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XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
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Chapter 162

AMOUNT RECOVERABLE IN SUBROGATION

*Lawrence T. Bowman, Donald A. Waltz, David H. Fisk, and Bradford T. Smith**

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Abstract

* * *

Chapter 162 examines the amounts recoverable by insurers in subrogation actions. Subrogation actions are claims brought by an insurer for damages paid to another. For the most part such claims are governed by traditional damages principles given that the insurer stands in the shoes of the insured in pursuing the claim. The insurer takes the rights of the insured against the tortfeasor or other liable party to recover the insurance proceeds it has paid to its insured. Therefore, to a large extent the measure of recovery for the insurer is the same measure of recovery to which the insured is subjected. This chapter examines the general law regarding the measure of damages recoverable in such subrogation claims, including loss of use and lost profits, and also examines several issues which are prevalent in subrogation claims, including the economic loss doctrine, recovery for code upgrades for which the insurer must compensate the insured, stigma damages claims in situations where the physical damage to the property is questionable, and recovery of attorney's fees.

Section 162.01 provides an introduction to rights of subrogation. There are three types of subrogation: equitable, contractual (also known as "conventional") and statutory. Equitable subrogation rights typically arise by virtue of payment of the debt of another and thus operate under common law and equitable principles. Contractual or "conventional" subrogation arises by virtue of a contract. Most subrogation today is contractual subrogation. After an overview, this section begins in Section 162.01[2] by discussing the subrogation receipt, which is a contract by which the insured agrees to cooperate and participate in the insurer's subrogation efforts. The subrogation receipt generally governs the rights of the insurer to prosecute the subrogation action. Next, Section 162.01[3] discusses the "loan receipt." The loan receipt is a somewhat antiquated tool that recognizes a fictional loan to the insurer that must be repaid only in the event that the insured recovers from a third party. The loan receipt is best used in situations where the insurer has subrogation rights but the actual recovery pursuit is being pursued primarily by the insured. Section 162.01[4] discusses insurance policy provisions that govern the right of subrogation. Often, a subrogation receipt or a loan receipt is not necessary because policy provisions themselves provide for and govern the rights of subrogation. Lastly, Section 162.01[5] discusses situations where the insurer may have a right of subrogation that arises by virtue of statute.

Section 162.02 addresses apportionment of any recoveries with the insured. This is a primary point of contention in any subrogation action. Virtually all jurisdictions have some version of the "Insured Made Whole" doctrine. Under that doctrine, the insurer does not have any rights of subrogation until the insured has been made whole by recovery of its deductible and any other uninsured losses. The Insured Made Whole doctrine is designed to provide the insured

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and gas leaks, and transit losses. He has written and presented on topics involving waivers of subrogation, construction contracts, and product failures.

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0003 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

with a right of first recovery in circumstances where there are limited available funds to satisfy the claim on the part of the defendant. Section 162.02[2] discusses the use of pro-ration agreements. A pro-ration agreement is an agreement by which the insurer and the insured agree, prior to the initiation of any suit, as to the apportionment of any recoveries by way of settlement or judgment. Typically, the insurer will agree to fund any litigation. The insured and the insurer may also enter into a pro-ration agreement whereby they agree that any recoveries will be shared according to certain percentages based upon the ratio of insured to uninsured losses. The pro-ration agreement also typically provides that the insured will satisfy its share of any expenses of the lawsuit and attorney's fees out of the insured's portion of any recovery. Section 162.02[3] discusses insurance policy provisions that may dictate allocation of any recoveries between the insured and the insurer. Some insurance policies provide for a means as to the apportionment of recovery between the insurer and the insured and provide that the insured is entitled to recover a certain portion of its uninsured losses. Section 162.02[4] discusses recovery of the insured's deductible. The insurer generally is not obligated to seek uninsured losses sustained by the insured which were not covered under the insurance policy, or which were in excess of limits. Nevertheless, many jurisdictions require that a subrogating insurer include the insured's deductible in any subrogation claim.

Section 162.03 discusses recovery for damage to structures. Although the general measure of property damage applies, certain aspects of insurance coverage for property losses create unique issues as they relate to the measure of damages in a third-party subrogation action. Specifically, insurers do not typically pay claims based upon "market value" or diminution in "market value." However, the measure of damages in third-party recoveries is often tied to valuation of the structure. If the insurer must pay full replacement cost on a home that is destroyed, the insurer may nonetheless be restricted to recovering for the "market value" of the structure in a third-party action. Similarly, where a building is partially destroyed, the insurer typically pays the cost of repair. However, the measure of damages in a third-party action may be limited to the diminution in value, although costs of repair can serve as a proxy for diminution unless they exceed the value of the structure and thus would result in "economic waste."

Section 162.03[3] discusses proof of the value of a structure. Typically, a real estate appraiser must be retained to testify as to the diminution in value. In situations where the structure can be valued separately from the land upon which it sits, the reduction in value should be based upon the value of the structure in isolation from the land. Section 162.03[4] discusses what proof is necessary at trial to establish the costs of repair. Many subrogating insurers attempt to establish costs of repair by use of the adjuster or general contractor as an "expert" to testify as to amounts expended in repairs. Alternatively, the insurer may attempt to introduce contractor invoices as "business records" to prove the costs of repair. This section discusses the potential evidentiary difficulties of proving costs of repair by these methods and how the only method to reliably prove these costs is by calling individual contractors as witnesses to testify as to the work that was performed, that such work was necessary and that the costs were fair and reasonable.

Section 162.03[5] discusses the special purpose building rule. As noted above, insurers that issue replacement cost policies must often compensate the insured for the full replacement cost of a structure even in situations where that replacement cost greatly exceeds the value of the structure. Examples can include old warehouses, old barns, bridges, churches and various types

0004 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

of public use buildings. There can be a large difference between the replacement cost that the insurer is required to pay and the actual value of the structure. In those situations, the subrogating insurer prefers to recover for that full replacement cost, rather than be limited to a valuation measure of damages such as "market value." Therefore, the insurer often attempts to invoke the special purpose building rule. Under that rule, if a structure does not have a "market value," the plaintiff is entitled to recover for either the replacement cost of the structure or the actual value of the structure to the owner. A key issue in this area is whether the replacement cost amount awarded to the plaintiff must be reduced for depreciation. Generally, the answer is no. However, if the award to the plaintiff would result in a substantial windfall to the plaintiff or a substantial betterment to the destroyed structure, the court can take into account the remaining useful life of the structure and reduce the award for any applicable depreciation.

Section 162.03[6] examines the insurer's recovery for amounts paid to an insured for the loss of use of the damaged property. The general rule is that a plaintiff may not recover for loss of use of property that is totally destroyed, on the assumption that the plaintiff should have replaced the property with other similar property immediately. If the property was damaged and could be repaired, the plaintiff generally is entitled to recover for loss of use during the period of repair. The general rule has been eroded by more recent court decisions. In circumstances where the plaintiff could not readily replace its property because it was unique or the plaintiff lacked the financial means to do so, modern courts may take these circumstances into account and award damages for loss of use even when the property has been totally destroyed.

Section 162.04 discusses recovery of damage to personal property. Some of the same principles that apply to claims for damage to structures also apply to claims for damage to personal property. The general method of calculating damages to personal property is the difference in fair market value of the property immediately before and immediately after the loss occurred. Specific types of property may be subject to different damage models. Replacement costs may be awarded in losses involving retail merchandise or special use property that has no market value. In losses involving household furnishings, appliances, clothing, and other personal effects, the appropriate measure of damages may be the actual value of the property to the owner given the condition it was in when the loss occurred, excluding any fanciful or sentimental considerations. Some jurisdictions will even allow sentimental value damages when the property is irreplaceable and has its primary value in sentiment. Finally, when personal property is damaged but not destroyed and is capable of being repaired, a plaintiff may be entitled to recover the cost to repair the property, in addition to damages for the loss of use of the property or lost profits while it is being repaired.

Section 162.05 discusses recovery of lost profits. Any business interruption losses paid by the insurer under a Commercial Property policy will be recoverable by the insurer in a subrogation claim. Section 162.05[2] discusses uninsured losses and the difficulties of including those uninsured losses in any pro-ration agreement between the insurer and the insured. Lost profits claims are by their nature uncertain and unliquidated. Therefore, it is difficult to enter into a pro-ration agreement which fairly allocates recoveries between insured and uninsured losses. This section discusses strategies and options for the insurer in addressing those uninsured losses. Section 162.05[3] discusses the reasonable certainty requirement as to lost profits adopted by all jurisdictions. Section 162.05[4] discusses various methodologies for calculating lost profits, including the "before and after" method, the "yardstick" method, and

the "market share" method. These various methods can be used to calculate the lost profits sustained by the insured in order to present a claim that satisfies the reasonable certainty requirement. Section 162.05[5] discusses the special circumstances of lost profits claims involving new businesses. The majority of jurisdictions hold that a new business is not *per se* precluded from recovering for lost profits if the lost profits claim can satisfies the reasonable certainty requirement. Lastly, Section 162.05[6] discusses the necessity of expert testimony and issues as to the reliability of expert testimony imposed by courts relative to lost profits claims.

Section 162.06 discusses the economic loss doctrine which restricts recovery of economic losses to contract claims, rather than tort claims. This issue is of pivotal importance in subrogation claims. A large percentage of subrogation claims involve damage to property that was purchased from a supplier. In those circumstances, the insurer may be limited to tort remedies and cannot proceed on contract claims against that supplier. This issue is quite important in that the statutes of limitation applicable to tort claims generally begin to run when the damage occurs, whereas contract statutes of limitation typically begin to run at the time of sale. If a substantial period of time has elapsed since the sale, the statute of limitation on contract claims may have expired. If the economic loss doctrine restricts the insured to contract claims in any subrogation action, the insurer may not have any rights against the tortfeasor.

There are three types of economic loss. Section 162.06[3] discusses *Robin's Dry Dock* economic loss, which bars tort remedies if the plaintiff sustains purely financial losses as a result of damage to property which is not owned by the insured. Section 162.06[4] discusses the most common type of economic loss, involving products liability claims. In products liability claims, recovery for damage to the "product itself" will generally be restricted to contract claims, specifically under warranty principles. This doctrine is not applicable when the product damages "other property." What constitutes "other property" is often a subject of dispute. Last, section 162.06 [5] discusses contractual privity economic loss, which restricts the plaintiff to contract claims in some situations where the contract relationship predominates over the tort relationship.

Section 162.07 discusses recovery for "stigma damages." Stigma damage occurs when there is diminished value to property caused by a negative perception as to the value of the property, as opposed to actual physical damage to the property. Often, property insurers are required to pay claims based upon potential damage to property held for consumer sale when the property has been exposed to some potentially damaging event, but may, or may not, have any physical damage. In that circumstance, the property has been stigmatized and its market value is greatly diminished. This is particularly applicable if the insurer has a "Brand and Label" clause in its policy that permits the insured to remove its brand or label from products and declare that the product must be sold for salvage. In that event, the salvage value is greatly reduced. The product may or may not have been physically damaged, but nonetheless there is a very real loss in market value for which the insurer must compensate the insured. This section discusses methods by which the insurer can prove its stigma damage claim, and areas of the law which can be analogized to a given claim, including real estate sales, termite damage claims, and environmental losses.

Section 162.08 examines recovery for expenses incurred to upgrade property to code requirements. Standard insurance policies include coverage for "Code and Ordinance." Such Code and Ordinance coverage requires insurers to compensate the insured for additional costs incurred by the insured in repairs because of the obligation to comply with modern building

0006 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

codes. There is a philosophical debate as to whether the defendant in a subrogation action must pay for such code upgrades. On one hand, the cost of such code upgrades is a real out-of-pocket cost which would not have been incurred but for the defendant's conduct. On the other hand, code upgrades provide a "betterment" to the insured, and defendants argue that they should not be obligated to pay for that increase in value. There is a split of authority on this issue. The majority rule holds that the costs of such code upgrades is compensable, whereas the minority holds that recovery for such code upgrades would result in a noncompensable betterment to the insured.

Section 162.09, discusses the recovery of attorney's fees in subrogation claims. As in most cases, attorney's fees are not recoverable in subrogation claims unless authorized by statute or a contract between the insured and the responsible party. There are numerous statutes, both state and federal, that allow for the recovery of attorney's fees in specific cases. Many of these statutes incorporate offer of judgment provisions that allow the defendant, and sometimes the plaintiff, to recover costs, which can include attorney's fees. Section 162.09[3] examines the evidence considered by most jurisdictions in evaluating the reasonableness and necessity of the amount of fees claimed.

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Table of Contents

§ 162.01 Subrogation Agreements

- **[1] Overview**
- **[2] The Subrogation Receipt**
- **[3] The Loan Receipt**
- **[4] Insurance Policy Provisions**
- **[5] Statutory Rights of Subrogation**

§ 162.02 Apportionment of Recovery With the Insured

- **[1] The "Insured Made Whole" Doctrine**
- **[2] Proration Agreements**
- **[3] Insurance Policy Provisions**
- **[4] Recovery of Insured's Deductible**

§ 162.03 Damage to Structures

- **[1] Overview**
- **[2] Measure of Damages**
- **[3] Proving Diminution in Value**
- **[4] Proving Costs of Repair**
  - **[a] Overview**
  - **[b] The Adjuster and General Contractor as an Expert**
  - **[c] Proof of Repairs by Invoices**

0007 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

[5] Special Purpose Building Rule

[6] Loss of Use Damages

§ 162.04 Damage to Personal Property

[1] Measure of Damages

[2] Fair Market Value of Destroyed Property

[3] Replacement Cost for Retail Merchandise and Special Use Property

[4] Actual Value to the Owner for Household Goods

[5] Sentimental Value

[6] Cost of Repair and Loss of Use or Lost Profits

§ 162.05 Recovery of Lost Profits

[1] Overview

[2] Uninsured Losses

[3] The "Reasonable Certainty" Requirement

[4] Methods of Proving Lost Profits

[5] "New" Businesses

[6] Expert Testimony and "*Daubert*" Issues

§ 162.06 The Economic Loss Doctrine

[1] Injured Party Generally Cannot Recover in Tort for "Economic Damages"

[2] The Three Types of Economic Loss

[3] "*Robins Dry Dock*" Economic Loss

[4] Products Liability

[a] Development of the Doctrine

[b] "Other Property"

[5] "Contractual Privity" Economic Loss Doctrine

§ 162.07 Recovery of Stigma Damages

[1] What Are Stigma Damages?

[2] Hypothetical Example of Stigma Damage Subrogation

[3] Philosophical Basis of Stigma Claims

[4] Case Law on "Stigma"

[a] Overview

[b] Home Sales

[c] Termite Damage

[d] Environmental Damage

[5] Proving Stigma Damage

§ 162.08 Recovery for Code Upgrades

[1] Theoretical Debate as to Whether Damage Was Caused by Tortfeasor

[2] The Majority Rule—Jurisdictions Allowing Recovery

[3] Minority Rule—Jurisdictions Refusing Recovery

0008 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

§ 162.09 Recovery of Attorney's Fees

[1] Common Law Rules—American Rule vs. English Rule

[2] Statutory Basis

[3] Proving Attorney's Fees

§ 162.01 Subrogation Agreements

[1] Overview

There are three types of subrogation: equitable, contractual and statutory.

Equitable subrogation arises when a party pays a debt that should have been satisfied by another party. In that case, the subrogee (the one who has paid the pre-existing debt) obtains a right of action against the third party that should have paid the debt. So, when a property insurance carrier pays a claim, it becomes subrogated to the rights of the insured against any third party legally or equitably responsibly for the loss.

The second form of subrogation right is contractual. The contract of insurance may affirmatively provide that the subrogee may pursue the subrogor's rights against third parties. Property insurance policies frequently contain subrogation language. Additionally, a subrogation claim may be affected by separate agreements, including a subrogation receipt and a loan receipt.

Finally, in some cases, statutory provisions may affect subrogation rights. The following sections will describe these various agreements and provisions in greater detail.

[2] The Subrogation Receipt

Insurers may request the insured to execute a "Subrogration Receipt" upon payment of a claim. A typical subrogation receipt reads as follows:

SUBROGATION RECEIPT

Know All Men By These Presents:

That, in consideration for the sum of ______________ Dollars, ($______________), paid to the Undersigned by the ______________, hereinafter referred to as insurer, under Policy No. ______________, in full settlement of all claims and demands by reason of loss which occurred on ______________, to ________________________

(Automobile, Building, Stock, etc.)

the Undersigned hereby assign, set over, transfer or subrogate to the said insurer, all the rights, claims, interest, choses or things in action to the extent of the amount paid as aforesaid, which the Undersigned may have against any person, persons, or corporation, who may be liable, or hereafter adjudged liable for the loss or damage aforesaid, and hereby authorized and do empower the said insurer to sue, compromise, or settle in the name of the Undersigned or otherwise, and the said insurer is hereby fully substituted in the place of the Undersigned and subrogated to all rights in the premises to the amount so paid.

0009 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

> The Undersigned warrants that no settlement has been made with the wrongdoer for the aforesaid loss or damage.
>
> It is expressly stipulated that any action taken by the said insurer shall be without charge or cost to the Undersigned.

There is no legal requirement for the insured to sign a subrogation receipt, nor is it a precondition to the right of the subrogated insurance carrier to commence a subrogation action against the responsible third party.

The subrogation receipt nonetheless has served as a useful device by which the insured acknowledges and affirms the right of the subrogated carrier to initiate a subrogation action against responsible third parties.

The sample subrogation receipt also contains a warranty from the insured that no settlement has been made with the responsible third party. The sample subrogation receipt also stipulates that the subrogated insurance carrier will proceed at no cost or charge to the insured.

Because use of the subrogation receipt device is not mandatory and the subrogated insurance carrier has the right to proceed in the absence of the signed subrogation receipt from the insured, the wording of subrogation receipts are not uniform.

[3] The Loan Receipt

In some cases an insurer might make payments to its insured in the form of a "loan." A typical loan receipt provides:

LOAN RECEIPT

> Received from ______________ Insurance Company (hereinafter referred to as "Company") the sum of $______________, as a loan, without interest, repayable only in the event and to the extent of any net recovery the undersigned may make from any person or persons, corporation or corporations, or other parties, causing or liable for the loss or damage to the property described below, or form any insurance effected on such property, as a security for such repayment the undersigned hereby pledges to the said company all his, it or their claim or claims against said person, persons, corporation or corporations, or other parties, or from any insurance carrier or carriers, and any recovery thereon, and hereby delivers to said Company all documents necessary to show his, its or their interest in said property.
>
> The undersigned covenants that no settlement has been made by the undersigned with any person or persons, corporation or corporations, or other parties against whom a claim may lie, and no release has been given to anyone responsible for such loss, and that no such settlement will be made, nor release given without the written consent of the said Company; and the undersigned covenants and agrees to cooperate fully with the said company, to promptly present claim and, if necessary, to commence, enter into and prosecute suit against such person or persons, corporation or corporations or other parties, through whose negligence or other fault the aforesaid loss was caused, or who may otherwise be responsible therefore, with all due diligence in his, its or their name.
>
> In further consideration of said loan, the undersigned hereby guarantees that he, it or

0010 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

> they are the owner(s) of said property and entitled to recover upon said claim for loss or damage thereof and hereby appoint(s) the managers and/or agents of the said Company and their successors with irrevocable power to collect any such claim or claims, and to begin, prosecute, compromise or withdraw in his, its or their name, but at the expense of the said company, any and all legal proceedings that the said Company may deem necessary to enforce such claim or claims, and to execute in the name of the undersigned any document that may be necessary to carry the same into effect for the purposes of this agreement. Any legal proceedings are to be under the exclusive direction and control of said Company. The property hereinabove set forth is as follows: ____
>
> Agreed on this __________ day of __________, 20—.
>
> __________
>
> By: __________

Use of loan receipts is relatively rare. Under the terms of the loan receipt, the payment by the insurance carrier to the insured is classified as a "loan" that is repaid when the insured recovers for the damage from a responsible third party.

The loan receipt is useful when the insured has, in addition to payment it has received from the insurance carrier, a large uninsured loss which the insured wishes to pursue against the third party. The loan receipt constitutes acknowledgement by the insured that carriers' "loan" will be paid out of any recovery obtained by the insured.

Use of loan receipts can be problematic and can lead to disputes with the insured. They are best to be avoided. They do, however, resolve a question which is frequently left unanswered in the jurisprudence of many states regarding the recovery of subrogation proceeds from settlements obtained by the insured which arguably pertain to claims for uninsured damages. The issue involves whether the subrogated carrier has a right to receive repayment of the amount it has paid its insured out of any recovery the insured makes against third parties, including recoveries for uninsured losses.

The better, less acrimonious practice would be for the insured and the subrogated carrier to enter into a pro rata and joint prosecution agreement which acknowledges both the insured and the uninsured claims and sets up an agreed, enforceable pro rata sharing of recoveries and expenses for the prosecution of the recovery action by both parties.

[4] Insurance Policy Provisions

A typical contractual subrogation clause reads as follows:

TRANSFER TO US OF SALVAGE, RIGHTS OF RECOVERY AGAINST OTHERS

> In the event of loss or damage, at our option, we may take as salvage any **Business Personal Property or Personal Property of Others** (see paragraphs **b.** and **c.** of **Covered Property**), the value of which we pay under this policy. If any person or organization to or for whom we make payment under this policy has rights to recover

0011 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:07 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

> damages from another, those rights are transferred to us to the extent of our payment. That person or organization must do everything necessary to secure our rights to such salvage and to recover such damages and must do nothing after the loss to impair those rights.

Because policy provisions vary from policy to policy, it is important to examine the terms of the policy carefully. The key difference from policy to policy is the wording which describes the nature of the transfer as either "in whole" or "in part" to the subrogated carrier upon payment of the insured claim to the policyholder. The language in the example describes a transfer "to the extent of our payment." This language arguably sets up a pro rata recovery relationship between the subrogated carrier and its insured, as discussed below. The language can also be used to overcome an insured's claim to a priority of recovery vis-à-vis the subrogated carrier to the extent that courts have been willing to enforce such language to establish a co-equal rights to the recovery on the part of the subrogated carrier and its insured.

States differ on their approach to enforcing one party or the other's right to a priority of recovery. Several states have held, in the absence of any contractual language defining the priority of recovery, that the insured has a right to be "made whole" before the subrogated carrier may recover from a responsible third party. The "made whole" doctrine is discussed in Section 162.02[1] below.

The modern trend is to enforce the contractual language in a policy as establishing an arms-length bargaining governing the recovery between the subrogated carrier and its insured.[1] It makes sense to have contractual language in the first party property insurance policy governing the priority of recovery, or establishing a pro rata recovery relationship between the subrogated carrier and its insured, which provides a salutary effect of eliminating disputes on this subject.

Difficulties may arise when the third party is under-insured or financially irresponsible and unable to pay in full both claims from the subrogated carrier and the uninsured claim of the insured. This situation must be resolved with either a court enforcing the insured's right to be made whole before the subrogated carrier is entitled to recover from a third party, or requiring the parties to recover from the third party on a pro rata basis.

The important point is to be familiar with state law governing the enforceability of the insurance policy provisions governing the right and priority of recovery, discussed in Section 162.02[1] below. The second point is to examine the insurance policy provisions to see exactly what has been agreed to with respect to the priority of recovery and the sharing of expenses.

[5] Statutory Rights of Subrogation

Statutory subrogation rarely arises in the property subrogation field. Perhaps the

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[1] **TX—***See* Fortis Benefits v. Cantu, 234 S.W.3d 642, 647 (Tex. 2007).

most common variety of statutory subrogation arises in the worker's compensation context.

