the context of a new and untried business venture. International Control Corp. v. National Semi-Conductor Corp., 833 F.2d 491 (3d Cir. 1987); Grossberg v. Judson Gilmore Associates, Inc., 196 Ga.App. 107, 108, 395 S.E.2d 592, 594 (1990); Coastland Corp. v. Third National Mortgage Co., 611 F.2d 969, 978 (4th Cir. 1979).

Within these broad parameters, there are not a great many hard and fast rules concerning the proper method of proving such losses. The flexibility of the courts in this regard reflects a recognition that proof of a loss of income claim necessarily depends upon proof of a purely hypothetical scenario: what would have happened if the injury had not occurred. While it is necessary to prove the damages with reasonable certainty, the claimant is not necessarily required to document every cancelled order or present each prospective customer who would have purchased products or services from the claimant, but did not, as a result of the loss.

Rather, the claimant need only provide some evidentiary basis for the award of lost profits. Franklin Music v. American Broadcasting Companies, 616 F.2d 528, 546 (3d Cir. 1979); Computer Systems Engineering, Inc. v. Qantel Corp., 740 F.2d 59, 67 (1st Cir. 1984); Batterman v. American Stores Co., 67 Pa. 193, 80 A.2d 66, 74 (1951); In re Knickerbocker, 827 F.2d 281, 288 (8th Cir. 1987). "Where there is a basis in the evidence for a reasonable computation of the damages suffered considering the nature of the transaction, a verdict may be based thereon, though there may be involved some uncertainty about it. Weinglass v. Gibson, 304 Pa. 203, 155 A. 439, 440 (1931).

The generally accepted evidentiary standard for proof of lost earnings in a tort action is set forth under comment (d) to Restatement (Second) Torts, §912, which states, in pertinent part:

Although the burden is on the injured person to prove with a fair degree of certainty that the business or transaction was or would have been profitable, it is not fatal to the recovery of substantial damages that he is unable to prove with definiteness the amount of the profits he would have made or the amount of harm that the defendant has caused. It is only essential that he present such evidence as might reasonably be expected to be available under the circumstances. Restatement (Second) Torts, §912, comment (d); (emphasis supplied).

accord, ABC-Paramount Records, Inc. v. Topps Record Distributing Co., supra, 374 F.2d 455, 461 (5th Cir. 1967); Bangor Punta Operations, Inc. v. Universal Marine Co., Ltd., 543 F.2d 1107, 1110 (5th Cir. 1976); Page County Appliance Center v. Honeywell, 347 N.W. 2d 171, 178 (Iowa 1984) (tax return showing decreased earnings was alone deemed sufficient evidence of damages caused by defendant's tortious conduct). Even where the claimant cannot demonstrate a history of profitable operations, lost profits may nevertheless be recovered if the claimant can establish that there was a pre-loss trend toward profitability. Novatel Communications v. Cellular Telephone Supply, Inc., 856 F.2d 151 (11th Cir. 1988). Expert testimony can often supplement, or even supplant, proof of the claimant's actual earnings and profitability history, and provide the required evidentiary basis for an award of lost profits. In re Knickerbocker, 827 F.2d 281, 288 (8th Cir. 1987).

The evidentiary standards for proof of lost profits are generally flexible enough to permit the utilization of the data developed in the course of the adjustment of a first-party business interruption loss. With a few exceptions, the same legal principles that would limit or preclude a recovery under the tort measure of damages would have the same effect upon the amount recoverable under the business interruption provisions of the policy. Therefore, differing legal standards under tort law and under the terms of the insurance contract are not the most frequent source of problems in proving such claims. Rather, the difficulties tend to arise from the vagaries of the different environments in which the claims are presented and resolved.

As an example, consistent with the goal of properly and equitably resolving the policyholder's claims, business interruption claims are often adjusted on the basis of projected revenue losses during the projected suspension periods that have not expired by the time the adjustment is concluded. On the other hand, even the longest periods of business suspension will likely have ended before the time comes to prove the revenue loss in a subrogation action. At that point, the loss projections developed in the adjustment process are of merely academic interest to the opposing party, who will be seeking evidence demonstrating that an actual revenue loss either did or did not occur. Due to circumstances that could not reasonably have been anticipated by the insurer or insured during the adjustment process, it may well turn out that the actual period of business suspension was significantly shorter than projected, or even that there was no provable loss during the projected suspension.

For instance, when a property loss shuts down the production line of a plant working at full capacity to fill a backlog of orders, the adjustment of the business interruption loss may be premised upon the assumption that each day of lost production translates into a loss of profits on the goods that would have been produced on that day. However, an unexpected downturn in the insured's market, even one happening months after the occurrence of the casualty, may free up some of the insured's manufacturing capacity so that the insured is ultimately able to "make up" the lost production with no loss of sales.