Health insurance payments may be governed by statutes, such as ERISA, which may have important consequences for the prosecution and enforcement of the subrogated claim. Subrogated ERISA claims may take priority over any and all claims for out-of-pocket losses or for reimbursement.[2]

§ 162.02 Apportionment of Recovery With the Insured

[1] The "Insured Made Whole" Doctrine

The made whole doctrine affects the priority of rights to recovery in subrogation claims involving both an insured's uninsured claim and an insurer's right to recoup the payments it made under its policy. There are three main variations of the made whole doctrine: 1) the insured be made whole; 2) a pro-rata rule; and the rarer 3) insurer made whole doctrine. In an Insured Made Whole state, the insurance company is typically required to reimburse its insured, completely, including uninsured losses and any applicable deductible, prior to collection of any portion of the subrogation recovery based on equitable subrogation. However, application of the doctrine is not always clear, and it may depend on whether the case involves equitable subrogation, contractual subrogation, and even statutory subrogation.

The made whole doctrine derived from the common law and is based on equity principles that limit an insurer's ability to recover in subrogation until the insured is made completely whole. Thus, in equity the insured has a priority in collection. The basis for the doctrine stands on the equitable principle that, if the insured's loss is in excess of what he has recovered from both his insurance company and a third-party tortfeasor, his insurer loses its right to subrogate against any other party.[1] In the context of equitable subrogation, equity allows subrogation for the benefit of the insurer, particularly where it prevents the insured from making a double recovery.[2] However,

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[2] *See generally* **US—**Admin. Comm. of the Wal-Mart Assocs. Health & Welfare Plan v. Willard, 393 F.3d 1119 (10th Cir. 2004).

[1] *See:*

AL—Wolfe v Alfa Mut. Ins. Co., 880 So. 2d 1163, 1165 (Ala. 2003);

MI—Washtenaw Mut. Fire Ins. Co. v. Budd, 175 N.W. 231, 232 (Mich. 1919);

PA—Jones v. Nationwide Property and Cas. Ins. Co., 32 A.3d 1261, 1270 (Pa. 2011);

TX—Fortis Benefits v. Cantu, 234 S.W.3d 642, 647 (Tex. 2007).

[2] *See:*

CA—Chandler v. State Farm Mut. Auto. Ins. Co., 596 F. Supp. 2d 1314, 1317 (Cal. 2008);

CT—Fireman's Fund Ins. Co. *v.* TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 40 (Conn. 2013);

HI—AIG Haw. Ins. Co. v. Rutledge, 955 P.2d 1069, 1079–1080 (Haw. 1998);

IA—Allied Mut. Ins. Co. v. Heiken, 675 N.W.2d 820, 824–825 (Iowa 2004);

KY—Wine v. Globe Am. Cas. Co., 917 S.W.2d 558, 562 (Ky. 1996);

0013 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:08 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

where the insured has not been made whole because of the lack of insurance coverage or available recovery from a tortfeasor, equity may cut the other direction.[3] In other words, equity requires that when both the insured and the insurer must, to some extent, go unpaid, the loss should be borne by the insurer because that is a risk the insured has paid it to assume.[4]

Even if the insured made whole doctrine is the default doctrine in a given state, that does not necessarily preclude parties from contractually altering the application of the default rule with a policy provision or a post-loss proration agreement. In some states the insured made whole doctrine may be modified by contract, most likely in a provision of the insurance policy.[5] Texas, for example, allows parties to contractually

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MO—Keisker v. Farmer, 90 S.W.3d 71, 75 (Mont. 2002);

NC—St. Paul Fire & Marine Ins. Co. v. W.P. Rose Supply Co, 198 S.E.2d 482, 485 (N.C. 1973);

OR—Koch v. Spann, 92 P.3d 146, 148 (Or. 2004).

[3] *See:*

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 41 (Conn. 2013);

FL—Intervest Constr. of Jax, Inc. v. General Fid. Ins. Co., 133 So. 3d 494, 504 (Fla. 2014);

TX—Fortis Benefits v. Cantu, 234 S.W.3d 642, 647–648 (Tex. 2007).

[4] *See:*

AK—O'Donnell v. Johnson, 209 P.3d 128, 135 (Alaska 2009);

AR—Franklin v. Healthsource of Ark., 942 S.W.2d 837, 839–840 (Ark. 1997);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 41 (Conn. 2013);

RI—Lombardi v. Merchants Mut. Ins. Co., 429 A.2d 1290, 1291 (R.I. 1981);

TX—Fortis Benefits v. Cantu, 234 S.W.3d 642, 647–648 (Tex. 2007);

WA—Thiringer v. American Motorist Co., 588 P.2d 191, 193 (Wash. 1978).

[5] *See:* **US/CA—**Chandler v. State Farm Mut. Auto. Ins. Co., 596 F. Supp. 2d 1314, 1318 (C.D. Cal. 2008);

AL—International Underwriters/Brokers, Inc. v. Liao, 548 So. 2d 163, 164 (Ala. 1989); Wolfe v Alfa Mut. Ins. Co., 880 So. 2d 1163, 1165 (Ala. 2003);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 40 (Conn. 2013);

FL—Intervest Constr. of Jax, Inc. v. General Fid. Ins. Co., 133 So. 3d 494, 504 (Fla. 2014);

GA—Woodcraft by Macdonald, Inc. v. Georgia Cas. and Sur. Co., 743 S.E.2d 373, 374 (Ga. 2013);

IL—Capitol Indem. Corp. v. Strikezone, 646 N.E.2d 310, 312 (Ill. 1995);

IN—Erie Ins. Co. v. George, 681 N.E.2d 183, 188–191 (Ind. 1997);

LA—Roberts v. Richard, 743 So. 2d 731, 734 (La. 1999);

KY—Wine v. Globe Am. Cas. Co., 917 S.W.2d 558, 562 (Ky. 1996);

MN—Hershey v. Phys. Health Plan of Minn., Inc. 498 N.W.2d 519, 520–521 (Minn. 1993);

NJ—Providence Wash. Ins. Co. v. Hogges, 171 A.2d 120, 123–124 (N.J. 1961);

NV—Canfora v. Coast Hotels and Casinos, Inc., 121 P.3d 599, 604 (Nev. 2005);

NY—Winkelmann v. Excelsior Ins. Co., 650 N.E.2d 841, 844 (N.Y. 1995);

0014 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:08 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

express their intent regarding reimbursement, rather than being controlled by external rules imposed by courts or equity.[6] A key component of analysis in these states is whether the contractual language used is sufficient to overcome the application of the insured made whole doctrine.[7] Some states, such as Indiana, may require the insurance policy to expressly and unequivocally remove all doubt that the policy intends to modify application of the insured made whole doctrine.[8] Less common is the requirement in California that the policy not only have clear and specific language that the insurer may have the right to subrogation even if the insured is not made whole, but also that the insurer actively participate and share in the burden of making the recovery.[9] Each jurisdiction has its own set of requirements and policies for determining whether the contractual language is sufficient to overcome the application of the made whole doctrine.[10] While some states may require only general language,

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OH—N. Buckeye Educ. Council Grp. Health Benefits Plan v. Lawson, 814 N.E.2d 1210, 1215 (Ohio 2004);

OK—Manokoune v. State Farm Mut. Auto. Ins. Co., 145 P.3d 1081, 1086 (Okla. 2006);

PA—Jones v. Nationwide Property and Cas. Ins. Co., 32 A.3d 1261, 1270 (Pa. 2011);

SD—Julson v. Federated Mut. Ins. Co., 562 N.W.2d 117, 120 (S.D. 1997);

TX—Fortis Benefits v. Cantu, 234 S.W.3d 642, 647–648 (Tex. 2007);

UT—Kramer v. State Retirement Bd., 195 P.3d 925, 932 (Utah 2008);

WA—Thiringer v. American Motorist Co., 588 P.2d 191, 194 (Wash. 1978);

WV—Kanawha Valley Radiologists, Inc. v. One Valley Bank, N.A., 557 S.E.2d 277, 282 (W. Va. 2001).

[6] **TX—**Fortis Benefits v. Cantu, 234 S.W.3d 642, 647–648 (Tex. 2007).

[7] *See*:

US/CA—Chandler v. State Farm Mut. Auto. Ins. Co., 596 F. Supp. 2d 1314 (C.D. Cal. 2008);

AL—Wolfe v Alfa Mut. Ins. Co., 880 So. 2d 1163, 1165 (Ala. 2003);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 40 (Conn. 2013);

FL—Intervest Constr. of Jax, Inc. v. General Fid. Ins. Co., 133 So. 3d 494, 504 (Fla. 2014);

GA—Woodcraft by Macdonald, Inc. v. Georgia Cas. and Sur. Co., 743 S.E.2d 373, 374 (Ga. 2013);

IN—Erie Ins. Co. v. George, 681 N.E.2d 183, 188–191 (Ind. 1997);

NV—Canfora v. Coast Hotels and Casinos, Inc., 121 P.3d 599, 604 (Nev. 2005);

OH—N. Buckeye Educ. Council Grp. Health Benefits Plan v. Lawson, 814 N.E.2d 1210, 1215 (Ohio 2004);

OK—Manokoune v. State Farm Mut. Auto. Ins. Co., 145 P.3d 1081, 1086 (Okla. 2006);

UT—Kramer v. State Retirement Bd., 195 P.3d 925, 932 (Utah 2008);

WV—Kanawha Valley Radiologists, Inc. v. One Valley Bank, N.A., 557 S.E.2d 277, 282 (W. Va. 2001).

[8] **IN—**Erie Ins. Co. v. George, 681 N.E.2d 183, 188–191 (Ind. 1997).

[9] **CA—**Progressive West Ins. Co. v. Yolo County Superior Court, 37 Cal. Rptr. 3d 434, 442 (2005).

[10] *See*:

others may require a clear and explicit or an express agreement by the parties to overrule the made whole doctrine.[11]

Not all states will allow the parties to modify application of the default rule. For example, in Arkansas, there is a strict adherence to the application of the made whole doctrine that prevents an insurer from making any recovery until the insured is made

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US/CA—Chandler v. State Farm Mut. Auto. Ins. Co., 596 F. Supp. 2d 1314 (C.D. Cal. 2008);

US/PA—Watson v. Allstate Ins. Co., 28 F. Supp. 2d 942, 946 (M.D. Pa. 1998);

AL—Wolfe v Alfa Mut. Ins. Co., 880 So.2d 1163, 1165 (Ala. 2003);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 40 (Conn. 2013);

FL—Intervest Constr. of Jax, Inc. v. General Fid. Ins. Co., 133 So. 3d 494, 504 (Fla. 2014);

GA—Woodcraft by Macdonald, Inc. v. Georgia Cas. and Sur. Co., 743 S.E.2d 373, 374 (Ga. 2013);

IN—Erie Ins. Co. v. George, 681 N.E.2d 183, 188–191 (Ind. 1997);

MN—Westendorf v. Stasson, 330 N.W.2d 699, 703 (Minn. 1983);

NJ—Providence Wash. Ins. Co. v. Hogges, 171 A.2d 120, 123–124 (N.J. 1961);

NV—Canfora v. Coast Hotels and Casinos, Inc., 121 P.3d 599, 604 (Nev. 2005);

OH—N. Buckeye Educ. Council Grp. Health Benefits Plan v. Lawson, 814 N.E.2d 1210, 1215 (Ohio 2004);

OK—Manokoune v. State Farm Mut. Auto. Ins. Co., 145 P.3d 1081, 1086 (Okla. 2006);

UT—Kramer v. State Retirement Bd., 195 P.3d 925, 932 (UT. 2008);

WV—Kanawha Valley Radiologists, Inc. v. One Valley Bank, N.A., 557 S.E.2d 277, 282 (W. Va. 2001).

[11] *See*:

US/CA—Chandler v. State Farm Mut. Auto. Ins. Co., 596 F. Supp. 2d 1314 (C.D. Cal. 2008);

US/PA—Watson v. Allstate Ins. Co., 28 F. Supp. 2d 942, 946 (M.D. Pa. 1998);

AL—Wolfe v Alfa Mut. Ins. Co., 880 So. 2d 1163, 1165 (Ala. 2003);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 40 (Conn. 2013);

FL—Intervest Constr. of Jax, Inc. v. General Fid. Ins. Co., 133 So. 3d 494, 504 (Fla. 2014);

GA—Woodcraft by Macdonald, Inc. v. Georgia Cas. and Sur. Co., 743 S.E.2d 373, 374 (Ga. 2013);

IN—Erie Ins. Co. v. George, 681 N.E.2d 183, 188–191 (Ind. 1997);

MN—Westendorf v. Stasson, 330 N.W.2d 699, 703 (Minn. 1983);

NJ—Providence Wash. Ins. Co. v. Hogges, 171 A.2d 120, 123–124 (N.J. 1961);

NV—Canfora v. Coast Hotels and Casinos, Inc., 121 P.3d 599, 604 (Nev. 2005);

OH—N. Buckeye Educ. Council Grp. Health Benefits Plan v. Lawson, 814 N.E.2d 1210, 1215 (Ohio 2004);

OK—Manokoune v. State Farm Mut. Auto. Ins. Co., 145 P.3d 1081, 1086 (Okla. 2006);

UT—Kramer v. State Retirement Bd., 195 P.3d 925, 932 (UT. 2008);

WV—Kanawha Valley Radiologists, Inc. v. One Valley Bank, N.A., 557 S.E.2d 277, 282 (W. Va. 2001).

0016 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:08 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

whole.[12] Therefore, the insurer is precluded from seeking subrogation until the insured has been fully compensated and is in a position where any further recovery would be inequitable because it would allow the insured to recover twice.[13] The applicable burden in Arkansas can be even more tedious because when an insured is made whole may require a judicial determination or an agreement by the parties.[14] A unilateral determination by the insurance company that its insured has been made whole is insufficient.[15]

At least one state, New Hampshire, has refused to apply the made whole doctrine when the recovery from a tortfeasor was less than the insured's loss and the insurer's payments.[16] The *Dimmick* case involved an injury suffered by a minor plaintiff in an automobile accident. The minor's parent filed suit against the tortfeasor seeking to recover for the minor's injuries. The parent eventually settled with the tortfeasor for an amount less than the minor's total damages and the amount of an insurer's payments. The insurer attempted to intervene, seeking reimbursement for its payments through subrogation. The New Hampshire Supreme Court refused to apply the Made Whole Doctrine and instead held that the trial court must make separate findings as to the extent of loss suffered by the minor versus the parent, and allow the insurer to recover on a pro-rata basis in proportion to its payments to, and the loss of, the parent.[17]

At least two states, Illinois and Maryland, have applied what is known as the Insurer Made Whole Doctrine. Under this doctrine, the insurer can obtain a priority right to subrogate, even if the insured is not made whole, via its contractual subrogation provision.[18] In *Trogrub,* Geico attempted to subrogate on a portion of the settlement

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[12] *See*:

AR—Franklin v. Healthsource of Ark., 942 S.W.2d 837, 839–840 (Ark. 1997);

CO—Colo. Rev. Stat. § 10-1-135;

MS—Armstrong v. Miss. Farm Bureau Cas. Ins. Co., 66 So. 3d 188, 191 (Miss. 2011);

MT—Swanson v. Hartford Ins. Co., 46 P.3d 584, 590 (Mont. 2002);

NE—Blue Cross and Blue Shield of Neb., Inc. v. Dailey, 268 Neb. 733 (2004);

TN—Abbott v. Blount Co., 207 S.W.3d 732, 734 (Tenn. 2006);

WI—Ruckel v. Gassner, 646 N.W.2d 11, 12–13 (Wis. 2002).

[13] **AR—**Franklin v. Healthsource of Ark., 942 S.W.2d 837, 839–840 (Ark. 1997).

[14] **AR—**Riley v. State Farm Mut. Auto. Ins. Co., 381 S.W.3d 840, 849 (Ark. 2011).

[15] **AR—**Riley v. State Farm Mut. Auto. Ins. Co., 381 S.W.3d 840, 849 (Ark. 2011).

[16] **NH—**Dimick v. Lewis, 497 A.2d 1221, 1224 (N.H. 1985).

[17] **NH—**Dimick v. Lewis, 497 A.2d 1221, 1224 (N.H. 1985).

[18] *See*:

ID—Cedarholm v. State Farm Mut. Ins. Co., 338 P.2d 93, 95–96 (Idaho 1959);

IL—American Family Mut. Ins. Co. v. Plunkett, 14 N.E.3d 676 (Ill. 2014) (citing Capitol Indem. Corp. v. Strike Zone, S.S.B. Corp., 646 N.E.2d 310 (Ill. 1995)); Trogub v. Robinson, 853 N.E.2d 59, 64 (Ill. 2006);

0017 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:08 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

obtained by its insured in a minor car accident case. The Illinois appellate court held that in the case of an insurance contract, subrogation rights arise where (1) a third party caused the loss and is primarily liable to the insured, (2) the insurer is secondarily liable to the insured via its insurance policy, and (3) the insurer pays the insured under that policy, thereby extinguishing the debt owed by the third party.[19] The court further held that if the insurance contract gives the insurer the right to subrogate, the contract will override common law and will be enforced to allow the insurer full subrogation, even if the insured has not been made whole.[20]

The made whole doctrine is applied differently from state to state. Counsel must be careful to avoid inadvertently violating state law and damaging the insured's right to additional recovery. There are some useful generalizations, however. The made whole doctrine does not create a cause of action allowing the insured to recover more than the payments under its insurance policy. In most instances, the doctrine doesn't prevent the insurer from seeking subrogation until the insured has been made whole. Rather, the doctrine protects the insured's right to an additional recovery beyond the insurer's payment from the third-party tortfeasor. This right is particularly important when recovery from a third party is limited to an amount less than both the insured's loss and the insurer's payment. Application of the made whole doctrine in those instances, unless altered by an allowable contractual provision, permits the insured to recover for its full loss, including the deductible, before its insurer can make a recovery on its payment. In essence, equity requires that where an insurer and insured attempt to recover from a third party simultaneously, but the tortfeasor cannot make both whole, the insured will most likely have the priority right of recovery.[21]

Notably, some states have adopted statutes for proration under certain types of insurance coverage that may affect the made whole doctrine because these statutes also control inclusion of deductibles, and splitting of fees. For example, the Arizona Administrative Statute § R20-6-801 H4 requires that insurer's deductible be included in any subrogation attempt.[22] The statute further requires that subrogation recoveries shall be shared on a proportionate basis with the insured, unless the deductible has

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MD—Stancil v. Erie Ins. Co., 740 A.2d 46, 49–50 (Md.1999).

[19] **IL—**Trogub v. Robinson, 853 N.E.2d 59, 64 (Ill. 2006).

[20] **IL—**Trogub v. Robinson, 853 N.E.2d 59, 64 (Ill. 2006).

[21] *See*:

AK—O'Donnell v. Johnson, 209 P.3d 128, 135 (Alaska 2009);

AR—Franklin v. Healthsource of Ark., 942 S.W.2d 837, 839–840 (Ark. 1997);

CT—Fireman's Fund Ins. Co. v. TD Banknorth Ins. Agency, Inc., 72 A.3d 36, 41 (Conn. 2013);

RI—Lombardi v. Merchants Mut. Ins. Co., 429 A.2d 1290, 1291 (R.I. 1981);

TX—Fortis Benefits v. Cantu, 234 S.W.3d 642, 647 (Tex. 2007);

WA—Thiringer v. American Motorist Co., 588 P.2d 191, 193 (Wash. 1978).

[22] **AZ—**Ariz. Admin. Code § 20-6-801(H)(4).

been otherwise recovered.[23] Other statutes may limit a proportionate split of a recovery to situations where the insurer has retained outside counsel. California's Code of Regulations title 10 § 2695.7(q) states:

> Every insurer that makes a subrogation demand shall include in every demand first party claimant's deductible. Every insurer shall share subrogation recoveries on a proportionate basis with first party claimant, unless first party claimant has otherwise recovered whole deductible amount. No insurer shall deduct legal or other expenses from recovery of deductible unless insurer has retained outside attorney or collection agency to collect that recovery.[24]

[2] Proration Agreements

In general, proration agreements provide parties in subrogation matters the opportunity to address and agree upon how expenses and recoveries will be apportioned in the case. They may also address other important issues, including when each can settle or require that both parties agree to a settlement before ending litigation. As a practical benefit, the proration agreement prevents disagreements during litigation that could either jeopardize or delay a resolution and should be well thought out to address potential complications. This is particularly true where there are limited available funds to recover from a third party and the insured and the insurer have substantial damages to recover. By implementing an adequate proration agreement may reduce the likelihood of a conflict arising later.

Proration agreements are often necessary in subrogation cases where the insured has hired counsel to recover its payments, but the insured has an uninsured loss that should be included in the litigation. The proration agreement may then be used to supply details as to how the parties want the litigation to be handled and establish in advance how the parties will split expenses and recoveries. For example, some proration agreements may provide that the insurer will pay the litigation expenses upfront, but in exchange may seek the insured's agreement to reimburse it on a pro-rata basis, should a recovery be made. As addressed in the Made Whole Doctrine section above, there may be both contractual and statutory limitations on how the agreements can address subrogation and expenses.

The proration agreement can also be used as a means for counsel to navigate his or her concurrent representation of both the insurer and the insured. By setting out their respective rights and obligations before suit is instituted, counsel can simplify issues related to allocation of recovery and expenses. Counsel may also need to account for other potential conflicts that may arise, which can be avoided by managing the insured's and the insurer's expectations. In other words, the proration agreement may allow or eliminate future disagreement between the carrier and their insured, which not only benefits counsel in litigating his case, it also avoids a requirement by him to

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[23] **AZ—**Ariz. Admin. Code § 20-6-801(H)(4).

[24] **CA—**Cal. Code of Regs. tit. 10 § 2695.7(q).

choose sides after a recovery is made or expenses need to be paid. Further, because of different recovery theories or other limitations, there is potential for parties to disagree as to when a settlement should be taken or a suit should be dropped. Tied to this is the allocation of expenses incurred, and the expenses that would continue should one party choose to continue with the litigation. If the proration agreement addresses each party's right to settle during the litigation, counsel can avoid a conflict and has also confirmed how the incurred expenses will be split at that point.

One issue that might arise is the calculation of a pro-rata split when one or more of the elements of damages are unliquidated or uncertain. A typical example includes lost profits, which may be the subject of various calculations and expert analysis. Because the amount of lost profits is generally unknown or disputed when litigation begins, the parties to a proration agreement will need to take steps to account for the uncertainty. There are two possible solutions. The parties may agree on the amount of the uncertain damages, limiting the amount that will be included in the proration agreement calculations. Alternatively, the parties may decide not to include the uncertain damages in the proration agreement, requiring the party seeking those damages to bear the cost and expenses associated with their recovery outside of the pro-rata split.

Finally, a well written proration agreement can encourage an insured to participate in litigation. For example, in some instances an insured may have an uninsured loss that, while not insignificant, is somewhat limited by the prospects of recovery versus required litigation expense. A proration agreement that limits the insured's risk, allows for sharing of the risk, and may even require the insurer to front the risk and expense until a recovery, will go a long way in encouraging the insured to participate. By offering the insured a proration agreement, the insurer and subrogating counsel may increase the likelihood that the insured will participate in the litigation. An invested and interested insured is much more likely to fulfill its obligation to support the insurer's subrogation efforts under the policy. It may also allow the insurance company to file the litigation in the name of the insured, which may eliminate or reduce jury bias against the insurance company.

[3] Insurance Policy Provisions

The insured's policy may also address his or her subrogation obligations, the insurer's subrogation rights, and the treatment of uninsured losses, including the recovery of the insured's deductible. An exemplar subrogation provision states:

> Subrogation:
>
> The insured must cooperate in any subrogation proceedings. The company may require from the Insured an assignment of all rights of recovery against any party for loss to the extent of this company's payment.
>
> This company will not acquire any rights of recovery that the Insured has expressly waived prior to the loss. No such waiver will affect the Insured rights under the policy.
>
> Any recovery for subrogation proceedings, less expenses incurred by this company in such proceedings, will be payable to the Insured in the proportion that the amount of:

0020 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:09 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

a) Any applicable deductible; and

b) Any provable uninsured loss:

bears to the entire loss amount.

In this example, the policy addresses the distribution of any recovery, including recovery of the insured's deductible, by applying a proration distribution in relation to the entire loss. Policy language should be reviewed against applicable law and followed to the extent possible unless an enforceable waiver is obtained from the insured.

[4] Recovery of Insured's Deductible

Most types of insurance require the insured to pay a deductible. Depending on the law of the state where the policy is written and the type of insurance, how and when the insurer is required to reimburse its insured for their deductible may depend on application of the concepts discussed above, or be decided purely by statute. Over 20 states now have adopted laws or codes that govern reimbursement of insurance deductibles in the context of subrogation. The statutes vary from state to state, but most often address when the insurer must include the insured's deductible in its demand, how any recovery is going to be split, and what fees and expenses can be shared with the insured.

The following states have statutes that require the deductibles be included in any subrogation demand: Alaska,[25] Arizona,[26] Arkansas,[27] California,[28] Connecticut,[29] Illinois,[30] Iowa,[31] Kentucky,[32] Minnesota,[33] Missouri,[34] Nebraska,[35] Nevada,[36] New Jersey,[37] New York,[38] Ohio,[39] Oklahoma,[40] Oregon,[41] Pennsylvania,[42] Rhode Island,[43]

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[25] **AK—**Alaska Admin. Code tit. 3 §§ 26.080, 26.090.

[26] **AZ—**Ariz. Admin. Code § 20-6-801(H)(4).

[27] **AR—**Ark. Admin. Code 054.00.43-10.

[28] **CA—**Cal. Code Regs. tit 10, § 2695.7.

[29] **CT—**Conn. Gen. Stat. § 38a-351a.

[30] **IL—**215 Ill. Comp. Stat. 5/143b.

[31] **IA—**191 Iowa Admin. Code r. 15.43(507B).

[32] **KY—**806 Ky. Admin. Regs. 12:095 § 7.

[33] **MN—**Minn. Stat. § 72A.201.

[34] **MO—**Mo. Code Regs. Ann. tit. 20 § 100-1.050.

[35] **NE—**210 Neb. Admin. Code 60.009.03.

[36] **NV—**Nev. Admin. Code § 686A.680.

[37] **NJ—**N.J. Admin. Code § 11:3-10.7.

[38] **NY—**N.Y. Comp. Codes R. & Regs. tit. 11, § 216.7.

[39] **OH—**Ohio Admin. Code § 3901-1-54.

[40] **OK—**Okla. Admin. Code § 365:15-3-8.

Utah,[44] Virginia,[45] Washington,[46] and West Virginia.[47]

In addition to whether an insured's deductible must be included in any subrogation demand, some states regulate what expenses, if any, can be deducted from the recovery before the full deductible is provided. For example, Wyoming's statute relating to automobile insurance recovery requires that an insurer seeking subrogation on a paid claim must include the insured's deductible in its claim cannot deduct any expenses from the deductible upon making a recovery.[48] The insurer can only recover once the full deductible that is reimbursed to the insured.[49] If the amount of the deductible exceeds the recovery, the insurer pays the recovery to the insured.[50]

In contrast, a Rhode Island statute requires the insurer to include the first party claimant's deductible, if any, in subrogation demands, but upon recovery the insurer can pay the insured its full deductible, less the insured's pro-rata share of subrogation expenses, if any.[51] The statute continues, however, that the "subrogation expenses, as opposed to the insured's deductible, are subject to proration based on percentage of fault."[52]

It should be noted that most state statutes addressing the requirement to recover a deductible are applicable only to automobile policies. However, some states have either combined or separate statutes that apply to recovery of deductibles for both automobile and property insurance policies.[53]

§ 162.03 Damage to Structures

[1] Overview

Application of the measure of damages to structures is a very important issue in

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[41] **OR—**Or. Admin. R. 836-080-0240.

[42] **PA—**31 Pa. Code § 146.8(c).

[43] **RI—**Code of R.I. Rules 02 030 073, also cited as R.I. Admin. Code 11-5-73:2.

[44] **UT—**Utah Admin. Code r.590-190.

[45] **VA—**14 Va. Admin. Code § 5-400-80.

[46] **WA—**Wash. Admin. Code § 284-30-393.

[47] **WV—**W. Va. Code R. § 114-14-7.

[48] **WY—**Wyo. Stat. Ann. § 26-13-113.

[49] **WY—**Wyo. Stat. Ann. § 26-13-113.

[50] **WY—**Wyo. Stat. Ann. § 26-13-113.

[51] **RI—**Code of R.I. Rules 02 030 073.

[52] **RI—**Code of R.I. Rules 02 030 073.

[53] *See*:

AK—Alaska Admin. Code tit. 3 § 26.090.

CA—Cal. Code Regs. tit 10, § 2695.7.

CT—Conn. Gen. Stat. § 38a-351a.

RI—R.I. Gen. Laws. § 27-8-12.

subrogation claims both as to the amount of recovery and as to the subrogating insurer's burden of proof. The insurer will typically calculate an "Actual Cash Value" or "ACV" amount for the damage, which is based upon the cost of repair or replacement less an applicable depreciation allowance. The insurer will then pay that ACV amount to the insured pending completion of repairs, even under a replacement cost policy. The difference between the ACV amount and the cost of repairs or restoration (known as "Replacement Cost Value" or "RCV") is retained by the insurer as a "holdback." The "holdback" is paid to the insured upon confirmation that the insured has actually committed to expend that amount for repairs.

The insurer ordinarily prefers to avoid a valuation measure of damages in a resulting subrogation action for two reasons. First, a valuation measure of damages may very well lead to a lower amount of recovery. In the case of a total destruction of the insured premises, a market value measure of damages may result in the insured suffering a shortfall in its recovery. In that instance, if the insured has paid full replacement cost, it may very well have paid in excess of market value for the structure, but the recovery will be limited to market value. Second, if the damage is partial and repairable, the insurer prefers to avoid a "valuation" measure of damage because the insurer's proof as to the amount of the damages is generally the cost of repairs that the insurer paid, rather than some hypothetical valuation figure.

[2] Measure of Damages

Where the structure is destroyed, the measure of damages is the value of the structure at the time it is destroyed.[1] The exception to this rule is the "Special Purpose Structure" rule discussed in subsection 162.02[5]. " 'Market value is the amount a willing buyer, who is under no obligation to buy, would pay a willing seller, who is under no obligation to sell."[2] "Market value" is a distinct concept and has been distinguished from a "value to the owner" measure of damage in that with regard to the latter, the "factfinder may consider original cost and cost of replacement, the opinions upon value given by qualified witnesses, the gainful uses to which the property has been put, as well as other facts reasonably tending to shed light on the subject."[3]

A party generally cannot recover both permanent and temporary damages, as they are deemed mutually exclusive.[4] However, sometimes cost to repair the property and

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[1] **CT—**Wasko v. Manella, 865 A.2d 1223, 1229 (Conn. App. Ct. 2003);

PA—Oliver-Smith v. City of Phila. 962 A.2d 728, 731 (Pa. Commw. Ct. 2008);

WA—Thompson v. King Feed & Nutrition Service, Inc., 105 P.3d 378, 383 (Wash. 2005).

[2] **US/TX—**Factory Mutual Ins. Co. v. Alon, 705 F.3d 518, 521(5th Cir. 2013).

[3] **TX—**Control Solutions v. Gharda, USA, Inc. 394 S.W.3d 127, 169 (Tex. App.—Houston [1st Dist.] 2012, review granted).

[4] **TX—**Royce Homes, L.P. v. Humphrey, 244 S.W.3d 570, 582 (Tex. App.—Beaumont, 2008, pet. denied).

0023 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:09 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

the diminished value of the property are not mutually exclusive. "Once a property owner properly pleads and proves that there will be diminished value to the property even after repairs are made, he is entitled to both cost of repair and diminished value damages."[5]

The majority of subrogation cases involve repairable damages to structures. The measure of damage for temporary, repairable damage to structures would seem to be a simple matter. However, courts formulate, reformulate and restate the basic rule in several different ways.

Generally, the measure of damages for damage to a structure is the diminution in market value caused by the damage.[6] While the measure of damage for permanent injuries is the diminution in value, if the damage is temporary, the measure for cost of repair can serve as the measure of damages so long as the cost of repair is less than the diminution in value.[7] Although the measure of damages is diminution in value, restoration costs are permitted as the measure of damages so long as such restoration costs do not exceed the diminution in value.[8] This leads some jurisdictions to articulate the "lesser of" rule, in that the plaintiff may recover the "lesser of" the diminution in value or the cost of repairs.[9] Thus, the exception has swallowed the rule, because few

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[5] **MS—**Harrison v. McMillan, 828 So. 2d 756, 771 (Miss. 2002);

TX—Century 21 Page One Realty v. Naghad, 760 S.W.2d 305, 309 (Tex. App.—Texarkana 1988, no writ).

[6] **AL—**Birmingham Coal & Coke Co. v. Johnston, 10 So. 3d 993, 998 (Ala. 2008);

AZ—A Tumbling-T. Ranches v. Flood Control Dist. of Maricopa County, 217 P.3d 1220, 1239 (Ariz. Ct. App. 2009);

CO—Scott v. County of Custer, 178 P.3d 1240, 1248 (Colo. Ct. App. 2007);

MO—Riddell v. Bell, 262 S.W.3d 301, 304 (Mo. Ct. App. 2008);

OH—Stuckhouse v. Logagate Property Management, 872 N.E.2d 1294, 1296 (Ohio. Ct. App. 2003);

PA—Christian v. Yanoviak, 945 A.2d 220, 222 (Pa. Super. Ct. 2008).

[7] **MA—**Clean Harbors Envtl. Servs. v. Boston Basement Techs., Inc., 916 N.E. 2d 406, 411 (Mass. App. Ct. 2009).

[8] **US/IL—**Normand v. Orkin Exterminating, 193 F.3d 908, 911 (7th Cir. 1999);

US/LA—Banks v. City of New Orleans, 620 F. Supp. 2d 741, 745 (E.D. La. 2008);

AZ—A Tumbling-T. Ranches v. Flood Control Dist. of Maricopa County, 217 P.3d 1220, 1239 (Ariz. Ct. App. 2009);

FL—U.S. Steel v. Benefield, 352 So. 2d. 892, 894–95 (Fla. Dist. Ct. App. 1977);

IL—Peluso v. Singer Gen. Precision, Inc., Link Div., 365 N.E.2d 390, 391 (Ill. App. Ct. 1977);

KY—Newsome v. Billips, 671 S.W.2d 252, 253 (Ky. Ct. App. 1984);

NE—Omega Chemical Co. v. United Seeds, Inc., 560 N.W.2d 820 (Neb. 1997);

[9] **US/IL—**Normand v. Orkin Exterminating Co., Inc., 193 F.3d 908, 911 (7th Cir. 1984);

PA—Christian v. Yanoviak, 945 A.2d 220, 222 (Pa. Super. Ct. 2008);

WA—Thompson v. King Feed & Nutrition Service, Inc., 105 P.3d 378, 383 (Wash. 2005).

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XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

insurers or insureds have any reason to obtain a before and after market value to their property once it has been damaged. The insurer prefers to present the cost of repairs as evidence of the measure of damages.

Cost of repairs can serve as the measure of damage unless such costs are clearly disproportionate to the diminution in value.[10] If repair is feasible and does not cause economic waste, then the plaintiff may recover the cost of repair. Otherwise, the plaintiff is entitled to the decrease in market value caused by the injury.[11] This issue was addressed by a court in Connecticut in *Centimark v. Village Manor Associates, L.P.*:[12]

> [P]rovided, of course, that the cost does not exceed the former value of the property and provided also that the repairs do not enhance the value of the property over what it was before it was damaged . . . . The cost of repairs, therefore, is the proxy for diminution in value caused by damage to the property. Because there are, in effect, alternative measures of damages, the plaintiff need not introduce evidence of both diminution in value and cost of repairs.[13]

It makes sense for the cost of repair damages to serve as a "proxy" for diminution in value. If the market value of a home is $100,000 and it is damaged such that it would cost $10,000 to repair, it is reasonable to conclude that the market value is now $90,000. As noted in *Newsome v. Phillips*:[14]

> [The plaintiffs] did not offer proof of the difference in fair market value of their property immediately before and immediately after the alleged damage, but the fact that the only proof of the difference in the before and after values was to be less than their estimated cost of repair was not the issue. In the absence of evidence to the contrary, it may be presumed that the anticipated cost of repair would reduce the value by an equal amount.[15]

Given that cost of repairs may serve as the measure of damages, but only if it does not exceed diminution in value, the question arises as to plaintiff's evidentiary burden so as to establish a prima facie claim of damages. Does the plaintiff need to introduce evidence as to cost of repairs and also introduce evidence as to diminished value to establish that cost of repairs do not exceed diminished value? Courts routinely hold

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[10] **MO—**Riddell v. Bell, 262 S.W.3d 301, 304 (Mo. Ct. App. 2008);

NJ—St. Louis, LLC v. Final Touch Glass & Mirror, 899 A.2d 1018, 1027–1028 (N.J. Super App. Div. 2006).

[11] **TX—**Hall v. Hubco, Inc., 292 S.W.3d 22, 32 (Tex. App.—Houston [14th Dist.] 2006, pet denied).

[12] **CT—**Centimark v. Vill. Manor Assocs., L.P., 967 A.2d 550, 565 (Conn. App. Ct. 2009).

[13] **CT—***Centimark*, 967 A.2d at 565 (quoting Willow Springs Condominium Ass'n, Inc. v. Seventh BRT Development Corp., 717 A.2d 77 (Conn. 1998).).

[14] **KY—**Newsome v. Billips, 671 S.W.2d 252, 255 (Ky. Ct. App. 1984).

[15] **KY—***Newsome*, 671 S.W.2d at 253 (quoting State Property & Bldg. Com., etc. v. H. W. Miller Constr. Co., 385 S.W.2d 211 (Ky. 1964).

that proof as to diminished value is not an element of the claim.[16] The plaintiff does not have the burden of establishing that the costs of repair do not exceed diminished value of the structure. Rather, the defendant has the burden of demonstrating that the cost of repairs exceeds the diminished value if the defendant wishes to restrict the plaintiff to a value measure of damages.[17]

One decision that is particularly instructive on this issue is *Birmingham Local Coal & Coke Co. v. Johnson*.[18] In this case, the plaintiffs' homes were damaged by blasting operations. The measure of damages in Alabama for damage to real property is diminution in value. Yet the plaintiffs' offered at trial evidence only as to the costs of repair and offered no evidence as to diminution in value. The Court nonetheless held that damages were properly awarded because the defendant did not offer any evidence that the damages exceeded diminution in value.

If proposed repairs are not economically feasible, cost of repairs cannot serve as the measure of damages. For example, when the cost of repairing property damaged by spills of crude oil and saltwater was six times the value of the land, the proper measure of damages was diminished value, not cost of repairs.[19] Thus, the market value of the property serves as a "ceiling" on the damages.[20]

[3] Proving Diminution in Value

Proving diminution in value is a relatively simple process. The plaintiff must typically engage a real estate appraiser to offer an opinion at trial as to the value of the structure before and after the fire.

An area of potential confusion concerns the practicalities of the evaluation as it relates to damage to structures when determining the diminution in value caused by the damage. Is the structure viewed as having its own value, separate and apart from the land on which it sits, or is the evaluation performed on the land with the structure as a component? This issue was addressed by the Supreme Court of Washington in 2005. In *Thompson v. King Feed & Nutrition Service*,[21] the plaintiff's barn was destroyed by a fire caused by spontaneous combustion of wet hay. The plaintiff brought suit against the defendant King Feed & Nutrition Services ("King Feed") to recover for the damages to the barn. At trial, a real estate agent testified that the value of the barn itself was $400,000. The contractor also testified that it cost more than $500,000 to rebuild

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[16] **GA—**Esprit Log and Timber Farm House v. Wilcox, 691 S.E.2d 344, 347 (Ga. Ct. App. 2010);

OH—Martin v. Design Constr. Services, Inc., 902 N.E.2d 10 (Ohio 2009).

[17] **CT—**Centimark Corp. v. Village Manor Assocs., 967 A.2d 550, 565 (Conn. App. Ct. 2009).

[18] **AL—**Birmingham Coal & Coke, Co. v. Johnson, 10 So. 3d 993, 998 (Ala. 2008).

[19] **TX—**North Ridge Corp. v. Walraven, 957 S.W.2d 116, 119 (Tex. App.—Eastland, 1997, writ ref'd).

[20] **US/NE—**Trimble v. ASARCO, Inc., 83 F. Supp. 2d 1034, 1040 (D. Neb. 1999).

[21] **WA—**Thompson v. King Feed & Nutrition Serv., 105 P. 3d 378 (Wash. 2005).

the barn. King Feed, on the other hand, called a real estate associate who estimated that the barn added only $100,000 to $110,000 overall value to the real estate.

After a verdict in favor of the plaintiff, King Feed argued on appeal that the proper measure of damages was the diminished value of the property as a whole after the fire rather than the lost value of the barn itself, and under the "lesser than" rule, the plaintiff should not have been able to recover more than the diminished value of the land as a whole. The Supreme Court of Washington disagreed, and held that the "lesser than" rule had no application to circumstances involving a complete destruction of a building. The court noted "[T]he 'lesser than' rule is limited to situations where the property is damaged incapable of repairs. None of these cases support the contention that the 'lesser than' rule should be applied when a building is completely destroyed."[22] Importantly, the court also noted that for purposes of determining the lost value of the building, the structure must be valued separately rather than determining the diminished value of the land as a whole.[23]

[4] Proving Costs of Repair

[a] Overview

Proving property damages at trial can be a painstaking endeavor. Subrogation cases typically require multiple witnesses to prove property damages. Generally, an insurance adjuster will testify. The insurer may also retain a consultant to review the property damage claim by the insured to determine whether the cost to repair such damage is fair and reasonable. While some minor losses may only require the involvement of one specialty repair contractor, typically the insured will be required to hire a general contractor to coordinate the repairs and retain various subcontractors to perform the repairs. The issue at time of trial is which of these individuals need to be called as witnesses in order to prove the damages.

[b] The Adjuster and General Contractor as an Expert

A plaintiff may attempt to have his adjuster or general contractor serve as an "expert" and rely upon Rule 703 of the Federal Rules of Evidence (or its state counterpart) that the expert reasonably relied upon information and estimates from subcontractors and others as to the cost to repair certain damage. This is a very questionable undertaking. While the adjuster or general contractor may qualify as an expert, and while Federal Rule of Evidence 703 does allow an expert to rely upon facts and data which is not otherwise admitted into evidence, if the expert reasonably relies upon the facts and data in formulating his opinion, that does not necessarily apply to this situation. The various information that the expert relies upon in this instance are the estimates and/or repairing voices of subcontractors, which are in and of themselves "opinion" as opposed to mere fact.

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[22] **WA—***Thompson*, 105 P.3d at 382.

[23] **WA—***Thompson*, 105 P.3d at 383.

0027 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:09 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

Courts generally will not permit a valuation expert to simply "parrot" the opinion of another witness who does not testify. In *In re James Wilson Associates*,[24] an architect attempted to testify as to the physical condition of a building as reported to him by an engineer. The court rejected such testimony, noting:

> The fact that inadmissible evidence is the (permissible) premise of the expert's opinion does not make that evidence admissible for other purposes, purposes independent of his opinion. . . . If for example the expert witness (call him A) basis's opinion in part on a fact (call it X) that the parties lawyer told him, the lawyer cannot in closing argument tell the jury "see, we proved X through our expert, witness A." That was the kind of handoff attempted in this case. The issue was the state of the building, and the expert who evaluated that state—the consulting engineer—was the one who should have testified. The architect could use what the engineer told him to offer an opinion within the architect's domain of expertise, but he could not testify for the purpose of vouching for the truth of what the engineer had told him—of becoming in short the engineer's spokesman. Why Metropolitan did not call the engineer as a witness is unexplained, but it is improper to use an expert witness as a screen against cross-examination (though the other side could always call him as an adverse witness and cross-examine him).[25]

In contrast, in *Factory Mutual Insurance Co. v Alon USA, LP*,[26] an appraisal expert testified regarding the fair market value of certain equipment. In doing so, he relied upon information from the insured regarding the remaining useful life of the equipment. The expert "appears merely to have adopted the depreciation number provided by [the insured's] employee; it is not clear how he used his past experience as an appraiser to deem the employee's estimate reliable."[27] The *Factory Mutual* court permitted the testimony because "in so far as [the expert] educated and interviewed [the insured's] employees [the expert] did more than just repeat information gleaned from external sources . . . . Furthermore [the expert was] demonstrating his familiarity with the appraisal of heavy industrial plants broadly . . . ."[28] The court thus held that the District Court did not abuse its discretion in admitting the testimony.

Therefore, a general contractor who has no idea whether a particular subcontractor's work is in fact necessary, or has no idea as to the reasonableness of the subcontractor's charges, cannot merely serve as the conduit for that subcontractor's opinion. The better practice is to call the individual subcontractors to testify as to the fairness and reasonableness of their estimates and/or invoices.

The role of the insurance adjuster is also limited. The insurance adjuster may or may not have sufficient qualifications and background to be able to offer an opinion as to

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[24] **US/IL—***In re* James Wilson Assocs., 965 F 2d 160 (7th Cir. 1992).

[25] **US/IL—***James Wilson*, 965 F.2d at 173 (internal citations omitted).

[26] **US/TX—**Factory Mutual Ins. Co. v Alon USA, LP, 705 F.3d 518 (5th Cir. 2013).

[27] **US/TX—***Factory Mutual*, 705 F.3d at 724–725.

[28] **US/TX—***Factory Mutual*, 705 F.3d at 724–725.

0028 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:10 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

whether the repairs necessitated by the damages were fair and reasonable. In most instances, that information is beyond the expertise of the insurance adjuster such that the insurance adjuster can only testify that he paid certain amounts because he received either estimates or actual invoices from the insured in those amounts, and either he, a consultant retained by him, or both he and the consultant reviewed the invoices and found them to be reasonable. That testimony is of limited value at trial. That testimony may not even be admissible, and equally important, may not support a verdict if that is the only testimony as to damages.

In contrast, the insurance adjuster serves an important role if suit is brought in the name of the insurer as opposed to the insured. In subrogation cases, the insurer must prove that it actually issued an insurance policy to the insured, that the insurance actually paid for the damages, the methodology and reasons why it paid certain categories of damages and that the insurer is thus subrogated to the extent of those payments. In some instances the insurer must also prove that the damages were in fact covered under the policy. The insurance adjuster serves an important function for this purpose. The insurance adjuster who handled the claim will be required to testify at trial if suit is brought in the name of the insurer so as to satisfy this vital element of proof. Beyond that, the insurance adjuster often cannot provide sufficient proof to support a damages claim.