The insidious impact that the passage of time between the occurrence of the loss and the adjustment and the presentation of the subrogation claim can have on the damages recoverable can also manifest itself in other ways. For instance, the insured may retain damaged inventory with a credit applied against the loss amount for the inventory's "salvage" value and later there may be no evidence that the insured actually sold the goods at a reduced price. Another example is an insured who cannot produce actual repair bills approaching the amount of the repair estimates utilized to establish the adjusted property loss.

The opposing party's legitimate, but nevertheless aggravating, interest in actual as opposed to projected revenue losses and other damages data gives rise to another problem. Generally, the opposing party will request in discovery financial information regarding the insured's operations both prior to and following the loss. While such information may be directly germane to the damages claimed in the subrogation action, it likely was not requested during, and was not even germane to, the first-party adjustment process. The sensitive nature of this information, not to mention the sheer burden of assembling it, often means that complying with legitimate discovery requests pushes the insured's cooperation obligations to the absolute limit. The best practical solution is to enter into a pro-ration agreement with the insured whenever possible so that the insured has some financial stake in the success of the subrogation effort, to the extent of the insured's legitimate uninsured losses.

2. The Recoverability of Consequential Damages in Total Loss Situations

Where there is a claim for lost rentals, there is at least an issue whether the lost rentals can be recovered when the rental property was totally destroyed. Sandoro v. Harlem-Genesee Market, 105 A.D.2d 1103, 482 N.Y.S.2d 165 (1984). A similar issue can arise with respect to a claim for loss of use of totally destroyed property. American Jet, Inc. v. Leyendecker, 683 S.W.2d 121 (Tex. Civ. App. 1984); Cowhey v. Dornhaffer, 47 D&C 2d. 190, 193 (Mercer County Pa. C.P. 1969); Anno 18 ALR 3d 497, §8. The rationale for precluding the recovery of lost rentals or loss of use damages is that a property's capability to generate income is reflected in its market value, so that an award of damages that includes both the full value of the property as well as damages for loss of income or loss of use represents a double recovery. See also Babich v. Pittsburgh & New England Trucking Co., 563 A.2d 163 (Pa. Super. 1989), where the court refused to allow an owner of a building occupied for business purposes to recover consequential damages in the form of lost revenues and rental costs incurred for substitute space after the building was destroyed by the defendant's truck, on the grounds that such losses were not compensable when the damage to the property was permanent.

The theory behind precluding recovery of consequential damages apparently assumes that one whose income-producing property is totally destroyed can and should immediately procure replacement property to avoid interrupting the income stream. However, the exclusion of consequential damages in a total loss situation fails to recognize that, until the defendant actually pays the claimant the money reflecting the value of the destroyed property, the injured party will effectively be deprived of the value of the property. Thus, the argument for exclusion makes sense only in jurisdictions, like New York, where prejudgment interest is available from the date of a property loss, (See New York C.P.L.R. §§5001 and 5004), and then only when a replacement for the destroyed property is readily available. (Note that New York law only allows a subrogated insurance carrier to recover prejudgment interest from the date of the payment to its insured. American Home Insurance Co. v. Morris Industrial Builders, Inc., 192 A.D.2d 477, 597 N.Y.S.2d 27 (1st Dept. 1993)).

Other jurisdictions have rejected the argument that no damages for loss of use of property can be recovered in total loss situations, at least for the period reasonably required to replace the property. Dennis v. Ford Motor Co., 471 F.2d 733, 736-37 (3d Cir. 1973) (predicting Pennsylvania law); Huff v. Thornton, 287 N.C.1, 213 S.E. 2d 198, 204 (1975); Reynolds v. Bank of America, 53 Cal. 2d 49, 345 P.2d 926 (1959); Bartlett v. Garrett, 130 N.J. Super 193, 325 A.2d 866 (Dist. Ct. 1974); Louisville & I.Ry. Co. v. Schuester, 183 Ky. 504, 209 S.W. 542 (1914); Guido v. Hudson Transit Lines, 178 F.2d 740 (3d Cir. 1950) (applying New Jersey law); Artech Service, Inc. v. MacDonald Construction Co., 150 So.2d 465 (Fla. App. 1963); Allanson v. Cummings, 81 A.D. 2d 16, 439 N.Y.S. 2d 545 (4th Dept. 1981); Anno. 18 A.L.R. 3d 497, §§9-11.