Given that the insurance adjuster probably cannot provide sufficient testimony to support a damages claim, it will be necessary for the plaintiff to call as witnesses the actual contractors or consultants who either provided damages estimates or actually performed the repairs. It is therefore often necessary to call the subcontractors first, have them testify as to the fairness and reasonableness of the repairs performed and offer into evidence estimates or invoices prepared by those contractors. The plaintiff may then call the general contractor to testify as to his role in the total amount charged by various subcontractors, together with any additional charges of the general contractor itself. The plaintiff can then call the consultant retained by the insurance company, who reviewed the charges submitted by the insured and confirmed that in his opinion they were reasonable. Last, the plaintiff can call the insurance adjuster to testify as to his review of the damages, the amount paid by the insurance carrier, and the reasons those amounts were paid. Failure to follow this order of witnesses can result in witnesses being precluded from offering testimony as to certain amounts of damages if they are unqualified to offer testimony as to the necessity and reasonableness of those costs.

[c] Proof of Repairs by Invoices

Another method often used is to attempt to introduce invoices from the various subcontractors and trades as "business records" so that the estimates and invoices serve as the proof of damages rather than opinion testimony from a live witness. The business record rule is an exception to the hearsay rule and provides that evidence of regularly conducted activities, made at or near the time of the events, kept in regular

course of business, made as a regular practice, and sponsored by a custodian or qualified witness are admissible.[29]

The problem with using the insurance adjuster or general contractor as a sponsoring witness to introduce invoices from various subcontractors as "business records" is twofold. First, the subcontractor invoices are not regularly kept records of the sponsoring witness who is testifying. Instead, a third party maintains them and then provides them to the witness. For example, if the general contractor testifies as to damages and attempts to introduce subcontractor invoices as business records, it is doubtful that he can satisfy the requirements of the business record rule because they are not business records of the general contractor. While under some circumstances the courts will permit this testimony, the witness must be able to testify that his business determined the accuracy of the information generated by the first business."[30]

Moreover, there is the issue of hearsay within hearsay. Pursuant to Federal Rule of Evidence 805, if there is hearsay within the hearsay, each component of the hearsay must satisfy a hearsay exception.[31] Therefore, if the subcontractor invoice contains the subcontractor's opinion as to the costs of repair, the subcontractor's invoice may not be admissible even if the general contractor can otherwise establish that the subcontractor invoice has become a business record of the general contractor. A more sound practice is to call the subcontractor himself to testify as to his activities, establish the business record qualifications of his invoices, and offer an opinion as to the necessity and reasonableness of the cost of repairs.

[5] Special Purpose Building Rule

The special purpose building rule is of particular importance in subrogation matters because insurers routinely issue policies that reimburse the insured based upon the cost of repair rather than market value. An insured may insure a bridge, a church, a TV antenna tower, etc. in such a manner that the insurer is required to reimburse the insured for the costs to replace the structure even though the structure had no market value or the insurer was forced by its policy to pay in excess of any market value.

A common issue arises when a structure is damaged which does not have a typical "market value." This is very similar to the "value to owner" concept with regard to personal property such as clothing, etc. The item does not have a ready market value, but nonetheless has very real value to the owner. The classic example of a specialty purpose building is a church. While churches certainly have some market value, they do not have a ready market value as does a home. If the church is destroyed, the measure of damages for total destruction of the property would typically be market value. However, it would be patently unfair to restrict the church congregation to

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[29] **US—**Fed. R. Evid. 803(6).

[30] **TX—**Martinez v. Midland Credit Corp., 250 S.W.3d 481, 485 (Tex. App.—El Paso, 2008, no pet.)

[31] **US—**Fed. R. Evid. 805.

recovery only of the market value of the church if the market value is in fact far less than the intrinsic value of the church to the congregation.

This issue has led to the development of the "special purpose building rule," which is the law in the majority of jurisdictions. This issue was addressed in the landmark case *Trinity Church of Boston v. John Hancock*.[32] That action addressed the proper measure of damages related to damage to Trinity Church in Boston caused by construction of the John Hancock Tower located adjacent to the church. Excavation at the John Hancock site resulted in differential settlement of the church foundation. The measure of damages for property damage in Massachusetts was typically diminution in value. However, the Supreme Judicial Court of Massachusetts recognized that was not the proper measure of damages relative to the church. The court summarized the Specialty Building Rule as follows:

> The general rule for measuring property damages diminution in market value. . . . However, "market value does not in all cases afford correct measure of indemnity, and is not therefore a 'universal test.' " . . . For certain categories of property, termed "special-purpose property" (such as the property of nonprofit, charitable or religious organizations), there will not generally be an active market from which the diminution in market value may be determined. The parties agree that Trinity Church falls within the definition of special-purpose property and that the damage to the church should not be measured on the basis of fair market value.
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> In such cases, this court has been cognizant of the need for greater flexibility in the presentation of evidence relating to damages and has provided "[s]pecial opportunities for proof of value . . . where it is felt that there is no market value . . . . The courts in these cases . . . may be doing no more than recognizing that more complex and resourceful methods of ascertaining value must be used where the property is unusual or specialized in character and where ordinary methods will produce a miscarriage of justice."
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> In a number of situations involving special-purpose property, the cost of reproduction less depreciation has been utilized as an appropriate measure of damages. . . .
>
> Replacement or restoration costs have also been allowed as a measure of damages in other contexts where diminution in market value is unavailable or unsatisfactory as a measure of damages. . . . Where expenditures to restore or to replace pre-damaged conditions are used as the measure of damages, a test for reasonableness is imposed. Not only must the cost of replacement reconstruction be reasonable, the replacement or reconstruction itself must be reasonably necessary in light of the damage inflicted by a particular defendant. In some cases "to make such a restoration would be an uneconomical and improper way of using the property" and "might involve a very large disproportionate expense to relief from the consequences of a slight injury."[33]

In light of this refined measure of damages involving special use property, the

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[32] **MA—**Trinity Church in the City of Boston v. John Hancock Mut. Life Ins. Co., 502 N.E.2d 532 (Mass. 1987).

[33] **MA—***Trinity Church*, 502 N.E.2d at 535–556.

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XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

Massachusetts Supreme Judicial Court held that Trinity Church was entitled to recover for cost of repair damages even though those repair damages might well have to be incurred well into the future.

While the classic example of special use property is a church, courts have invoked the special use property doctrine for television towers,[34] bridges,[35] and other similar property[36] when the property did not have a ready market value and the plaintiff had a particular reason to repair the property.

The most substantial body of law regarding the specialty purpose building rule is in New York. In order for a structure to qualify as a specialty purpose building, it must be: "(1) unique and specially built for the purpose for which it was designed, (2) the improvement must have been designed for a special use and must be so specially used; (3) there must be no market for the property and no sales of property for such use; and (4) the improvement must be an appropriate improvement at the time of the injury and its use must be economically feasible and reasonably expected to be replaced."[37]

An issue that frequently arises in special use property cases is whether depreciation must be deducted from the measure of damages. Philosophically, given that the very underpinnings of the special use property doctrine are that the plaintiff is entitled to repair the property rather than find other, similarly depreciated property, it would seem that depreciation would not be appropriate. However, courts have required a reduction for depreciation if the award of full restoration costs would result in an obvious and substantial betterment to the plaintiff. For example, in *General Services v. U.S. Mineral Products, Inc.*,[38] the court required an adjustment to the replacement cost of a government office building where the replacement structure provided a substantially new structure and would have resulted in betterment to the plaintiff. In contract, in *Boston Old Colony Ins. Co. v. Tiner,*[39] the court held that there was no reason to reduce replacement cost for depreciation when a television tower had significant useful life remaining such that there was no indication that the plaintiff benefitted from the tower's collapse.

The specialty use property exception has also sometimes been applied where

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[34] **US/LA—**Boston Old Colony Ins. v. Tiner Associates, Inc., 288 F.3d 222, 231–232 (5th Cir. 2002).

[35] **IN—**Warrick County v. Waste Management of Evansville, 732 N.E.2d 1255, 1260 (Ind. Ct. App. 2000).

[36] **MO—**Leonard Missionary Baptist Church v. Sears Roebuck and Co., 42 S.W.3d 833, 837 (Mo. 2001).

[37] **US/NY—***In re* Sept. 11 Litigation, 590 F. Supp. 2d 535, 542 (S.D.N.Y. 2008); Heidorf v. Town of Northumberland, 985 F. Supp. 250, 261 (N.D.N.Y. 1997);

NY—*In re* County of Suffolk, 392 N.E.2d 1236 (N.Y. 1979) (quoting Matter of Nassau County (Colony Beach Club of Lido), 349 N.Y.S.2d 422, 426 (N.Y. App. Div. 1973), aff'd, 353 N.E.2d 849 (N.Y. 1976)).

[38] **PA—**Pa. Dept. of General Services v. U.S. Mineral Products, Inc., 898 A.2d 590, 599 (Pa. 2006).

[39] **US/LA—**Boston Old Colony Ins. Co. v. Tiner, 288 F.3d 222 (5th Cir. 2002).

homeowners have attachment to their long-time personal residences and they are entitled to recovery restoration costs, even when that "is disproportionate to the underlying value of the home."[40] However, merely because the plaintiff claims that the property has special value to the owner, does not make that an issue which must be submitted to the jury. In *Oliver-South v. City of Philadelphia,*[41] the court held that it was error for the trial court to submit to the jury an instruction that provided that the plaintiff could recover the cost of repairs or the "special value to the plaintiff, whichever is greater . . ." when the plaintiff had only recently purchased the property and there was no evidence that the plaintiff had expended any significant funds to repair or rehabilitate the property.

[6] Loss of Use Damages

Generally, loss of use damages are recoverable only when the damage to the property is temporary.[42] If the damage to the property is permanent or if the property is totally destroyed, loss of use damages are typically not available on the assumption that the plaintiff should have replaced the destroyed property with new property and thus had no loss of use.

More recently, courts have taken a more realistic view of such loss of use damages. For example, in *Gateway Foam Insulations, Inc. v. Jokerst Paving & Contracting, Inc*.,[43] the plaintiff's equipment was destroyed by the defendant. The equipment was unique, and therefore it took some time to replace the equipment. The plaintiff sued for lost profits, claiming that lost profits were appropriate under the circumstances because it took some time to replace the specialized equipment. The court held that under the circumstances, loss of use damages in the form of lost profits were recoverable given that the plaintiff reasonably could not replace the property immediately. The rationale behind denying recovery of loss of use damages in the case of total destruction is typically that the plaintiff is deemed to be fully recompensed once he replaces his property. As noted by the *Gateway* court, that is because "the owner of the property is fully compensated upon receipt of the expenses of replacement."[44] However, the *Gateway* court also noted "there is a growing trend to permit recovery of lost profits even where property is replaced if there is a reasonable delay in the replacement of the property and awarding loss of use damages will not result in a windfall to the

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[40] **US/LA—**Pauls v. New Orleans City, 620 F. Supp. 2d 741, 745–746 (E.D. La. 2009);

LA—Holzenthal v. Sewerage and Water Dist. of New Orleans, 950 So. 2d 55, 79 (La. Ct. App. 2007).

[41] **PA—**Oliver—South v. City of Phila., 962 A.2d 728, 732 (Pa. Commw. Ct. 2008).

[42] **MO—**Gateway Foam Insulations, Inc. v. Jokerst Paving & Contracting, Inc., 279 S.W.3d 179, 185 (Mo. 2009).

[43] **MO—***Gateway*, 279 S.W.3d at 185.

[44] **MO—***Gateway*, 279 S.W.3d at 185 (quoting Stark Brothers Nurseries & Orchards Co. v. Wayne Daniel Truck, Inc. 718 S.W.2d 204, 206 (Mo. Ct. App. 1986).

0033 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:11 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

plaintiff."[45] If the property cannot be replaced without some delay, that rationale does not exist and the plaintiff should be able to recover loss of use profits in order to be fully compensated for his damages.[46] If the property can be repaired, the plaintiff is typically entitled to recover for loss of use during the period of repairs. The loss of use damages are typically limited to the time period it reasonably takes to repair the property.[47] Generally, for purposes of loss of use damages, the plaintiff's inability to have property fixed for financial or other reasons will be taken into account when determining the reasonableness of time required to repair the property.[48]

§ 162.04 Damage to Personal Property

[1] Measure of Damages

Personal property consists of movable items and includes everything from automobiles to animals and retail merchandise to the contents in a home—furniture, appliances, clothing, and personal effects. Depending on the severity of damage to the property, the recoverable damages in a subrogation action are measured by the loss or reduction in the property's value or by the cost to repair the property plus any damages for either loss of use of the property or loss of profits while it is being repaired.

Generally, the measure of damages for personal property that is destroyed is the difference in fair market value of the property immediately before and immediately after the loss occurred.[1] Other values, including replacement cost, actual or intrinsic value, and sentimental value, can be recoverable in appropriate cases.

When personal property is damaged but not destroyed, a plaintiff can typically recover the cost to repair the property, as well as damages for the loss of use of the property while it is being repaired. If the loss of use of the property adversely affects the plaintiff's business, the plaintiff may be entitled to damages for lost profits.

[2] Fair Market Value of Destroyed Property

Fair market value is typically defined as the amount that a willing buyer would pay a willing seller when neither is obligated to buy or sell.[2] It is the primary method of valuation when it is not economically feasible to repair the property or the property is lost. Certain types of property, such as retail merchandise, special use items, household furnishings, appliances, clothing, personal effects, family heirlooms, and memorabilia, should be valued using other methods.

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[45] **MO—***Gateway*, 279 S.W.3d at 185.

[46] **MO—***Gateway*, 279 S.W.3d at 185.

[47] **MO—***Gateway*, 279 S.W.3d at 185.

[48] **MO—***Gateway*, 279 S.W.3d at 185.

[1] **US/NJ—**Guido v. Hudson Transit Lines, 178 F.2d 740, 742 (3d Cir. 1950);

NY—Gass v. Agate Ice Cream, 190 N.E. 323 (N.Y. 1934);

TX—Thomas v. Oldham, 895 S.W.2d 352, 359 (Tex. 1995).

[2] **TX—**Exxon Corp. v. Middleton, 613 S.W.2d 240, 246 (Tex. 1981).

0034 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:11 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

In most first-party claims, adjusters calculate damages based on replacement cost or actual cash value, which is replacement cost less depreciation. Some courts have found that actual cash value is synonymous with or constitutes some evidence of fair market value,[3] but that is not always the case and the typical way an insurer calculates actual cash value (replacement cost less depreciation) may not be equivalent to fair market value in a third-party subrogation action.[4]

In a subrogation action, the amount paid by the insurance company, without additional evidence, is typically insufficient to establish the fair market value of the property.[5] Additional evidence can be in the form of opinion testimony from the owner of the property, the adjuster who evaluated and calculated the damages in the first-party claim, or a qualified appraiser. Other evidence can include appraisals, photographs depicting the condition of the property both before and after the loss, and estimates of the cost to repair the property. The purchase price of the property may also be relevant, especially if the property was recently purchased or when considered along with its age, use, obsolescence, and condition at the time of the loss.[6] Evidence of sales price may constitute some evidence of fair market value after a loss occurs, as long as the sale was not a forced sale or otherwise out of the ordinary,[7] but an unaccepted offer to purchase or sell property will not typically constitute evidence of

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[3] **CA—**Cheeks v. California Fair Plan Assn., 61 Cal. App. 4th 423, 426 (1998);

FL—Am. Reliance Ins. Co. v. Perez, 689 So. 2d 290, 291 (Fla. Dist. Ct. App. 1997) (synonymous);

MO—Warren Davis Props. V, L.L.C. v. United Fire & Cas. Co., 4 S.W.3d 167, 173 (Mo. Ct. App. 1999) (synonymous) (citing DeWitt v. Am. Family Mut. Ins. Co., 667 S.W.2d 700, 708 n.6 (Mo. banc 1984); Pannell v. Mo. Ins. Guar. Ass'n, 595 S.W.2d 339, 355 (Mo. Ct. App. 1980));

NC—Surratt v. Grain Dealers Mut. Ins. Co., 328 S.E.2d 16, 20 (N.C. Ct. App. 1985) (synonymous);

NE—Olson v. Le Mars Mut. Ins. Co. of Iowa, 696 N.W.2d 453, 458 (Neb. 2005) (synonymous);

TX—Adams v. State Farm Mut. Auto. Ins. Co., 264 S.W.3d 424, 428 (Tex. App.-Dallas 2008, pet. denied) (some evidence); Guar. County Mut. Ins. Co. v. Williams, 732 S.W.2d 57, 60 (Tex. App.-Amarillo 1987, no writ) (synonymous).

[4] **IL—**Smith, for Use of Inter-Ocean Cas. Co., v. Allemannia Fire Ins. Co. of Pittsburgh, 219 Ill. App. 506, 513 (Ill. App. Ct. 1920) ("actual cash value means reproduction value less depreciation for age and not market value").

[5] **TX—**Hartford Ins. Co. v. Jiminez, 814 S.W.2d 551, 552 (Tex. App.-Houston [1st Dist.] 1991, no writ) (citing Waples-Platter Co. v. Commercial Standard Ins. Co., 294 S.W.2d 375, 376 (Tex. 1956)).

[6] **TX—**Am. Jet, Inc. v. Leyendecker, 683 S.W.2d 121, 127–28 (Tex. App. 1984); Burris v. Krooss, 563 S.W.2d 875, 879 (Tex. Civ. App. 1978).

[7] **TX—**Flukinger v. Straughan, 795 S.W.2d 779, 790 (Tex. App.—Houston [14th Dist.] 1990, writ denied); Gulf, C. & S. F. R. Co. v. Hillis, 320 S.W.2d 687, 691 (Tex. Civ. App.-Waco 1959, no writ). *Cf.* SPT Fed. Credit Union v. Big H Auto Auction, Inc., 761 S.W.2d 800, 801–802 (Tex. App.—Houston (1988) (price at which property sold in foreclosure sale is not evidence of fair market value because sale is not a free one between willing buyer and willing seller); Price v. Gulf Atlantic Life Ins. *Co.*, 621 S.W.2d 185, 187 (Tex. Civ. App.—Texarkana 1981, writ ref'd n.r.e.) (same)).

its fair market value.[8]

Adjusters and appraisers usually will have specialized knowledge based on their experience, training, or education that will allow them to provide opinion testimony that will help the trier of fact understand the evidence and determine the fair market value of the damaged property. As such, they should be designated as expert witnesses and vetted to make sure their opinions are admissible under the applicable rules of evidence. In order for a property owner's opinion as to fair market value to be admissible, the owner must testify about matters within the owner's knowledge and establish familiarity with the market value.[9] No matter who is offering opinion testimony about fair market value, the testimony should show that the opinion specifically refers to the fair market value of the property and not some other value.

These means of proving recoverable damages are generally applicable to the alternative methods of valuation discussed below.

[3] Replacement Cost for Retail Merchandise and Special Use Property

In losses involving retail merchandise and special use property that has no market value, the applicable measure of damages is the property's replacement cost.

When dealing with retail merchandise, assuming the merchandise was in good/like new condition at the time of loss, replacement cost generally equates to the fair market value of the property.[10] The market that determines the retailer's recoverable damages is the market in which the retailer would go to replace its merchandise.

If a plaintiff can establish that the lost or destroyed property did not have a fair market value but is replaceable, then the proper measure of damages is the cost to replace the property reduced by any betterment that might result from the replace-

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[8] **TX—**Young v. Qualls, 279 S.W.3d 670, 676 (Tex. App.—Amarillo 2005), *review granted, judgment rev'd*, 223 S.W.3d 312 (Tex. 2007) (citing Hanks v. Gulf, Colorado & Santa Fe Ry. Co., 320 S.W.2d 333, 336–337 (Tex. 1959); Lee v. Lee, 47 S.W.3d 767, 785 (Tex. App.—Houston [1st Dist.] 2001, pet. denied)).

[9] **TX—**Porras v. Craig, 675 S.W.2d 503, 504–505 (Tex. 1984) (citing Coker v. Burghardt, 833 S.W.2d 306, 307 (Tex. App.—Dallas 1992, writ denied)).

[10] **US/KY—**Rudd Constr. Equipment Co. v. Clark Equipment Co., 735 F.2d 974, 984–985 (6th Cir. 1984);

US/MO—Chevron Chem. Co. v. Streett Indus., Inc., 534 F. Supp. 801, 803 (E.D. Mo. 1982);

US/WI—United States v. Crown Equip. Corp., 86 F.3d 700, 710–711 (7th Cir. 1996);

AR—Whaley v. Crutchfield, 294 S.W.2d 775, 779 (Ark. 1956);

MO—Stark Bro's Nurseries & Orchards Co. v. Wayne Daniel Truck, Inc., 718 S.W.2d 204, 205–206 (Mo. Ct. App. 1986);

NC—Kaplan v. Winston-Salem, 209 S.E.2d 743, 745 (N.C. 1974);

NY—Dubiner's Bootery, Inc. v. Gen. Outdoor Adver. Co., 200 N.Y.S.2d 757 (N.Y. App. Div. 1960).

ment.[11] Examples of property that does not have a fair market value include dies and molds specially designed and manufactured in order to fabricate plastic handles and knobs for electrical appliances,[12] a crude oil storage tank,[13] and a gold leaf professional sign advertising a law office.[14] These types of property all have a special use and would have little value, if any, to someone other than the owner.

[4] Actual Value to the Owner for Household Goods

In losses involving household furnishings, appliances, clothing, and other personal effects, the appropriate measure of damages is the actual value of the property to the owner given the condition it was in when the loss occurred, excluding any fanciful or sentimental considerations.[15] Household goods are generally considered not to have a true fair market value.[16] While an argument can be made that a market exists for secondhand goods, part of the loss the owner sustains in these cases is being deprived of property that is especially adapted to the owner's use. Certain items that could be considered household goods and personal effects, such as golf clubs, pianos, and poker chips, may still be valued by some courts pursuant to their market value because they are not necessary for the enjoyment of the home and their value to the owner is not more than their value in the secondhand market.[17]

This method of valuation is necessarily dependent on the property owner's testimony as to the value of the property to the owner. Other evidence that can help support the property's value includes the condition of the property when the loss

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[11] **TX—**Shaw Tank Cleaning Co. v. Texas Pipeline Co., 442 S.W.2d 851, 854–855 (Tex. Civ. App. 1969), writ refused NRE (Apr. 22, 1970).

[12] **NY—**Cutler-Hammer, Inc. v. Troy, 126 N.Y.S.2d 452, 453 (N.Y. App. Div. 1953).

[13] **TX—**Shaw Tank Cleaning Co. v. Texas Pipeline Co., 442 S.W.2d 851 (Tex. Civ. App. 1969), writ refused NRE (Apr. 22, 1970).

[14] **TX—**Pringle v. Nowlin, 629 S.W.2d 154, 155 (Tex. App. 1982), writ refused NRE (June 30, 1982).

[15] **AZ—**Devine v. Buckler, 603 P.2d 557, 558 (Ariz. Ct. App. 1979);

AR—Cecil v. Headley, 373 S.W.2d 136, 140–141 (Ark. 1963);

CT—Duka v. Hotel Associates, Inc., 185 A.2d 86, 87 (Conn. Cir. Ct. 1962);

MS—McManus v. Temple, 195 So. 2d 830, 832 (Miss. 1967);

OH—Employers' Fire Ins. Co. v. United Parcel Serv. of Cincinnati, 99 N.E.2d 794, 796–797 (Ohio Ct. App. 1950);

OK—Joe Hodges Transfer & Storage v. Keeffe, 115 P.2d 251, 252 (Okla. 1941);

SC—Nelson v. Coleman Co., 155 S.E.2d 917, 921 (S.C. 1967);

TX—Gulf States Utilities Co. v. Low, 79 S.W.3d 561, 566 (Tex. 2002).

[16] **AZ—**Devine v. Buckler, 603 P.2d 557, 558 (Ariz. Ct. App. 1979);

DE—Phillips v. Delaware Power & Light Co., 201 A.2d 160, 161 (Del. Super. Ct. 1964);

TX—Ricks v. Smith, 204 S.W.2d 12, 15 (Tex. Civ. App. 1947), writ refused NRE.

[17] **KY—**Union Light, Heat & Power Co. v. Heving, 62 S.W.2d 789, 791 (Ky. 1933).

0037 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:11 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

occurred, its original cost, age, use, replacement cost, and anything else that bears on its value, such as what it would cost to actually go out and spend the time and money to replace the property.[18]

Invariably, defendants will argue that replacement cost should not be used to value household goods because it would represent an economic gain to the plaintiff. However, the measure of damages for personal property is ultimately up to the trier of fact, who has discretion to award damages within the range of evidence presented at trial.[19]

[5] Sentimental Value

Sentimental value damages will generally come into play in subrogation actions only when the insured is also pursuing a claim for uninsured losses. While most courts exclude fanciful or sentimental considerations when valuing personal property, special rules may apply when the property's primary value is sentimental.[20] For example, damages for irreplaceable family heirlooms, such as a grandmother's wedding veil, grandfather's pistol, great-grandmother's jewelry, great-great-grandmother's handmade bedspreads, and other items going back several generations, may factor in the feelings of the owner for such property.[21]

As with claims for actual value damages, owner testimony is essential in claims in which the property owner is seeking sentimental value damages. The property owner should be prepared to explain the history of the property and why the owner has a special connection to the property. Even though the owner considers the property to be irreplaceable, the owner should also provide a reasonable dollar amount for the sentimental value that potential jurors will not balk at.

[6] Cost of Repair and Loss of Use or Lost Profits

When personal property is damaged and capable of being repaired, a plaintiff may

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[18] **MS—**McManus v. Temple, 195 So. 2d 830, 832 (Miss. 1967);

RI—DeSpirito v. Bristol Cnty. Water Co., 227 A.2d 782, 784 (R.I. 1967);

TX—Allstate Ins. Co. v. Chance, 590 S.W.2d 703, 704 (Tex. 1979).

[19] **AR—**Zhan v. Sherman, 913 S.W.2d 776, 779 (Ark. 1996);

TX—Gulf States Utilities Co. v. Low, 79 S.W.3d 561, 566 (Tex. 2002).

[20] **FL—**Carye v. Boca Raton Hotel & Club Ltd. P'ship, 676 So. 2d 1020, 1021 (Fla. Dist. Ct. App. 1996);

IN—Campins v. Capels, 461 N.E.2d 712, 721 (Ind. Ct. App. 1984) (allowing damages based on sentimental value attached to auto racing championship rings which were destroyed through another's criminal act);

MO—Shewalter v. Wood, 183 S.W. 1127, 1128 (Mo. Ct. App. 1916);

TX—City of Tyler v. Likes, 962 S.W.2d 489, 497 (Tex. 1997);

WI—Harvey v. Wheeler Transfer & Storage Co., 277 N.W. 627, 629 (Wis. 1938).

[21] **TX—**Strickland v. Medlen, 397 S.W.3d 184, 189, 192 (Tex. 2013); Brown v. Frontier Theatres, Inc., 369 S.W.2d 299, 304–305 (Tex. 1963).

0038 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:11 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

be entitled to cost of repair damages in a subrogation action.[22] To recover cost of repair damages, the plaintiff needs to establish the reasonable cost of the repairs necessary to restore the property to its former condition.[23] Cost of repair damages may be limited if the repair costs exceed the value of the property prior to the loss or the diminution in market value of the property resulting from the loss.[24]

While receipts and similar documents are generally admissible to show what someone actually paid for repairs, they are typically not sufficient to establish that the reasonableness and necessity of the repair costs.[25] Testimony from adjusters, property owners, and service providers should be used to establish the reasonableness and necessity of the repair costs.

When cost of repair damages are recoverable, so are damages for the loss of use of the property during the period of time reasonably required to repair the property.[26] Even when property is totally destroyed, some jurisdictions may allow loss of use damages during the period of time reasonably required to obtain a suitable replacement.[27]

Loss of use damages are normally measured by the reasonable rental value of

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[22] **FL—**Airtech Serv., Inc. v. MacDonald Constr. Co., 150 So. 2d 465, 466 (Fla. Dist. Ct. App. 1963);

NE—Chlopek v. Schmall, 396 N.W.2d 103, 110 (Neb. 1986);

NJ—Parisi v. Friedman, 46 A.2d 808, 808 (N.J. 1946);

NY—Gass v. Agate Ice Cream, 190 N.E. 323, 324 (N.Y. 1934);

PA—Holt v. Pariser, 161 Pa. Super. 54 A.2d 89, 91 (Pa. Super. Ct. 1947);

TX—Riddell v. Mays, 533 S.W.2d 910, 911 (Tex. Civ. App. 1976).

[23] **NY—**Gass v. Agate Ice Cream, 190 N.E. 323, 324 (N.Y. 1934);

TX—Milby Auto Co. v. Kendrick, 8 S.W.2d 743, 744 (Tex. Civ. App. 1928), writ dismissed w.o.j. (Jan. 30, 1929).

[24] **IA—**Long v. McAllister, 319 N.W.2d 256, 261 (Iowa 1982);

NJ—Parisi v. Friedman, 46 A.2d 808, 808 (N.J. 1946);

NY—Gass v. Agate Ice Cream, 190 N.E. 323, 324 (N.Y. 1934);

OH—Allstate Ins. Co. v. Reep, 454 N.E.2d 580, 581 (Ohio Ct. App. 1982).

[25] **TX—**McGinty v. Hennen, 372 S.W.3d 625, 627–628 (Tex. 2012); Allright, Inc. v. Lowe, 500 S.W.2d 190, 191–192 (Tex. Civ. App. 1973).

[26] **KS—**Warren v. Heartland Auto. Servs., Inc., 36 Kan. App. 2d 758, 765, 144 P.3d 73, 79 (Kan. Ct. App. 2006);

NY—Gass v. Agate Ice Cream, 190 N.E. 323, 324 (1934);

OH—Hayes Freight Lines v. Tarver, 73 N.E.2d 192, 193 (Ohio 1947);

TX—Riddell v. Mays, 533 S.W.2d 910, 911 (Tex. Civ. App. 1976).

[27] **AL—**Alaska Constr. Equip., Inc. v. Star Trucking, Inc., 128 P.3d 164, 169 (Alaska 2006);

CA—Reynolds v. Bank of Am. Nat'l Trust & Sav. Ass'n, 345 P.2d 926, 927 (Cal. 1959);

HI—Fukida v. Hon/Hawaii Serv. & Repair, 33 P.3d 204, 209–211 (Haw. 2001);

IA—Long v. McAllister, 319 N.W.2d 256, 261 (Iowa 1982);

similar property.[28] The fact that no substitute is actually rented will not necessarily preclude a plaintiff from recovering the reasonable cost of renting a substitute,[29] but some courts may limit the recovery to the period of time during which a substitute was actually rented.[30]

Testimony from adjusters, property owners, and service providers should be used to establish the duration of any actual rental, the reasonable period of time in which the owner was without the use of the damaged property, and the applicable daily, weekly, or monthly rental rate for a similar item.

If the loss of use of the property adversely affects the plaintiff's business, then the plaintiff's loss of use damages may be in the form of lost profits.[31] For further information concerning damages for lost profits, see Section 162.05, *Recovery of Lost Profits* below.

§ 162.05 Recovery of Lost Profits

[1] Overview

Subrogation claims are dominated by issues concerning physical damage to property. However, insurer's recovery efforts very frequently include lost profits claims. Commercial Property policies almost always include coverage for the insured's

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LA—Neloms v. Empire Fire & Marine Ins. Co., 859 So. 2d 225, 233 (La. Ct. App. 2003);

NE—Chlopek v. Schmall, 396 N.W.2d 103, 110 (Neb. 1986);

NJ—Bartlett v. Garrett, 325 A.2d 866, 867 (N.J. Dist. Ct. Cumberland County 1974).

[28] **US/NY—**Koninklijke Luchtvaart Maatschaapij, N. V. v. United Technologies Corp., 610 F.2d 1052, 1056 (2d Cir. 1979);

US/TN—Corporate Air Fleet of Tennessee, Inc. v. Gates Learjet, Inc., 589 F. Supp. 1076, 1082 (M.D. Tenn. 1984);

FL—Meakin v. Dreier, 209 So. 2d 252, 254 (Fla. Dist. Ct. App. 1968);

IL—Fairchild v. Keene, 416 N.E.2d 748, 749 (Ill. App. Ct. 1981);

IN—Hamacher v. Decker Livestock, Inc., 536 N.E.2d 304, 305 (Ind. Ct. App. 1989);

MS—Nat'l Dairy Products Corp. v. Jumper, 130 So. 2d 922, 923–924 (Miss. 1961);

OH—Robbins Motor Transp., Inc. v. Key GMC Truck Sales, Inc., 381 N.E.2d 1329, 1331 (Ohio Ct. App. 1978).

[29] **IL—**Fairchild v. Keene, 416 N.E.2d 748, 749 (Ill. App. Ct. 1981);

MO—Lenz Constr. Co. v. Cameron, 674 P.2d 1101, 1103 (Mont. 1984);

TX—Luna v. N. Star Dodge Sales, Inc., 667 S.W.2d 115, 118 (Tex. 1984).

[30] **US/TN—**Corporate Air Fleet of Tennessee, Inc. v. Gates Learjet, Inc., 589 F. Supp. 1076, 1082 (M.D. Tenn. 1984).

[31] **NE—**Chlopek v. Schmall, 396 N.W.2d 103, 110 (Neb. 1986);

PA—Koren v. George, 48 A.2d 139, 140 (Pa. Super. Ct. 1946);

TX—Wells Fargo Bank Nw., N.A. v. RPK Capital XVI, L.L.C., 360 S.W.3d 691, 710 (Tex. App. 2012).

business interruption so long as that business interruption is caused by property damage. A typical policy provision contained on Commercial Property Form CP 00 30 0402 "Business Income (and Extra Expense) Coverage Form" published by ISO Properties, Inc., provides:

> We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration." The "suspension" must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations. The loss or damage must be caused by or result from a Covered Cause of Loss. With respect to loss or damage to personal property in the open or personal property in a vehicle, the described premises include the area within 100 feet of the site at which the described premises are located.

For purposes of this coverage, "Business Income" is defined as:

> a. Net Income (Net Profit or Loss before income taxes) that would have been earned or incurred; and
>
> b. Continuing normal operating expenses incurred, including payroll.
>
> For manufacturing risks, Net Income includes the net sales value of production.

Given that insurers must frequently pay lost profits claims in addition to claims for property damage, insurer subrogation claims will often include lost profits.

The primary issues confronting insurers seeking to recover lost profits are:

- Requirements concerning uninsured lost profits of the insured and the sharing of lost profits with the insured;
- The degree of certainty with which lost profits must be established;
- Methodologies employed to establish lost profits;
- Recovery of lost profits for damage to a new business;
- Expert testimony needed to establish lost profits; and
- Establishing the causal relationship (proximate cause) between the liability and the damage.

[2] Uninsured Losses

The most difficult issue related to allocation of subrogation recoveries involves uninsured lost profits claims of the insured.

This situation arises if the insured legitimately sustains business interruption losses that are in excess of the amount of business interruption coverage available under the insurance policy. The insured may settle its business interruption claim with the insurance company, but nonetheless claim that it is entitled to recover additional uninsured losses from the party responsible for the losses.

There are several methodologies by which the insurance carrier may approach the uninsured lost profits claims. The simplest methodology is for the parties to assert all

the claims without the use of a pro rata agreement.

Pro rata agreements are very effective for allocating expenses, attorney's fees, and recoveries between insured and uninsured losses when the uninsured losses are for a liquidated, certain amount. If the uninsured losses are not for a liquidated, certain, amount, the use of a pro rata agreement is much less effective. The insured will almost certainly insist that its uninsured losses are the maximum amount which it believes it will be able to recover from the defendant.

For example, assume the plaintiff suffered $1 million in insured property damage, but did not carry business interruption insurance on the policy. The insured may claim that it is entitled to $1 million for its lost profits, using a "model" for its damages that actually yields a projection far in excess of that which would actually be recoverable if the case were submitted to a fact finder at trial. In that instance, if the parties attempt to establish a pro rata agreement, the insured will most likely insist that it's full $1 million claim be considered as its damages for purposes of the pro rata agreement, thus yielding a pro rata agreement that calls for a 50/50 allocation of any recoveries.

If the insured's true recoverable lost profits claim is much less than $1 million, this would yield a pro rata agreement that is unreasonably advantageous to the insured and would not permit a fair allocation of the insured portion of the claim to the insurer. In that instance, the insurer may be better off proceeding without any pro rata agreement between the insured and the insurance carrier. This arrangement should not lead to difficulties if the case actually proceeds to trial, because the jury (or the judge in the bench trial) will set the amount of the respective losses. In the event of settlement considerations, the insurer and the insured will be required to agree to a settlement amount and allocation or, alternatively, may settle their own respective portions of the claim.

A pro rata agreement may nonetheless be helpful in three circumstances.

First, the insured may only be seeking lost profits in an amount which is actually supportable and recoverable under the law of the applicable jurisdiction. In that instance, the insurer may enter into a pro rata agreement with the insured based upon the amount claimed by the insured.

Alternatively, the insurance carrier and the insured may agree to seek in the lawsuit the maximum amount of lost profits claimed by the insured, but nonetheless agree to a pro rata agreement which is based upon a more realistic damage figure. For example, the insured may claim $1 million in lost profits, but the insured may nevertheless enter into a pro rata agreement to receive $500,000 in lost profits. The insured has every motivation to do this, especially in instances where the insurer agrees to front the costs and expenses of litigation.

Lastly, the parties can agree to a pro rata agreement that is based upon negotiated percentages. For example, if the insured claims $3 million in lost profits as compared to $1 million in property damage paid by the insurance carrier, the parties may nonetheless arbitrarily agree for the convenience of the parties to a 33 1/3% for the

0042 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:12 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

insured and 66 2/3% for the insurance carrier. Often times, the best approach for the insurer is to agree to an arrangement which may not be justified based upon a strict accounting sense, but rather encourages the insured to participate in the recovery pursuit in a cooperative manner rather than the insurer being at odds with the insured. Pursuing claims against the tortfeasor in a cooperative fashion can often maximize recovery. It therefore may be in the best interest of the insurer to compromise and permit a somewhat artificially high lost profits claim for purposes of the pro rata agreement in order to obtain the insured's full cooperation.

[3] The "Reasonable Certainty" Requirement

In virtually every jurisdiction, courts require that lost profits be established with reasonable certainty, as opposed to mere speculation.[1] Lost profits claims, by their nature, are somewhat speculative because the evidence will relate to events that did not happen (the earning of income in the future) as opposed to events that did in fact happen. The Courts therefore subject loss profits claims to very high scrutiny. One court aptly summarized the standard as follows:

> In order that a recovery may be had on account of loss of profits, the amount of the loss must be shown by competent evidence with reasonable certainty. Where the business is shown to have been already established and making a profit at the time when the contract was breached or the tort committed, such pre-existing profit, together with other facts and circumstances, may indicate with reasonable certainty the amount of profits lost. It is permissible to show the amount of business done by the plaintiff in a corresponding period of time not too remote and the business during

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[1] **US/GA—**McDermott v. Middle Eastern Carpet Co., 811 F.2d 1422, 1427 (11th Cir. 1987);

US/MN—Hinz v. Neuroscience, Inc., 538 F.3d 979, 984 (8th Cir. 2008);

US/MO—Cole v. Homier Distributing Co., 599 F.3d 856, 864 (8th Cir. 2010);

US/NM—Nanodetex Corp. v. Defiant Techs., 2009 U.S. App. LEXIS 22634, at *21–23 (10th Cir. Oct. 15, 2009);

AZ—County of La Paz v. Yakima Compost Co. Inc. 233 P.3d 1169, 1186 (Ariz. Ct. App. 2010);

CA—Cap Gemini America, Inc. v. Judd, 597 N.E.2d 1272, 1282 (Ind. Ct. App. 1992);

CO—Denny Construct., Inc. v. City and County of Denver 199 P.3d 742, 746 (Colo. 2009);

FL—Louie's Oyster, Inc. v. Villaggio Di Las Olas, Inc., 902 So. 2d 901, 902 (Fla. Dist Ct. App. 2005);

ID—Todd v. Sullivan Constr., LLC, 191 P.3d 196, 200 (Idaho 2008);

IL—Chicago Pizza, Inc. v. Chicago's Pizza Franchise, Ltd., 893 N.E.2d 981, 994 (Ill. App. Ct. 2008);

IN—Indianapolis City Market v. Mav., Inc., 915 N.E.2d 1013, 1024 (Ind. Ct. App. 2009);

LA—White Haute, LLC v. Mayo, 38 So.3d 944, 953 (La. Ct. App. 2010);

MD—Thomas v. Capital Med. Management Associates, LLC, 985 A.2d 51, 66 (Md. Ct. Spec. App. 2009);

NC—Media Network, Inc. v. Long Haymes Carr, Inc., 678 S.E.2d, 671, 687 (N.C. Ct. App. 2009);

ND—Langer v. Bartholomay, 745 N.W.2d 649, 659 (N.D. 2008);

PA—Quinn v. Bupp, 955 A.2d 1014, 1021 (Pa. Super. Ct. 2008).

0043 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:12 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

> the time for which recovery is sought. Furthermore, in calculating the plaintiffs lost, it is proper to consider the normal increase in business which might have been expected in the light of past development and existing conditions. . . . The rule denying recovery where the facts show that profits claimed are too uncertain or speculative, or where the enterprise is new or unestablished is still in force, on the grounds that the profits that might have been made from such businesses are not susceptible of being established by proof to that degree of certainty which the law demands.[2]

Although courts require proof of lost profits with reasonable certainty, they have also been careful to point out that given the inherently speculative nature of lost profits claims, "fastidious exactitude,"[3] and "mathematical precision"[4] is not required.

[4] Methods of Proving Lost Profits

Lost profits are those profits that would have been earned by the insured "but for" the injury sustained. In other words, the awarding of lost profits should place the insured in same profit position it would have been in had no injury occurred. The proper measure of lost profits is lost "net profits" as opposed to lost "gross profits."[5] Lost net profits are gross profits less any variable costs (also known as "non-continuing expenses") that are saved by the insured not having to incur the expense of generating the goods and services that would have generated the profits. For example, when a restaurant is shut down by a fire, the restaurant will lose the income stream that it would have generated during the downtime. However, the restaurant saved expenses by not having to pay workers. It woul also have saved cost of goods sold in the form of food costs. Those amounts must be subtracted to determine let lost profits. Fixed or "continuing" expenses, such as a rent or mortgage that does not abate as a result of the incident, are not deducted from income to determine lost net profits because they are incurred by the insured even though the insured is not earning an income stream from that cost.

The lost profits damage model may take several forms. Some experts simply follow the insurance policy wording and project past net income into the future, and subtract "variable costs" that would have been expected, add any expected fixed or "continuing" costs, and subtract actual net income to achieve a lost profits figure. In contrast, other experts determine revenues lost as a result of the injury and subtract saved or variable costs to determine lost profits. If lost profits are calculated to be incurred beyond the date of trial, those calculated beyond the trial date are then discounted to

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[2] **TX—**Texas Instruments v. Tele Tron Energy Management, 877 S.W.2d 276, 279 (Tex. 1994) (quoting Southwest Battery Corp. *v.* Owen, 115 S.W.2d 1097, 1098–1099 (Tex. 1938) (internal citations omitted)).

[3] **US/NM—**Nanodetex Corp. v. Defiant Techs., 2009 U.S. App. LEXIS 22634, at *21–23 (10th Cir. Oct. 15, 2009);

[4] **AZ—**County of La Paz v. Yakima, 233 P.3d 1169, 1186 (Ariz. Ct. App. 2010).

[5] **MS—**Brothers v. Winstead, 129 So. 3d 906, 926 (Miss. 2014).

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VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

present value as of the date of trial. In either case lost revenues must be determined.

There are generally four accepted methods of establishing lost revenues.

With an established business, the "before and after" method is the most widely used method to establish lost revenues because it is based on financial data that is most readily available and courts will give the most credence to past performance of the business.[6] The school of thought is that, but for the injury, the insured's revenues would have been comparable for the periods prior and subsequent to the injury. For example, in the case of a fire at an established business that was not developing a new product, or operating in a rapidly changing market, and whose revenue was expected to continue into the future, the claimed lost revenues are simply the amount of revenues that have been obtained in the past, and projected into the future. Future revenues are often adjusted for historical revenue trends.

The lost profits damage model may take several forms. Some experts simply follow the insurance policy wording and project past net income into the future, and subtract "variable costs" that would have been expected, add any expected fixed or "continuing" costs, and subtract actual net income to achieve a lost profits figure. Other experts determine revenues lost as a result of the injury and subtract saved or variable costs to achieve a lost profits figure. That lost profits figure is then discounted to present value. With an established business whose income and costs would be expected to remain constant into the future, it is difficult to question this methodology.

A second method of establishing lost revenues for lost profits calculations is the "market share" method.[7] Under the market share method, an historical relationship is established between the insured's revenue and that of the market the insured operates in to determine its market share. Without data to the contrary, it is projected that the insured would have continued to maintain whatever share of the market it maintained prior to the defendant's liability producing conduct. In other words, if the insured were in an oligopoly with only three competitors, and the insured held 25% of the market, and as a result of the defendant's liability—producing conduct that share of the market was reduced to 15%, the insured's damage model projects that the lost revenues are 10% of the market share that the insured would have otherwise maintained. The market share model is a particularly good model if the insured has only a few competitors in an established geographical market and therefore calculation of the market share is relatively reliable as is the projection that but for certain events the insured would have been able to maintain that market share. With regard to this

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[6] **US/OK—**Southwest Stainless, L.P. v. Sappington, 582 F.3d 1176, 1187 (10th Cir. 2009);

US/TX—Meaux Surface Protection v. Fogleman, 607 F.3d 161, 171 (5th Cir. 2010);

RI—R.I. Managed Eye Care, Inc. v. Blue Cross & Blue Shield of R.I., 996 A.2d 684, 693 (R.I. 2008);

SC—Vortex Sport and Entertainment, Inc. v. Ware, 662 S.E.2d 444, 450–451 (S.C. Ct. App. 2008).

[7] *See, e.g.,* **TX—**Fraud-Tech, Inc. v. Choicepoint, Inc., 102 S.W.3d 366, 382–83 (Tex. App. Fort Worth, 2003, no pet.).

method, the insured must also account for variables that might have otherwise reduced the insured's market share even without the defendant's liability-producing conduct. Obviously, the use of the market share method requires that the insured's business be established and that market share percentages are capable of being determined.