F. Extra Expense and Additional Living Expense

Subject to the potential issue discussed above regarding the preclusion of an alleged "double recovery", extra expenses (in the case of losses involving commercial policyholders) and additional living expenses (in the case of homeowners) are generally recoverable as consequential damages. Restatement (Second) Torts, §§927 and 928(b); Huff v. Thornton, 287 N.C.1, 213 S.E. 2d 198, 204 (1975). Such expenses are subject to standards of economic and commercial reasonableness.

III. OTHER "CATCH-ALL" SOLUTIONS

Of course, there is not always a solution to every damages problem. In some cases, the differing legal standards or the simple non-existence of competent evidence of damages under the appropriate legal standard will preclude recovery in a subrogation action of at least a portion of the amount paid under the first-party policy, even in a case of clear liability.

As noted previously, the "unique property" or "peculiar value" doctrine can serve as a basis for proving and recovering damages from a tortfeasor based upon the information developed as a result of the first-party adjustment. By definition, however, not every property can be "unique."

There are a couple of other strategies that can help in many cases. These include using the testimony of the insured to prove the amount of the loss, and the use of motions to bifurcate the liability and damages issues in a subrogation action.

A. Utilizing the Testimony of the Insured as to the Value of the Property

Virtually every jurisdiction recognizes that a property owner is presumed to be competent to testify as to the value of his or her own property. Silver v. Television City, Inc., 207 Pa. Super. 150, 205 A.2d 335 (1965); Lane v. Oil Delivery, Inc., 216 N.J. Super. 413, 524 A.2d 405, 409 (A.D. 1987); Tulin v. Bostic, 152 A.D.2d 887, 544 NYS 2d 88, 89 (2d Dept. 1989); Brannon v. State Roads Commission, 305 Md. 793, 506 A.2d 664 (1984); Birmingham Railway, L&P Co. v. Hinton, 47 So. 576, 157 Ala. 630 (1908). This doctrine authorizes property owners to offer "lay opinions" regarding the value of their property, even when they lack the normal qualifications for opinion or "expert" testimony. The doctrine presumes that a property owner will normally have sufficient familiarity with the property to provide at least minimally useful information as to its value.

This doctrine can be useful in those instances where there is no other available proof of the damages under the appropriate legal standard, or where it is necessary to bootstrap the information developed in the course of the first-party adjustment into something that would be admissible as proof of the damages recoverable in the third-party tortfeasor context. The doctrine may also prove useful in those instances where the subrogation litigation has proceeded in the name of the insured and there would be no other way to prove damages at trial and continue to keep the insurance company's interest in the background.

However, there are many reasons why utilization of the insured's "lay opinion" on damages will not work or should not be attempted in particular cases. For example, the insured may be reluctant, unwilling or simply unable to provide the required evidentiary support. Invocation of the cooperation provisions of the policy obviously will not be effective to compel the insured to hold an opinion which he or she simply does not have. Further, in some cases, the insured really may not have any basis for offering an opinion as to the value of his or her property. It is obviously critical not to place the insured in a potentially embarrassing situation, not only for the insured's sake, but also from the standpoint of avoiding alienating the jury.

Finally, the insured's opinion often may not be as persuasive as an independent, objective appraisal of the amount of loss, particularly where the opposing party is expected to offer such an appraisal. Thus, reliance upon the insured's opinion is best used in cases involving homeowner's personal property claims and other relatively straightforward claims as well as other situations where the insured truly is in the best position to know the value of the property. The insured may also be a good resource in those instances where a major dispute on damages is not really expected, but there is concern about establishing a prima facie case on damages under the applicable legal standard.

B. Bifurcation Motions

Strictly speaking, the typical ruling granting a motion for bifurcation, providing that liability issues will be tried separately from and prior to damages issues, technically only has the effect of <u>deferring</u> whatever problems may exist in the proof of the damages aspect of the case, and possibly only for a very brief time. However, from a practical standpoint, it is remarkable how a bifurcation ruling, particularly if granted early in a case, can serve to defuse potentially problematic damage issues. The bifurcation order will frequently have the effect of shifting the opposing party's focus away from the damages issues during the trial preparation stage, and enhance the natural tendency to regard the liability issues as the primary, if not exclusive, battleground. If the case has to be tried, a favorable outcome during the liability phase may well cause any lingering dispute regarding the damages issues to evaporate. If a settlement cannot be negotiated following the liability phase, a favorable outcome on the liability issues may at least pave the way for some form of alternative dispute resolution, which is generally more receptive to proof of damages via the methods and documentation commonly used in the insurance industry.

Another major benefit of bifurcation is that it normally permits the subrogated insurer's interest in the case to be excluded from the jury during the trial of the critical liability issues.