Another method of establishing lost revenues is the "yardstick" method.[8] The yardstick method compares historical revenues of other business(es) that are comparable or representative of the insured's business to historical revenues of the insured's business. Similar to the market share method, an historical relationship is established between or among the insured's revenue and that of the comparable business(es). Without data to the contrary, it is projected that into the future the insured would have continued to maintain whatever historical relationship existed between or among the comparable businesses it maintained prior to the insured's injury. In other words, if the insured's business is comparable to business X and business Y, the insured projects that it would have received the same percentage of total revenues of the three businesses after the injury as it received prior to the injury. There are two notable points regarding the yardstick method. First, the insured must be prepared to demonstrate the similarities between the businesses used as the "yardstick" such that it can establish that the "yardstick" businesses are indeed representative of the insured's business. If there are differences between the businesses, the insured must be prepared to demonstrate how the differences in the businesses do not render the insured's damage model unreliable. Second, the yardstick method may be the best, and in fact only, method that can be used for start-up businesses. The before and after method may not be available because the business does not have a "before" to extrapolate to a projected open "after." Therefore, the before and after method may not be available to a start-up business. The same is true as to the "market share" method. Courts may very well reject the market share method for determining lost profits with a startup business because any projected "market share" for the start-up could be deemed nothing more than speculation.[9]

A good example of the pitfalls yardstick method is *Celebrity Cruises, Inc. v. Essef Corp.*[10] That case arose from an outbreak of Legionnaires Disease on a Celebrity Cruise Line Ship. Celebrity sued parties responsible for the design, manufacture and distribution of a spa filter that supposedly allowed the outbreak to occur. Celebrity alleged lost profits and attempted to prove its claim by use of the yardstick method. In order to support its damages claims, it relied upon its own sales projections to establish its claim income stream for the six months after the incident. To establish income streams for the years after 1994, when the incident occurred, Celebrity utilized a

[8] *See, e.g.,* **TX—**DaimlerChrysler Motors Co. v. Manuel, 362 S.W.3d 160, 194 (Tex. App.—Fort Worth, 2012, no pet.).

[9] **TX—**Fraud—Tech, Inc. v. Choicepoint, Inc. 102 S.W.3d 366, 382–383 (Tex. App.—Fort Worth, 2003, no pet).

[10] **US/NY—**Celebrity Cruises, Inc. v. Essef Corp., 478 F. Supp. 2d 440 (S.D.N.Y. 2007).

damage model that estimated expected income based upon a "yardstick" of three other cruise lines, Royal Caribbean Cruise Line, Carnival Corp., and American Classic Voyages. Celebrity could not offer any evidence as to a single customer who refused to book on Celebrity or of a single travel agent who refused to book on Celebrity as a result of the incident. The judge therefore held that the jury's verdict award of in excess of $47 million was against the weight of the evidence, and ordered a new trial as to damages. In doing so, the court commented on the use of the yardstick method, and the dangers of using that method in connection with comparing the insured to dissimilar businesses. The court noted:

> While there was enough of a record of Celebrity's performance prior to the outbreak for the yardstick analysis to be admissible . . . , there was not enough to make a convincing argument. Celebrity's first full year of operation was 1998, and Richard Sasso acknowledged that in 1994, it was still a young and growing company. . . . . Thus, Celebrity's track record before the incident was neither sufficiently protracted nor sufficiently typical of the performance of a mature company in the cruise industry to provide strong validation for the yardstick analysis.
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> Even in the absence of sufficient historical data, [Celebrity's] analysis might nonetheless be convincing if components of [its] yardstick were similar enough to Celebrity. They were not. Carnival, for example, was a much larger business than Celebrity . . . . It was also more diversified. Not only did it operate cruise ships under more than one brand and in several different markets, but it also operated bus lines, land tours, and hotels, all of which were included in the financial data used by [plaintiffs] to construct [its] yardstick. . . ." Carnival's inclusion in the composite therefore undermines the legitimacy of the yardstick as a predictor of Celebrities performance.
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> The same is true of American Classic Voyages. While closer in size to Celebrity, its business consisted of operating paddlewheel riverboats on rivers and intercostal waterways within the United States and operating a cruise ship exclusively in the Hawaii market. . . . [O]ne of Celebrity's witnesses, acknowledged that he probably would not consider American Classic Voyages comparable to Celebrity.
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> Although these flaws do not render [Celebrity's] analysis inadmissible, they diminish its value in establishing lost profits. Accordingly, Essef is entitled to a new trial on the issue of lost profits.[11]

The *Celebrity Cruise* case demonstrates the potential flaws in using the yardstick method. The yardsticks must be representative of the insured's business. Moreover, if possible, the insured should offer specific examples of lost sales in order to establish that there is indeed a causal relationship between defendant's activities and the failure of the insured to achieve the same income streams in the businesses used as the yardstick.

Another method for establishing lost revenues is the "sales projection" or "budget"

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[11] **US/NY—***Celebrity Cruise*, 478 F. Supp. 2d at 451–452.

0047 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:12 EDT 2015
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VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

method.[12] This method compares historical actual revenues to historical projected or budgeted revenues prepared in the ordinary course of business or for purposes other than litigation. Similar to the market share and yardstick methods, an historical relationship is established between the insured's actual historical revenue and that of the insured's projected or budgeted revenues. Without data to the contrary, it is projected that into the future the insured would have continued to maintain whatever historical relationship existed between its actual and projected or budgeted revenues. As an example, if an insured consistently projects revenues within 5% of its actual historical revenues, the insured can project its future revenues to be within 5% of its historical budgeted revenues.

[5] "New" Businesses

A very difficult issue pertains to so-called "start-up" businesses. On one hand, projecting profits for a business that does not have a track record is *per se* speculative. On the other hand, some new businesses will indeed be successful and turn a profit. Therefore, there is no reason to deny lost profits as a matter of course simply because a business is a start-up business.

Many courts in the past have followed the "New Business Rule" which denied lost profits to new businesses as a matter of course. But that rule has now been rejected by the majority of jurisdictions.[13] New businesses will simply be subject to the reasonable certainty requirements for lost profits. They will of course have a more difficult time proving reasonable certainty without the track record of an established business. A minority of jurisdictions have adopted an intermediate approach, whereby a start-up business may recover lost profits but that claim will be subject to a greater degree of scrutiny.[14] There appears to be little difference in application of the two rules. If a start-up business must prove its lost profits with reasonable certainty, by its nature it faces greater scrutiny because of the absence of a track record. Therefore, the reasonable certainty requirement in and of itself would seem to be sufficient to protect against speculative claims of lost profits by start-up businesses.

One methodology that is particularly appropriate for start-up businesses is the "yardstick" method. The yardstick method compares the profitability of similar businesses to the business which sustained the lost profits. In order to be probative of

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[12] *See, e.g.,* **DE—**Honeywell Int'l, Inc. v. Air Prods. & Chems., Inc., 858 A.2d 392 (Del. Ch. 2004).

[13] See:

FL—W.W. Gay Mechanical Contractor, Inc. v. Wharfside Two, Ltd., 545 So.2d 1348, 1350 (Fla. 1989).

SC—Drews Co. v. Ledwith-Wolfe Associates, Inc., 371 S.E.2d 532, 533–534 (S.C. 1988).

[14] *See*:

US/NY—Jewell-Rung Agency, Inc. v. Haddad Org., Ltd., 814 F. Supp. 337, 342 (S.D.N.Y. 1993).

US/TX—Meaux Surface Petrotection, Inc. v. Fogleman, 607 F.3d 161, 171 (5th Cir. 2010).

0048 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:13 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

the lost profits of the insured, the business used as the yardstick must be so similar as to be representative of potential losses that were actually sustained by the insured.[15] This methodology is obviously most accurate in situations involving commodities products. A good example of this is *DaimlerChrysler Motors Co v. Manuel*.[16] In that case, Manuel was promised a new Chrysler dealership in addition to his existing Dodge dealership. Due to legal complications with another dealer, Manuel was prevented from opening that dealership at a time when car sales were particularly robust. He brought an action against Chrysler to recover for his year of lost sales. Ordinarily, proving lost profits for this startup business could be problematic but for a "yardstick" business existed by which Manuel could compare sales. An expert testifying on Manuel's behalf used existing dealership owned by Manuel as a "yardstick" for the profits lost by the startup. The court held that this methodology was acceptable given that the comparable dealership was also owned by Manuel and therefore "management" (which insured's expert testified was the most important factor in profitability) would be similar. Moreover, the two dealerships were in similar geographic and demographic areas.

The court therefore held that sales at the existing dealership were an adequate predictor of sales at the "start-up" dealership, and that slight differences between the two were not sufficient to render the methodology unsound or prevent recovery. In doing so, the court rejected any per se argument that new enterprises could not prove lost profit claims, noting:

> [W]here estimates are based on objective facts or data and/or firm reasons to expect a business to yield a profit, recovery is not prohibited simply because the enterprise is new. . . . It is the activity that is the enterprise, and if the activity is well-established, the fact that a newly formed entity is engaged in the activity will not preclude recovery.[17]

Many insureds seeking lost profits will not be lucky enough to own another similar business to use as a "yardstick." Nonetheless, the insured's business can be compared to other franchises (if it is a franchise) or, alternatively, similar businesses. Obtaining access to financial information of those similar businesses may be difficult but will be necessary in order to demonstrate that its damage model is not speculative.

The analysis becomes substantially more difficult if the insured is involved in producing an entirely new product or is part of a new industry. In that case, "the activity competitor that is the enterprise" is not well-established and it will be more difficult to prove that the new entity in fact sustained lost profits. In *Lightlab Imaging,*

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[15] **US/MN—**Hinz v. Neuroscience, Inc., 538 F.3d 979, 984–985 (8th Cir. 2008).

[16] **TX—**DaimlerChrysler Motors Co. v. Manuel, 362 S.W.3d 160, 194 (Tex. App.—Fort Worth, 2012, no pet.).

[17] **TX—***DaimlerChrysler*, 362 S.W.3d at 194 (internal citations omitted).

Inc v. Axsun Technologies, Inc.,[18] the insured manufactured and sold optical coherence tomography ("OCT"). Lightlab entered into a joint development relationship with a manufacturer of industrial lasers, Axsun to develop a new laser, which was developed under a confidentiality agreement. A competitor, Volcano, acquired Axsun and began to develop its own OCT technology. Lightlab brought suit against Axsun and Volcano seeking lost profits due to the breach of its confidentiality agreement. Lightlab projected lost profits well into the future, until 2038, but the court excluded this testimony holding that evidence as to Lightlab's future lost profits from its product that had not yet been marketed was speculative. Lightlab based its entire lost profits claim on the discounted cash flow method, which it claimed was the "most common method used to calculate lost profits."[19] However, Lightlab did not provide competent evidence as to the cash flow that was discounted.

Lightlab's model assumed that each Lightlab customer would replace an OCT product it is acquired with a new Lightlab OCT product every six years, until 2008. The court deemed this a "dubious assumption about brand loyalty."[20] Moreover, Lightlab had no record of profitability from the time it was formed in 1999 until 2010 and had no track record of profitable sales even as to its existing OCT products. Lightlab cannot point to a single customer that it had lost as a result of Axsun's breach of its confidentiality agreement. Last, Lightlab had not received regulatory clearance for its OCT product in the United States, Japan, South Korea or China, where would supposedly market its product. In closing, the court stated:

> Where Lightlab had no history of profitable sales and could point to no lost sales, where Weinstein's opinion depended on as yet undeveloped new products, where Lightlab had no regulatory clearance for its future products, and where it had no guaranteed funding needed to launch a sales and marketing infrastructure for its new products, we conclude that the judge did not abuse her discretion in determining that Weinstein's opinion should be at excluded as grounded in speculation.
>
> Before leaving the subject, we express our concern that traditional lost profits analysis as a measure of damages may not be an adequate model for analyzing harm caused by misappropriation of the trade secrets of a "startup" business. Such businesses often operate for years without profit. This fact should not render them "damage proof." In this case Lightlab recovered other significant damages and attorney's fees. We recognize that other theories of damages may lend themselves to misappropriation of trade secret cases and that such theories may be ripe for testing in our courts.[21]

It will often be very difficult for a startup business to use a methodology other than the yardstick method in order to establish an income stream to serve as the baseline for lost profits. The "market share" method will most likely be unavailable because the

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[18] **MA—**Lightlab Imaging, Inc v. Axsun Technologies, Inc., 13 N.E.3d 604 (Mass. 2014).

[19] **MA—***Lightlab*, 13 N.E.3d at 610.

[20] **MA—***Lightlab*, 13 N.E.3d at 612.

[21] **MA—***Lightlab*, 13 N.E.3d at 613–614 (citation omitted).

start of business will not yet have established a reliable market share with which to project lost future income.[22]

[6] Expert Testimony and "*Daubert*" Issues

There is no absolute requirement of expert testimony to establish lost profits. If a lay witness, including an employee of the plaintiff, has sufficient personal knowledge to establish lost profits there may be sufficient proof to support the claim.[23] The award must merely be based upon reasonable inferences and estimates.[24]

Given that expert testimony as to lost profits will by its nature pertain to events that did not actually happen and therefore by its very nature is somewhat speculative, it is not surprising that "*Daubert,*"[25] motions are often filed as to experts disclosed as testifying about lost profits. Pursuant to *Daubert*, and its progeny, expert testimony offered as to lost profits must be reliable. To a certain extent, *Daubert* has not altered the landscape of lost profits cases. Lost profits testimony has always been seen as somewhat speculative and therefore subject to evidentiary challenges that the testimony is unreliable and inadmissible. Virtually all jurisdictions have developed a substantial body of case law as to the degree of certainty necessary for lost profits testimony in order for that testimony to be able to support a lost profits award. If the court determines that the expert testimony as to lost profits did not establish profits to a reasonable certainty, the court would exclude the testimony because it did not meet the evidentiary standard.

Nonetheless, given that the *Daubert* factors do not readily apply to experts who are testifying as to matters which involve technical or specialized knowledge, as opposed to scientific studies or tests, courts have been quick to point out that the *Daubert* factors require a flexible analysis and that the judge in his gatekeeper role should apply only those factors that are applicable. In many situations, few if any of the factors apply when the expert is an investigative type expert and courts will often resort to a "general reliability approach" or determine whether there is any perceived "analytical gaps" in the expert's testimony.

Courts examining lost profits expert testimony will typically look at two factors to determine whether the testimony is admissible. First, does the expert follow a

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[22] **TX—**Fraud-Tech, Inc. v. Choicepoint, Inc. 102 S.W.3d 366, 382–83 (Tex. App.—Fort Worth, 2003, no pet).

[23] **ID—**Todd v. Sullivan, LLC, 191 P.3d 196, 200 (Idaho 2008).

US/NM—Nanodetex Corp. v. Defiant Techs., 2009 U.S. App. LEXIS 22634, at *21–23 (10th Cir. Oct. 15, 2009).

See generally **CT—**Message Center Mgmt., Inc. v. Shell Oil Products, Inc, 857 A.2d 936 (Conn. App. Ct. 2004).

[24] **CT—**Sullivan v. Thorndike, 934 A.2d 827, 833 (Conn. App. Ct. 2007), *cert. denied*, 942 A.2d 415 (Conn. 2008).

[25] *See* **US—**Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1979).

recognized methodology? In the lost profits realm, the methodologies are somewhat well-established. Generally, the measure of lost profits is the difference between projected profits received, less actual profits received, discounted to present value. Moreover, as fully outlined above, the methodologies for determining the projected lost profits to factor into the equation are also relatively well-developed. Courts have sanctioned the "yardstick" method, the "before and after" method and the "market share" method. The expert is generally required to employ one of these methodologies in order to establish an accepted methodology and hence "reliability." One court has stated that "an expert's decision not to use a process that has been generally accepted as valid . . . was not in and of itself an analytical gap. However, the expert must demonstrate that an 'alternative method' was indeed reliable."[26]

The expert will also be required to establish that the factual basis for his opinions and any assumptions are objectively sound. Even if the expert follows an established methodology such as the discounted cash flow method, the court may strike the expert testimony if the data or assumptions employed by the expert when utilizing the methodology are unsound. For example, courts have ruled that the cash flow method is not acceptable, and expert testimony is inadmissible, if there is no objective basis for the expert's cash flow projections other than the expert's *ipse dixit*. Moreover, a repeated basis for striking expert testimony occurs when the expert relies upon assumptions or opinions of the owner of a business as to future business conditions, such as market share,[27] subjective assessments as to lost lease values of damaged articles, and general growth rates of businesses in the economy as a whole, rather than the applicable market. In those situations, the expert did not opine as to the objective basis of the information provided to the expert by the owner, and therefore the expert did not have an objective basis for the data which served as the foundations for his opinion, and the opinion was unreliable.

These considerations are related to the expert's ability to rely upon information pursuant to Federal Rule of Evidence 703[28] or its state counterpart. Rule 703 provides that the facts or data upon which the expert bases his need not be admissible evidence so long as they are the type of facts and data upon which experts in this field typically rely in formulating their opinion. However, an important aspect of this rule is that the expert must be relying upon "facts or data" as opposed to opinion provided by others. If the supposed fact or data upon which the expert bases her opinion are also opinion—such as an owner's opinion as to future market share, or an owner's opinion as to future sales—then the expert may not serve as a mere conduit for that opinion. The expert must consider the opinion provided by others and utilize her expertise to

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[26] *See generally* **TX—**Vega v. Fulcrum Energy, LLC, 415 S.W.3d 481 (Tex. App.—Houston [1st Dist.] 2013, writ ref'd).

[27] **TX—**Fraud-Tech, Inc. v. Choicepoint, LLC, 102 S.W.3d 366, 382–383 (Tex. App.—Fort Worth, 2003, no pet).

[28] **US—**Fed R. Evid. 703.

0052 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:13 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

evaluate that opinion before she relies upon it as part of his "ultimate opinion." Otherwise, she risks her testimony being ruled inadmissible under Rule 703, or risks that testimony being inadmissible because she cannot testify as to the reliability of the facts or data upon which she bases her opinion.

§ 162.06 The Economic Loss Doctrine

[1] Injured Party Generally Cannot Recover in Tort for "Economic Damages"

The economic loss doctrine dictates that an injured party can recover in tort only for "economic damages" that flow from personal injury or damage to property he owns. Tort causes of action are intended to compensate the plaintiff for personal injury or property damage, including (with certain exceptions) the economic consequences of such injury or damage. If the plaintiff has not sustained personal injury or damage to his property, or has lost only his benefit of a contractual bargain, he has no tort cause of action against the defendant.

The economic loss doctrine permeates the subrogation field because the subrogating insurer often must avail itself of tort theories when contract or warranty causes of action are either not available or are otherwise limited. The most glaring example concerns statutes of limitation. The statute of limitation for contract or warranty often begins to run upon performance of the contract or delivery of the product rather than when the damage manifests itself or an incident causing damage occurs. Tort statutes of limitation typically begin to run when the incident occurs. If the warranty/contract statute of limitation expires before the incident causing damage occurs, the subrogating insurer must resort to tort claims for recovery.

[2] The Three Types of Economic Loss

The economic loss doctrine generally is applied in three categories:

1. The plaintiff sustains financial losses as a result of damage to property owned by another;
2. The plaintiff has purchased a product that has qualitative defects or a defect that damages only the product itself; or
3. The plaintiff has not received a contractual benefit of the bargain.

Each of these categories is a subset of the general rule, but viewing the doctrine through these different categories greatly simplifies the analysis.

[3] "*Robins Dry Dock*" Economic Loss

The first category of economic loss—loss as a result of damage to property owned by another—is best exemplified by the U. S. Supreme Court decision in *Robins Dry Dock Repair Co. v. Flint*.[1] In *Robins Dry Dock*, the propeller of a ship was damaged

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[1] **US/NY—**Robins Dry Dock Repair Co. v. Flint, 275 U.S. 303 (1927).

0053 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:13 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

while it was in dry dock. The company that chartered the ship from the owner had a provision in its charter contract that required the dry docking. The dry dock company was not a party to the charter contract and the chartering company was not a party to the dry dock contract. The ship was not available to the chartering company as a result of the damage to the propeller and that company sustained financial losses as a result.

The Supreme Court first held that the chartering company was not an intended beneficiary who could claim breach of the dry dock contract. The Court also held that the chartering company did not "have an interest protected by the law against unintended injuries inflicted upon the vessel by third persons who [knew] nothing of the charter."[2]

The Supreme Court outlined its reasoning as follows:

> Of course the contract of the petitioner with the owners imposed no immediate obligation upon the petitioner to third persons, as we already have said, and whether the petitioner performed it promptly or with negligent delay was the business of the owners and of nobody else. But as there was a tortious damage to a chattel it has sought to connect the claim of the respondents with that in some way. The damage was material to them only as it caused the delay in making the repairs, and that delay would be wrong to no one except for the petitioner's contract with the owners. The injury to the propeller was no wrong to the respondents but only to those to whom it belonged. But suppose that the respondent's loss flowed directly from that source. Their loss arose only through their contract with the owners—and while intentionally to bring about a breach of contract may give rise to a cause of action, . . . no authority need be cited to show that, as a general rule, at least, a tort to the person or property of one man does not make the tortfeasor liable to another merely because the injured person was under a contract with that other, unknown to the doer of the wrong . . . . The law does not spread its protection so far.[3]

The *Robins Dry Dock* decision stands for the general preposition that one cannot recover financial losses arising from damage to the property of another, but only for losses flowing from damage to one's own property.

A good example of the "Robins Dry Dock" application of the economic loss doctrine is seen in the case of *In re One Meridian Plaza Fire Litigation*.[4] In 1991, the property sustained a fire that damaged the tower, but it remained standing. The City of Philadelphia restricted access to the area around the building, such that even businesses that did not sustain direct physical damage were inaccessible to their owners. The court held that the financial losses sustained by the business owners could not be recovered under a negligence claim. The court rejected the argument that the financial losses must only foreseeably flow from that incident, noting "the economic loss doctrine precludes recovery when there has been no physical harm suffered, even

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[2] **US/NY—***Robins Dry Dock*, 275 U.S. at 308.

[3] **US/NY—***Robins Dry Dock*, 275 U.S. at 308 (internal citations omitted).

[4] **US/PA—***In re* One Meridian Plaza Fire Litigation, 820 F. Supp. 1460 (E.D. Pa. 1993).

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XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10]**[MX-SECNDARY:** 30 Jun 15 15:05]**[TT-:** 23 Sep 11 07:01 loc=usa unit=ch0162] **0**

where the economic loss was foreseeable."[5] The court also rejected the notion that physical invasion by smoke or soot was sufficient "property damage" to make economic losses sustained as a result of the lack of access to the businesses recoverable. The smoke and soot invasion is not what caused the economic losses. The economic losses were caused by lack of access to the businesses. The court held that there must be some causal nexus between the property damage and the economic losses:

> A rule requiring some nexus between the physical harm and the economic loss is a wiser, more equitable rule than merely using physical harm as a trigger to recovery for economic loss. Courts are well equipped to make such causation determinations, and I believe that Pennsylvania courts would require a connection between the physical harm and the economic loss. The *Restatement* comments relating to "parasitic" damages do not support plaintiffs' interpretation; in fact, they do the opposite. "Parasitic" implies a "symbiotic relationship" and this implies that damages for economic harm must be dependent upon the physical harm to be recoverable . . . .
>
> Furthermore, allowing plaintiffs to recover economic losses upon any showing of physical harm would open the door to a vast number of fraudulent claims. For example, many employees in the above hypothetical would undoubtedly claim that they too had left a coat in the closet. A requirement of some nexus between the physical harm and the economic loss largely prevents that possibility.[6]

The *Robins Dry Dock* limitation on recovering economic loss has limited application in the insurance context. Most property policies only recompense the insured for economic loss when such economic losses flow from property damage. Nonetheless there are situations where this aspect of the economic loss doctrine could impact upon a subrogation claim, such as when the insured sustains property damage sufficient to involve business interruption coverage, but the economic losses do not flow directly from the property damage sustained by the insured.

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[5] **US/PA—***One Meridian Plaza*, 820 F. Supp. at 1485 (citing Dundee Cement Co. v. Chemical Laboratories, Inc., 712 F.2d 1166, 1168 (7th Cir. 1983)).

[6] **US/PA—***One Meridian Plaza*, 820 F. Supp. at 1486 (internal citations omitted).

See also:

US/WI—Leadfree Enterprises, Inc. v. United States Steel Corp., 711 F.2d 805, 807–808 (7th Cir. 1983);

ID—Just's Inc. v. Arrington Constr. Co., 583 P.2d 997, 1005 (Idaho, 1978);

IA—Nebraska Innkeepers, Inc. v. Pittsburgh—Des Moines Corp., 345 N.W.2d 124, 128 (Iowa 1984);

MA—Stop & Shop Co. v. Fisher, 444 N.E.2d 368, 371 (Mass. 1983);

PA—Moore v. Pavex, Inc., 514 A.2d 137, 139 (Pa. Super. Ct. 1986).

Compare **NJ—**People Express Airlines, Inc. v. Consolidated Rail Corp., 495 A.2d 107, 116 (N.J. 1985), **NJ—**defendant may be liable for actual economic losses that are proximately caused by breach of duty of care to avoid the risk of economic injury to particularly foreseeable plaintiffs).

0055 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:13 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

[4] Products Liability

[a] Development of the Doctrine

Courts have had difficulty applying the economic loss doctrine to claims based on products liability principles such as those established by the Restatement (Second) of Torts § 402A. The Restatement, and many statutory or common law versions of strict products liability, applies only to personal injury or property damage. A question arises when the product damages only itself. On one hand, the plaintiff has sustained damage to property because he owned the product once it was purchased. On the other hand, the plaintiff has lost only what he has purchased and therefore has been deprived only of the benefit of his contractual bargain.

The boundaries of the economic loss doctrine in the products field were initially established by *Seely v. White Motor Co.*[7] and *Santor v. A.M. Kargheusian, Inc.*[8] In *Seely*, the plaintiff purchased a truck which bounced violently or "galloped" during operation. The truck subsequently overturned as a result of brake failure. The owner was not injured but the truck was damaged. The California Supreme Court addressed whether strict liability in tort was applicable to the property damage claim and held that warranty law governed the parties' disputes regarding their economic interests. However, the court left a door open regarding whether strict liability in tort could be used to pursue a claim for damage to the product itself. The court noted:

> Plaintiff contends that . . . the doctrine of strict liability in tort should be extended to govern physical injury to plaintiff's property as well as personal injury. We agree with this contention. Physical injury to property is akin to personal injury in that there is no reason to distinguish them. In this case, however, the trial court found that there was no proof that the defect caused the physical damage to the truck.[9]

The court clearly held that the plaintiff could not recover in strict liability for qualitative defects in the product, that a tort claim might lie when a defect causes damage.

Santor v. A & M Kargheusian, Inc.[10] represents the opposite point of view. In *Santor*, the plaintiff purchased carpet that contained qualitative defects. The plaintiff brought suit against the manufacturer. The plaintiff had purchased the carpet from a dealer and the manufacturer contended that the plaintiff could not recover economic damages from the manufacturer due to lack of privity. Distinguishing cases where lack of privity with the manufacturer was not an impediment to recovering under implied warranty theories, the New Jersey Court of Appeals rejected the plaintiff's claim:

> [A]bsent personal injury or damage to health consequent upon use of this product in

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[7] **CA—**Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965).

[8] **NJ—**Santor v. A & M Karagheusian, Inc., 207 A.2d 305 (N.J. 1965).

[9] **CA—***Seely*, 403 P.2d at 155.

[10] **NJ—***Santor,* 207 A.2d at 305.

> question, there is no action in this state on the part of a purchaser of goods for breach of warranty in respect of their quality or fitness for use except as against the party from whom he has purchased them.[11]

The New Jersey Supreme Court reversed this holding and adopted strict liability in tort and also held that a strict liability claim existed for damage to the product itself. "[A]lthough [strict liability] has been applied primarily in connection with personal injuries sustained by expected users from products which are dangerous when defective . . . the responsibility of the manufacturer should be no different where damage to the article sold or to other property of the consumers is involved."[12]

Faced with the opposing views of *Seely* and *Santor*, other courts have adopted an intermediate approach of examining whether a potentially dangerous incident caused the damage sufficient to give rise to a tort claim. For example, in *Pennsylvania Glass Sand Co. v. Caterpillar Tractor Co.,*[13] a front end loader manufactured by Caterpillar Tractor sustained a fire. The only item that was damaged was the front end loader. The statute of limitations had expired on the warranty claims and therefore the plaintiff was forced to pursue tort claims against the supplier of the front end loader. The U.S. District Court for the Middle District of Pennsylvania granted summary judgment in favor of Caterpillar on the basis that the manner in which the defect manifests itself is irrelevant in that a tort claim exists only for personal injury or property damage.

> [T]his reasoning applies regardless of the nature of the defect in the product. Whether the defect is one . . . which does not involve even a risk of physical injury or is one as alleged in this case, which poses a risk of physical injury, in both type cases the actual loss suffered by the plaintiff was economic harm.[14]

The U.S. Third Circuit Court of Appeals vacated this decision. In one of the handful of landmark decisions on this issue, the Third Circuit adopted a hybrid approach when the tort claim is for damage to the product itself, distinguishing between hazardous, as opposed to qualitative, defects in the product. The court noted that "[t]he gist of a products liability tort case is not that the plaintiff failed to receive the quality of product that the plaintiff has expected but that plaintiff has been exposed through a hazardous product, to an unreasonable, risk of injury to his person or his property"[15] and that "[t]he line that is drawn usually depends upon the nature of the defect and the manner in which the damage occurred."[16] Relying in part on the dicta in *Seely* quoted

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[11] **NJ—***Santor*, 207 A.2d at 309.

[12] **NJ—***Santor*, 207 A.2d at 312.

[13] **US/PA—**Pennsylvania Glass Sand Co. v. Caterpillar Tractor Co., 496 F. Supp. 712 (M.D. Pa. 1980), *vacated*, 652 F.2d 1165 (3d Cir. 1981).

[14] **US/PA—***Pennsylvania Glass Sand*, 496 F. Supp. at 715.

[15] **US/PA—**Pennsylvania Glass Sand Corp. v. Caterpillar Tractor Co., 652 F.2d 1165, 1169 (3d Cir. 1981) (citing J.W. Wade, *Is Section 402A of the Second Restatement of Torts Preempted by the UCC and Therefore Unconstitutional?,* 42 TENN. L. REV. 123, 127 (1974)).

[16] **US/PA—***Pennsylvania Glass Sand*, 652 F.2d at 1169.

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XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

above, the Court held that "the line between tort and contract must be drawn by analyzing interrelated factors such as the nature of the defect, the type of risk and the manner in which the injury arose . . . ."[17] The Court therefore held that the plaintiff could pursue a tort claim because the damage to the front end loader was caused by a sudden and dangerous occurrence and the alleged defect constituted a safety hazard.

Despite the *Pennsylvania Glass Sand* decision, the "sudden and calamitous" exception to the economic loss doctrine never became the majority position[18] as a result of the U.S. Supreme Court decision in *East River Steam Ship v. Transamerica.*[19] In *East River*, the Court adopted products liability, including strict liability, as part of maritime law. The Court also addressed whether recovery under strict liability is permitted when the product damaged only the product itself. The Court recognized that *Seely* stated the majority approach that damage to the product itself was non-recoverable economic loss, and that *Santor* stated the minority approach that "a manufacturer's duty to make non-defective products encompassed injury to the product itself, whether or not the defect created an unreasonable risk of harm."[20] The Court also acknowledged the intermediate approach represented by the *Pennsylvania Glass Sand* decision and by a decision from the Alaska Supreme Court, *Northern Power & Engineering Corp. v. Caterpillar Tractor Co.,*[21] finding that strict liability was available when the damage occurred as a result of a situation "potentially dangerous to persons or other property . . . ."[22] The *East River* court rejected the minority and intermediate approaches, stating:

> We find intermediate and minority land-based positions unsatisfactory. The intermediate positions, which essentially turn on the degree of risk, are too indeterminate to enable manufacturers easily to structure their business behavior. Nor do we find persuasive a distinction that rests on the manner in which the product is injured. We

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[17] **US/PA—***Pennsylvania Glass Sand*, 652 F.2d at 1169.

[18] Many states still follow some form of the *Pennsylvania Glass Sand* "intermediate approach" and hold that if the product creates a dangerous condition, tort remedies may be available. *See, e.g.*:

US/KS—Daitom Inc. v. Pennwalt Corp., 741 F.2d 1569, 1581–1582 (10th Cir. 1984);

AK—Northern Power & Eng. Corp. v. Caterpillar Tractor Co., 623 P.2d 324, 329 (Alaska 1981);

AZ—Cloud v. Kit Mfg., 563 P.2d 248, 251 (Ariz. 1977).

IA—American Fire & Cas. Co. v. Ford Motor Co., 588 N.W.2d 437, 439 (Iowa 1999);

MD—A.J. DeCoster v. Westinghouse Elec. Co., 634 A.2d 1330, 1334–1335 (Md. 1984);

MO—Streich v. Hilton-Davis, 692 P.2d 440, 445 (Mont. 1992);

WV—Anderson v. Chrysler Corp., 403 S.E.2d 189, 192–193 (W. Va. 1991).

[19] **US—**East River Steam Ship v. Transamerica, 476 U.S. 858 (1986).

[20] **US—***East River*, 476 U.S. at 868–869.

[21] **AK—**Northern Power & Engineering Corp. v. Caterpillar Tractor Co., 623 P.2d 324, 329 (Alaska 1984).

[22] **US—***East River*, 476 U.S. at 870.

> realize that the damage may be qualitative, occurring through gradual deterioration or internal breakage. Or it may be calamitous. But either way, since by definition, no person or other property is damaged, the resulting loss is purely economic. Even when the harm to the product itself occurs through an abrupt, accident-like event, the resulting loss due to repair costs, decreased value, and lost profits is essentially the failure of the purchaser to receive the benefit of its bargain—traditionally the core concern of contract law.
>
> We also decline to adopt the minority land-based view by *Santor* and *Emerson*. Such cases raise legitimate questions about the theories behind restricting products liability, but we believe that the countervailing arguments are more powerful. The minority view fails to account for the need to keep products liability and contract law in separate spheres and to maintain a realistic limitation on damages.[23]

The *East River* court adopted the reasoning of *Seely*, and held that damage to the product itself is best left to warranty law, rather than tort law. As a result of the *East River* decision, the *Seely* rule is now adopted by the majority of courts, although some jurisdictions follow different interpretations of the doctrine or have yet to squarely address the issue.

[b] "Other Property"

Given the *East River* majority rule that damage to the product itself is economic loss, there has been extensive litigation as to whether the claimed damage is limited to the product or also affects separate and distinct property such that tort remedies are available. Many plaintiffs have attempted to circumvent the economic loss doctrine by filing an action against a component part supplier in an attempt to create damage to "other property," claiming that the defective component part caused damage to the product as a whole.

The parameters of the majority rule as to what constitutes "other property" have been established by the U.S. Supreme Court in an admiralty case. In *Saratoga Fishing v. J.M. Martinac & Co.*[24] an engine room fire and flood led to the sinking of the fishing vessel M/V Saratoga. The plaintiff alleged that a defectively designed hydraulic system caused the fire. The hydraulic system had been provided as part of the ship when constructed and sold by J.M. Martinac. The ship was sold to an initial owner, who in turn added extra equipment, including a skiff, a seine net and various spare parts. The ship was then sold to Saratoga Fishing Co. ("Saratoga"). After the sinking, Saratoga brought a tort action against the manufacturer of the hydraulic equipment and the ship builder. The Ninth Circuit Court of Appeals held that Saratoga could not recover in tort for the value of the equipment because that equipment had been added prior to the purchase of the ship by Saratoga.

On appeal to the Supreme Court, the ship builder argued that Saratoga purchased the

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[23] **US—***East River*, 476 U.S. at 871 (internal citations omitted).

[24] **US—**Saratoga Fishing v. J.M. Martinac & Co., 520 U.S. 875 (1997).

ship and the additional equipment as a unit from the initial purchaser, and so allowing recovery for the additional equipment "would permit a user to recover for damage a defective component causes to a manufactured product other than to the component itself."[25] The *East River* court had previously held that a plaintiff cannot recover in tort from a component part manufacturer if a defect in a component damages the product into which the component is incorporated "since all but the very simplest of machines have component parts [a contrary] holding would require a finding of 'property damage' in virtually every case where a product damages itself. Such a holding would eliminate the distinction between warranty and strict products liability."[26] The *Saratoga* court rejected the ship builder's argument, holding that the manufacturer and the component part supplier can allocate their respective responsibilities through contract and that there is a distinction between components added to a product by a manufacturer prior to the product's sale and "those items added by the user to the manufactured product."[27] The *Saratoga* court emphasized that permitting the plaintiff to recover for damage to items that had been added to the product by a subsequent purchaser would not permit a plaintiff to recover in tort when a component part damages a product into which it has been integrated by a manufacturer.

Courts have struggled to define when a component is truly a separate product, a defect in which could result in damage to the "other property" when the component damaged the larger product into which it is integrated. For example, in 2010 the New Jersey Supreme Court held in *Dean v. Barrett Homes, Inc.*[28] that the "integrated component" doctrine did not preclude a strict liability claim for damage to a home caused by an "EFIS" siding system because the EFIS siding was not an integrated component of the home. This holding is consistent with the California Supreme Court decision *Jimenez v. Superior Court,*[29] which permitted a plaintiff to recover for damage to homes caused by defects in windows that had been integrated into the homes. On the other hand, if the component is truly an integrated part of the final product, courts typically will hold that a plaintiff cannot proceed in tort on the theory that the component was defective and damaged the product.[30]

The integrated product doctrine has often been addressed in the aviation field. An aircraft is typically an assembly of components manufactured by different suppliers, including the airframe, the avionics, the engine and the engine components. Courts routinely hold that the plaintiff cannot circumvent the economic loss doctrine and

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[25] **US—***Saratoga*, 520 U.S. at 883.

[26] **US—***East River,* 476 U.S. at 867 (quoting Northern Power & Engineering Corp. v. Caterpillar Tractor Co., 623 P.2d 324, 330 (Alaska 1981)).

[27] **US—***Saratoga*, 520 U.S. at 884.

[28] **NJ—**Dean v. Barrett Homes, Inc., 8 A.3d 766, 776–777 (N.J. 2010).

[29] **CA—**Jimenez v. Superior Court, 58 P.3d 450, 454–455 (Cal. 2000).

[30] **US/PA—***See, e.g.*, King v. Hilton Davis, 855 F.2d 1047, 1051–1052 (3d Cir. 1988).

recover in tort when damage to aircraft results from a defective component.[31]

This issue becomes even more vexing, however, when damage to the product is caused by a replacement component. A manufacturer frequently sells replacement components for its products; however, such replacement components often can be purchased from a different aftermarket supplier. If a replacement component is supplied by the manufacturer and proves defective, the manufacturer may argue that the component is part of the integrated whole and the manufacturer is not subject to tort claims for damage to the product caused by the defective component. There are conflicting opinions regarding this issue.[32]

Application of the economic loss doctrine to replacement components would seem to be completely fortuitous. A supplier of aftermarket components is a stranger to the original sale and if a defect in its product causes damage to property already owned by a consumer (the integrated product) it would seem that the economic loss doctrine should be inapplicable. Likewise, even when the replacement component part is supplied by the original manufacturer/supplier, it would not seem that the defendant should be afforded protection by the economic loss doctrine. The fact that the original manufacturer/supplier, as contrasted with the aftermarket supplier, provided the replacement component is completely fortuitous, and would provide a windfall to the original manufacturer/supplier simply because it supplied the original component.

[5] "Contractual Privity" Economic Loss Doctrine

The application of the economic loss doctrine in contract cases regarding the sale of tangible property has been relatively easy to apply. For example, with regard to home sales, courts will typically hold that the economic loss doctrine bars tort claims for qualitative defects in the house or when a defect in the home damages the home itself.[33] The application of the economic loss doctrine to service contracts has been much more problematic. Courts have had difficulty applying the economic loss doctrine in this context because, historically, professional negligence claims often arise from a professional's performance of a contractual service.

On one hand, if the services are performed improperly, the purchaser of the service

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[31] *See, e.g.*:

US/TX—American Eagle Ins. Co. v. United Technologies Corp., 48 F.3d 142, 144–145 (5th Cir. 1995);

FL—Turbomeca S.A. v. French Aircraft Agency, Inc., 913 So. 2d 714, 716–717 (Fla. Dist. Ct. App. 2005);

NV—Nat'l Union Fire Ins. Co. of Pittsburgh Pa. v. Pratt & Whitney Canada, Inc., 815 P.2d 601, 603–605 (Nev. 1991).

[32] **US/PA—**Agrotors, Inc. v. Bell Helicopter Textron, Inc., 2004 U.S. Dist. LEXIS 18543 (E.D. Pa. Sept. 10, 2004);

IL—Trans States Airlines v. Pratt & Whitney Canada, Inc., 682 N.E.2d 45, 53–59 (Ill. 1997).

[33] **TX—**Jim Walter Homes, Inc. v. Reed, 711 S.W.2d 617 (Tex. 1986).

has normally lost only her contractual benefit of the bargain, which typically has been viewed as economic loss. On the other hand, the failure of a professional to perform services typically has been viewed as giving rise to a malpractice/negligence claim. Given this conflict, courts have reached mixed results in the application of the doctrine to pure service providers.[34]

There are many different kinds of service contracts. Claims against doctors, lawyers, engineers, etc. for losses caused by their professional services typically are brought as tort claims. In contrast, failure of a company to publish a business listing in the "yellow pages" historically has been treated as a breach of contract.[35] Some courts apply the economic loss doctrine when the parties are in privity of contract, but recognize an exception regarding claims against those providing professional services.[36] This distinction is difficult to rationalize, other than on historical grounds.

In response to the difficulty of applying the economic loss doctrine to contracts for services, in 2013 the Florida Supreme Court took the somewhat dramatic step of limiting the doctrine solely to product liability claims. The concurring opinion in *Tiara Condominium Ass'n v. Marsh & McClennan Companies*[37] asserted that the decision merely "clarifies that the economic loss rule was always intended to apply only to products liability cases."[38] However, *Tiara* appears to have only focused on the application of the economic loss doctrine to service contracts, failing to expressly address whether its reasoning would apply to the *Robins Dry Dock* type of economic loss-loss as a result of damage to property owned by another[39] —or to cases in which the plaintiff has sustained only qualitative defects in other "non-product" tangible property that results in nothing more than a loss of plaintiff's benefit of the bargain. Despite the expansive language in the opinion, in all likelihood, *Tiara* will be confined to service contracts such as those analyzed in that opinion.

§ 162.07 Recovery of Stigma Damages

[1] What Are Stigma Damages?

Subrogation claims often involve recovery of stigma damages. Stigma damages can best be defined as diminution in value market of property that is caused by a negative perception of the property as opposed to physical damage to the property. Stigma damage claims are particularly relevant in subrogation when property is subject to a

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[34] *Compare* **WV—**Eastern Steel Constructors, Inc. v. City of Salem, 549 S.E.2d 266 (W. Va. 2001) (allowing tort claims against a design professional) *with* **ID—**Blahd v. Richard B. Smith, Inc., 108 P.3d 996 (Idaho 2005).

[35] **FL—**AFM Corp. v. Southern Bell Telephone & Tel. Co., 515 So. 2d 180 (Fla. 1987).

[36] **FL—**Moransais v. Heathman, 744 So. 2d 973 (Fla. 1989).

[37] **FL—**Tiara Condo. Ass'n v. Marsh & McLennan Cos., 110 So. 3d 399 (Fla. 2013).

[38] **FL—***Tiara*, 110 So. 3d at 409.

[39] The *Robins Dry Dock* type of economic loss is discussed in Section 162.05 above.

0062 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:14 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

potentially injurious event which may or may not have damaged the property but nonetheless caused the property to have a diminished market value.

It is important for parties pursuing subrogation claims to understand how first party property insurance coverage functions in connection with potential "stigma" damage claims. The insuring clause of most "All-Risk" insurance policies generally requires the property insurer to reimburse the insured for "accidental ***physical*** loss of or damage to the insured property." In stigma damage situations, the physical damage to the property will be questionable. However, in all cases there will be an event which has physically impacted the property in some manner, whether it is smoke damage, water damage, etc. The insurer may attempt to argue that the property has not been "physically" damaged but rather only exposed to an event and as such is not "damaged" for purposes of the policy. Therefore, stigma subrogation claims will often involve situations where coverage has been contested by the insurer, but the claim has ultimately been paid.

The most frequent stigma damage claim involves loss in value of consumer or commercial goods intended for resale. Even if there is no "physical damage," the insured can no longer sell the goods as first quality and instead must sell them at a discount on the salvage market. To deal with this situation, property policies often include a "Brand and Label Clause." A typical "Brand and Label" clause provides:

> In the event of a claim for loss or damage to the Insured Property under Section I of this Policy it is understood and agreed that any salvage of branded goods shall not be disposed of by sale without the consent of the insured. In the event of the Insured not consenting to such sale the salvage value as agreed shall be taken into account in the settlement of the loss. The insured may at its own expenses, stamp "salvage" on the merchandise or its containers, or may remove or obliterate the brands or labels, if such stamp, removal or obliteration will not physically damage the merchandise provided any such merchandise or containers are relabeling compliance with legal and/or statutory requirements provisions or regulations.

This provision is critical for cases involving stigma damages. If a manufacturer, wholesaler or retailer holds goods for resale under the insured's "brand," the insured has the option to declare that *potentially* damaged goods must be sold for salvage if they sustain virtually any degree of physical damage. For example, if the goods are exposed to smoke from a fire, they have undoubtedly sustained some degree of physical damage, even if the physical damage is undetectable. In that event, the owner of the "branded" property has the right to declare that the property must be sold for salvage rather than on the regular wholesale or retail market for the goods. Moreover, the owner also has the option to remove the "brands and labels" from the damaged goods so they are no longer identifiable as the insured's goods, or at a minimum that any purchaser will be on notice that the goods are no longer first quality. Obviously, this greatly diminishes the value of the goods on the resale market. However, if the insurance carrier pursues subrogation on the basis of this claim, it will have to prove

0063 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:14 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

such damage by virtue of "stigma" rather than by diminished market value caused by actual physical damage.

[2] Hypothetical Example of Stigma Damage Subrogation

One example of a stigma damage subrogation claim is a situation where carpeting in the possession of a wholesaler is exposed to a warehouse fire. The carpet is subject to potential smoke damage, but in reality may, or may not, have sustained any physical damage. There is really no "test" to be certain that the carpet has not been exposed to smoke to the extent that it will later emit an unpleasant odor. The wholesaler cannot simply sell the carpet to its retailers as "new" because if the carpeting later turns out to be defective because it emits smoke odors, the damages to the wholesaler in having to replace the carpet or recall the carpet would most likely be greater than the market value of the carpet in the first instance. Moreover, the wholesaler's reputation would be injured. In addition, the consumer protection laws of many states might prohibit the wholesaler from selling the carpet as "new" once it has been exposed to an event that has potentially caused damage to the carpet.

The wholesaler unable to sell the carpet as "new" will submit a claim to its insurer. The insurer may sell the carpet on the salvage market for the highest amount it can receive, but the recovery will be very little in salvage because the salvage market competes with a variety of factory "seconds" and other lesser quality goods.

An insurer bringing a subrogation claim against the tortfeasor that caused the fire will seek to recover the difference between the wholesale market value of the carpet and the amount received in salvage. The problem is that the "tort" measure of damages is usually perceived as physical damage to property rather than diminished market value of property that is caused by "stigma."

[3] Philosophical Basis of Stigma Claims

The first line of argument in any stigma damage claim by the insurer is that there is nothing unusual about the claim compared to other property damage claims. Stigma damages represent damages that are not repairable. By its very nature, the stigma cannot be removed. The measure of damages for permanent injury to property is typically diminution in market value.[1] "Market value" is typically defined as what a willing buyer would pay for the property.[2] Stigma causes a very real diminution in value. The only distinction between a stigma damage claim and a "typical" property claim is that the diminished market value is caused by the negative perception of a "willing buyer" towards the property rather than solely caused by physical damage to the property. In many respects, this is a distinction without a difference, because the diminution in market value is very real. Therefore, so long as there was some physical damage to the property, no matter how small, the diminution in market value should be recoverable.

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[1] *See* Section 162.04[2] above.

[2] *See* Section 162.04[2] above.

The counterargument for the defendant is closely tied to the economic loss rule. Pursuant to the economic loss rule, one cannot typically recover in tort unless there has been physical injury to the property. Consider the *One Meridian* fire damage case.[3] In that case, numerous property owners brought actions for loss of use of their property as a result of an office building fire. The businesses had been exposed to smoke but had not suffered any physical damage to their property. The court held that absent physical damage to the property, economic damages were not recoverable. Although the properties had sustained exposure to smoke, the actual cause of the loss of use of the properties was the fact that the area around the office building had been declared unsafe by the authorities. The physical effects of the smoke did not cause the economic losses. As such, the court held the economic losses were not compensable in a tort claim.

A similar argument can be made by a defendant in a case where the diminution in value of the property is not in fact caused by physical damage. A defendant may logically argue that any diminution in value that is not caused by physical damage to the property is in fact economic loss only, and therefore not compensable in a tort claim.

[4] Case Law on "Stigma"

[a] Overview

Because there are myriad types of stigma damage claims and very little case law in any given jurisdiction regarding stigma, it is very unlikely there will be controlling judicial precedents directly applicable to any given claim. The insurer pursuing a subrogation claim will in all likelihood have to analogize to precedents involving other stigma claims. The most substantial body of case law on this issue involves home sales, termite damage, and environmental damage to property.

[b] Home Sales

The facts of *Reed v. King*[4] provide an excellent example of stigma damages. A home was advertised as being in good condition and fit for an "elderly lady" living alone. Neither the seller nor his real estate agent disclosed that a woman and her four children had been murdered in the home 10 years earlier. Although the physical and functional value of the home and not been diminished in any manner by the murders, the court nonetheless held that the purchaser had a cause of action for the diminished value of the home. The court noted:

> Reputation and history can have a significant effect on the value of Realty. "George Washington slept here" is worth something, however physically inconsequential that consideration may be. Ill repute or "bad will" conversely may depress the value of property. Failure to disclose such a negative fact where it will have a foreseeably

[3] Discussed in Section 162.06[3] above.

[4] **CA—***Reed v. King,* 193 Cal. Rptr. 130 (Cal. Ct. App. 1983).

> depressing effect on income expected to be generated by a business is tortious. . . . Some cases have held that unreasonable fears of the potential buying public that a gas or oil pipeline may rupture may depress the market value of land and entitled the owner to incremental compensation in eminent domain . . . Whether Reed will be able to prove her allegation the decade-old multiple murder has a significant effect on market value we cannot determine. If she is able to do so by competent evidence she is entitled to a favorable ruling on the issues of materiality and the duty to disclose. Her demonstration of objective tangible harm would still a concern that permitting her to go forward will open the floodgates to rescission on subjective and idiosyncratic grounds.
>
> A more troublesome question would arise if a buyer in similar circumstances were unable to plead or establish a significant and quantifiable effect on market value. However, this question is not presented in the posture of this case. Reed is not alleged the fact of the murders has rendered the premises useless to her as a residence.[5]

The *Reed* case is an example of a court awarding stigma damages that may be useful to an insurer seeking subrogation for a claim paid because prior events have caused some sort of stigmatization of a home, resulting in diminution in value of the property.

[c] Termite Damage

Orkin Exterminating Company, Inc. v. DelGuidice[6] provides an additional example of a stigma damage claim. The plaintiff had a contract with Orkin to treat his new home for termites. The contract between Orkin and the plaintiff provided that so long as the plaintiff paid an annual premium, Orkin would repair any termite damage. The plaintiff's home became infested with termites, and the plaintiff claimed that in addition to $78,000 in repairs, Orkin should also be required to pay for stigma to the home caused by the termite infestation. The court rejected this argument. In doing so, the court relied upon traditional damage measures when the damage to the property was repairable. The court held that because diminution in value was not the measure of damages, diminution in value caused by stigma was not compensable. The court explained:

> The purpose of providing an alternative method of computing damages on the basis of diminution in value (the difference between the value of that which was provided and the value of what should have been provided) is to prevent economic waste and to prevent, as well, potential windfalls to plaintiffs. If a plaintiff can be made whole by being compensated by a repair, the law generally does not allow an additional windfall type of recovery for any diminution in value which occurs beyond the cost of repair. On the other hand, if diminution in value is less than the cost of repair, diminution in value becomes the standard because, to repair in such a circumstance would amount to economic waste. Applying these principles to the instant case, the diminished in value damages of $300,000 could have properly been presented to the

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[5] **CA—***Reed*, 193 Cal. Rptr. at 133.

[6] **FL—**Orkin Exterminating Co., Inc. v. DelGuidice, 790 So. 2d 1158 (Fla. Dist. Ct. App. 2001).

0066 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:15 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

> jury if competent substantial evidence had been presented that the cost to repair existing termite damage and the cost of providing effective termite eradication procedures would have constituted economic waste. In other words, had evidence been presented that the cost of repair was substantially greater than the diminution in value, diminution in value would have been the standard to apply.[7]

Because the contract between Orkin and the plaintiff provided for repairs, because there was evidence that the structure was repairable, and there was no evidence that such cost of repairs exceeded diminution market value of the home, the plaintiff was limited to the cost of repairs as the measure of damages. The court tacitly rejected stigma as a separate and distinct category of damages. Obviously, if the market value of the home had diminished $200,000 but the termite damage was repairable at a cost of $100,000, the repairs alone would not remove the stigma associated with the termite infestation. The physical damage to the home, although remedied by repairs, nonetheless could further diminish the market value of the home.

While the *Orkin* court's decision is not necessarily favorable to stigma subrogation claims, it illustrates that termite infestation cases provide precedents concerning whether the recovery of such stigma damages is available.[8]

[d] Environmental Damage

There is a substantial body of law concerning stigma damages caused by environmental damage to real property.[9] Properties often suffer exposure to toxic events. In some cases, owners allege that even after the physical damage to the property has been remediated, the property has suffered stigma as a result of the environmental damage. These cases generally involve stigma damages claims to real property, including buildings. Given that case law regarding stigma damages related to personal property is sparse, it is likely that the courts in many jurisdictions, will borrow from the law of real property when addressing stigma damage claims to personal property.

[5] Proving Stigma Damage

There are several ways to prove stigma damages. First, a court will most likely require expert testimony regarding the diminution in value. The plaintiff is in essence seeking compensation regarding diminution in value damage even after physical damage to the property has been repaired. A real estate appraiser may be required to testify as to the diminished value of the property in the case of a structure. With consumer goods that are sold for salvage on the basis of a claim that they can no longer

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[7] **FL—***Orkin*, 790 So. 2d at 1160.

[8] *See also* **KS—**Horsch v. Terminix Int'l Co., 865 P.3d 1044 (Kan. 1993).

[9] *See:*

US/PA—*In re* Paoli Railyard, 113 F.3d 444 (3d Cir 1997);

IN—Pflanz v. Foster, 888 N.E.2d 756 (Ind. 2008).

0067 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:15 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

be sold as new, an expert familiar with the industry market should be employed to testify regarding the diminution in market value and the dynamics of the wholesale/retail/salvage market for "seconds."

Consumer protection laws are another method of establishing stigma in situations involving consumer goods. Consumer protection statutes often provide that a seller is precluded from selling goods that are involved in an incident as "new." Therefore, in instances where the consumer goods have been exposed to an event, the consumer protection statutes themselves cause a diminution in market value because the property may only be sold as damaged goods rather than as "new" products.

In order to meet legal standards, the plaintiff should be prepared to show "some damage" to the property, no matter how small. For example, in the case of consumer goods, the plaintiff should be prepared to show that they sustained some damage by exposure to smoke. Expert testimony should be offered to establish that this exposure has affected the physical integrity of the product and made it less desirable. In that context, any damages that are caused by diminution in market value and do not relate to actual physical damage or actual deficient performance of the product should nonetheless be compensable as permanent injuries that flow from that property damage.

A primary judicial concern in allowing stigma claims is that they portend a "slippery slope" of fraudulent claims where there has been no real damage but the plaintiff might argue that the property has been "stigmatized." A judicial reaction to this potential problem is to impose additional evidentiary requirements on stigma claims so as to eliminate claims for which there is no legitimate basis. Courts may impose two requirements. They may require that the property have been subject to "some damage" so as to eliminate potentially frivolous claims that might arise when there has been no property damage whatsoever. It will also impose a requirement that whatever "fears" that create the stigma be reasonable. For example, if a plaintiff claims that there is a concern by potential purchasers that they could contract HIV because someone having HIV once rode in a car they wish to sell, that is not a legitimate "stigma" because any concerns by potential purchasers would not be reasonable.

In *Smith v. Kansas Gas Service Co.*,[10] the Supreme Court of Kansas grappled with this issue. The plaintiffs filed a class action, contending that their property had been stigmatized by the release of natural gas from a nearby storage facility and as such the value of that property had been diminished. In making this argument, the class plaintiffs attempted to rely upon the prior Kansas decisions that permitted recovery of stigma caused by termite damage and the installation of high-voltage power lines (in eminent domain cases). The court recognized that the termite and high-voltage power line cases involved two elements which were not present in the *Smith* case. First, both the termite line of cases and the high-voltage line of cases involved actual damage to

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[10] **KS—**Smith v. Kansas Gas Serv. Co.,169 P.3d 1052 (Kan. 2007).

0068 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:15 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

the property. In the case of the high-voltage line cases, that damage was in the form of installation of the power lines on the property in the first instance. In the termite line of cases, it was the physical damage caused by termites. There was "some" damage in each situation from which the stigma was a consequential result. Moreover, the court recognized that in both the termite cases and the high-voltage line cases the "fear" that resulted in the stigma was reasonable. People have reason to fear termites because they cause damage. People have reason to fear a high-voltage line because it can be hazardous. In contrast, a prior exposure to natural gas could not result in any reasonable fear. The *Smith* court concluded:

> Those cases instruct us that a diminution in property value resulting from the public's fear of high power transmission lines or fear of termite damage can be a component in measuring the damages suffered by the owner of property directly affected by the stigmatizing condition. Further, these cases stand for the proposition that the general public's fear of high power lines and termites is a reasonable concern. However, those cases do not answer our question. As noted, the plaintiff class did not prove that the stigmatizing condition directly affected its real property or that the stigma was a reasonable fear.[11]

Decisions from other jurisdictions are in accord with the *Smith* opinion.[12]

§ 162.08 Recovery for Code Upgrades

[1] Theoretical Debate as to Whether Damage Was Caused by Tortfeasor

Often after a commercial or residential property is damaged or destroyed, the repaired structure or the replacement structure must comply with current building codes. These building codes may be materially different from the building codes under which the building was originally constructed. Typically, newly adopted building codes do not apply to existing structures, such that the existing structure is "grandfathered" in. Pursuant to many building codes, if a structure is damaged such that its value is diminished by more than a certain percentage, the repaired structure or replacement structure must be constructed in a manner that meets current codes. Some of the most common upgrades which may be required relate to:

- Sprinkler systems;
- Handicapped accessibility;
- Weather resistant characteristics (hurricane, etc.);
- Asbestos/lead removal; and
- Set-back requirements.

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[11] **KS—**169 P.3d at 1060.

[12] *See, e.g.:*

US/VT—Graham v. Canadian Refining National Railway, 749 F. Supp. 1300, 1320 (D. Vt. 1990);

MI—Adkins v. Thomas Solvent Co., 487 N.W.2d 715, 721 (Mich. 1992).

0069 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:15 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

If the insured's property is damaged and the insured, as part of its repairs to the structure, must rebuild the structure so as to comply with current codes, the costs of the code upgrades are often covered pursuant to Code and Ordinance Coverage of an insurance policy. For example, the Insurance Services Office ("ISO") form endorsement HO 05 6204 01 provides such coverage as follows:

A. We will pay for the increased costs you incur due to the enforcement of any ordinance or law which requires or regulates:

1. The construction, demolition, remodeling, renovation or repair of that part of a covered building or other structure damaged by a Peril Insured Against;

2. The demolition and reconstruction of the undamaged part of a covered building or other structure, when that building or other structure must be totally demolished because of damage by a Peril Insured Against to another part of that covered building or other structure; or

3. The remodeling, removal or replacement of the portion of the undamaged part of a covered building or other structure necessary to complete the remodeling, repair or replacement of that part of the covered building or other structure damaged by a Peril Insured Against.

The insurer, being obligated to pay for "code upgrades" would obviously prefer to be able to recover the cost of these code upgrades in a subrogation claim against a tortfeasor. The issue is whether the tortfeasor should be obligated to pay for the upgrades.

There are two schools of thought on this issue. The majority rule holds that the insured would not have been obligated to incur the costs of the code upgrades but for the damage caused by the tortfeasor and therefore such costs are a recoverable element of damages.[1] The minority rule holds that the additional costs of code upgrades were not caused by the tortfeasor but by the governmental entity that adopted the code, that the upgrade would constitute "betterment" and that such costs are therefore not recoverable.

[2] The Majority Rule—Jurisdictions Allowing Recovery

The majority of courts that have addressed this issue have held that the cost of code upgrades naturally flow from the damages caused the tortfeasor and are therefore recoverable as damages. For example, in *One Beacon Insurance Group v. RSC Corp.*,[2]

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[1] *See, e.g.*:

MA—One Beacon Ins. Group v. RSC Corp., 868 N.E.2d 644 (Mass. App. Ct. 2007);

IL— Peluso v. Singer General Precision, Inc., 365 N.E.2d 390 (Ill. App. Ct. 1977);

WI—Zindell v. Central Mutual Ins. Co. of Chicago, 269 N.W. 327 (Wis. 1936).

[2] **MA—**One Beacon Ins. Group v. RSC Corp., 868 N.E. 2d 644, 647 (Mass. App. Ct. 2007).

the subrogated insurer, One Beacon Insurance Group, contended that it was entitled to recover the costs of the code upgrade. The court viewed the issue as whether the recovery of such code upgrades would " '. . . permit the injured party to recover more than is fair to restore him to his position prior to the loss. He should not recover a windfall.' "[3] In rejecting the argument that the code upgrades would constitute a betterment, the *One Beacon* court held:

> Here the defendants argue that the plaintiffs will recover a windfall if they can recover for code upgrades, because they will have a code-compliant house rather than one that is non-compliant. The fallacy in this reasoning is the assumption that the former must be worth more than the latter. Such is not the case unless the non-compliant house is burdened with an obligation to bring it up to code. There was no such obligation prior to the massive water infiltration. The house was grandfathered in its pre-code condition. Code compliance was not to make the house more livable or comfortable; it had nothing to do with the house being obsolete, non-functional, or worn out. It is simply part of the cost of doing the repair work necessitated by the defendants' failure to take adequate precautions against water damage. The recovery of the cost of the code upgrades did not violate the central principle, that "the replacement or reconstruction itself must be reasonably necessary in light of the damage inflicted by a particular defendant."[4]

In *Zindell v. Central Mut. Ins. Co. of Chicago*,[5] the plaintiffs sustained damage to their garage as a result of an automobile accident. The damaged garage had 8-inch walls, but the current building code required that a rebuilt structure have 12-inch walls. The court held that the plaintiffs were entitled to recover for the increased cost of utilizing 12-inch walls. Analogizing the more strict code requirements to increased costs of materials, the *Zindell* court stated that defendant's obligation "should be measured by the cost thereof under the conditions existing or lawfully imposed at the time of the negligent injury."[6]

Similarly, in *Peluso v. Singer General Precision, Inc.*, *Link Div*.[7] the court held that

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[3] **MA—***One Beacon*, 868 N.E 2d at 647 (quoting Mass. Port. Auth. v. Sciaba Constr. Corp., 54 Mass. App. Ct. 509, 517, 766 N.E.2d 118 (2002)).

[4] **MA—***One Beacon*, 868 N.E 2d at 647 (quoting Trinity Church in the City of Boston v. John Hancock Mut. Life Ins. Co., 399 Mass. 43, 50, 502 N.E.2d 532 (1987)).

See also **MN—**A. H. Jacobson Co. v. Commercial Union Assurance Co., 83 F. Supp. 674 (D. Minn. 1949) (Although *A. H. Jacobsen* involved a first-party insurance claim, it is one of the first opinions in this area of law and contains a reasoned discussion that when a local ordinance required a building to be rebuilt because more than 40% of its value had been lost by a fire but the building inspector refused to allow the insured to rebuild the damaged building, the insured's loss was the cost of replacing the building. The rebuilding costs exceeded the total insurance on the building.).

[5] **WI—**Zindell v. Central Mutual Ins. Co. of Chicago, 269 N.W. 327, 330–331 (Wis. 1936).

[6] **WI—***Zindell*, 269 N.W. at 330–331.

[7] **IL—** Peluso v. Singer General Precision, Inc., Link Div., 365 N.E.2d 390, 400–401 (Ill. App. Ct. 1977).

the cost of code upgrades was recoverable. Refusing to follow *Stenger v. Hope Natural Gas Co.*,[8] the *Peluso* Court held that where the measure of damages is the cost of repairs, the cost of building code improvements were naturally a part of those repairs and were recoverable.[9]

[3] Minority Rule—Jurisdictions Refusing Recovery

A minority of jurisdictions have held the cost of code upgrades is not recoverable because it would result in "betterment" to the plaintiff. That was the issue in *Mercer v. J & M Transportation Co*.[10] In that case, a house that was 25 to 30 years old was damaged by the tortfeasor. The house did not have plumbing, wiring, bathrooms or modern heating. The *Mercer* court found that the upgrades would be far in excess of the difference in value before and after the injury to the premises and were not compensable. To a certain extent this result made sense. The injured plaintiff was apparently "protected" from the costs of code upgrades by "grandfathering," but had chosen (or was forced by economic circumstances) not to have the building incorporate modern features that are present in virtually every residence. If recovery was awarded, the happening of the incident would have provided the owner with the financial resources to improve the structure with fundamental features that the owner no doubt wanted, but did not want to pay for or was not able to afford. In that instance, awarding the costs of code upgrades would have indeed provided the owner a betterment. But in another sense, the owner was penalized for his primitive tastes or his poverty. If the tortfeasor does not have to pay for these improvements, the owner must nonetheless incur the financial burden of improvements that he did not want, or worse yet, could not afford. In that sense, the *Mercer* rule penalizes the plaintiff for his lack of financial resources, a goal that certainly should not be sanctioned by the judicial system.

The court in *Long v. Magnolia Hotel Co.,*[11] rejected recovery based upon the cost of replacing a building with a "new brick building erected in conformity with the city's new building code at a cost of $23,669.00."[12] The court rejected two unidentified decision from Wisconsin and West Virginia because "[t]hose two cases are not shown to be the majority rule."[13] The court held that recovery was limited to the physical damage caused to the building itself as opposed to increased costs to conform with the "city's new building code."[14]

One distinguishing feature of this issue is whether the measure of damages required

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[8] **WV—**Stenger v. Hope Natural Gas Co., 80 S.E.2d 889 (W. Va. 1954).

[9] **IL—***Peluso*, 365 N.E.2d at 400–401.

[10] **GA—**Mercer v. J & M Transportation Co., 118 S.E.2d 716, 718 (Ga. Ct. App. 1961).

[11] **MS—**Long v. Magnolia Hotel Co., 111 So. 2d 645 (Miss 1959).

[12] **MS—***Long*, 111 So. 2d at 648.

[13] **MS—***Long*, 111 So. 2d at 649.

[14] **MS—***Long*, 111 So. 2d at 649.

0072 [ST: 162-1] [ED: 100000] [REL: 13] Composed: Mon Aug 3 12:40:15 EDT 2015
XPP 8.4C.1 SP #3 SC_00389 llp 60087 [PW=504pt PD=684pt TW=380pt TD=552pt]
VER: [SC_00389-Master:15 Jul 15 02:10][MX-SECNDARY: 30 Jun 15 15:05][TT-: 23 Sep 11 07:01 loc=usa unit=ch0162] 0

by the court (and proven by the plaintiff) is the cost of repairs or diminution in value. *Stenger v. Hope Natural Gas Co.,*[15] held that where the measure of damages is diminution in value, required code upgrades are not an appropriate consideration because those code upgrades are irrelevant to pre-damage value. On the other hand, *Peluso v. Singer Gen. Precision, Inc.*, *Link Div*. held that where the costs of repair is the measure of damage, material code upgrades are necessarily a part of the costs and are therefore compensable.[16]

§ 162.09 Recovery of Attorney's Fees

[1] Common Law Rules—American Rule vs. English Rule

The ability to recover attorney's fees in subrogation claims varies by jurisdiction and the type of claim being pursued. In the United States, the American Rule generally provides that each party to a lawsuit is responsible for paying its own attorney's fees, regardless of the outcome.[1] In contrast, the English Rule provides that the prevailing party may recover its attorney's fees from the losing party.[2]

Like most rules, there are exceptions to the American Rule. Most notably, a party may recover attorney's fees when authorized by statute or contract. When a contract authorizes the recovery of attorney's fees, the language of the contract should control over any applicable statutory authorization.[3]

Statutory and contractual provisions will often authorize a "prevailing party" to recover attorney's fees, so it is important to understand what constitutes a prevailing party. Some courts define the prevailing party as the party for whom judgment is rendered.[4] Other courts define the prevailing party as the party who successfully prosecutes the action or successfully defends against the action on the main issue.[5]

[2] Statutory Basis

There are numerous statutes, both state and federal, that allow for the recovery of attorney's fees in specific cases. For example, in Alaska civil cases, the prevailing party is generally entitled to recover attorney's fees based on a set schedule detailing

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[15] **GA—**Stenger v. Hope Nat. Gas Co, 80 S.E.2d 889 (Ga. Ct. App. 1954).

[16] **IL—***Peluso*, 365 N.E.2d at 400–401.

[1] **US—**Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975).

[2] **US—**Alyeska Pipeline, 421 U.S. at 247.

[3] **OK—**Sooner Builders & Investments, Inc. v. Nolan Hatcher Const. Servs., L.L.C., 164 P.3d 1063, 1069–1070 (Okla. 2007);

TX—Intercontinental Grp. P'ship v. KB Home Lone Star L.P., 295 S.W.3d 650, 653 (Tex. 2009).

[4] **OK—**Underwriters at Lloyd's of London v. N. Am. Van Lines., 829 P.2d 978, 981 (1992);

WA—Riss v. Angel, 934 P.2d 669, 681 (Wash. 1997).

[5] **FL—**Moritz v. Hoyt Enters., 604 So. 2d 807, 810 (Fla. 1992);

TX—Weng Enterprises, Inc. v. Embassy World Travel, Inc., 837 S.W.2d 217, 223 (Tex. App. 1992).

0073 [ST: 162-1] [ED: 100000] [REL: 13] **Composed:** Mon Aug 3 12:40:15 EDT 2015
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the amount of attorney's fees allowed.[6] In Montana cases seeking solely property damages to a motor vehicle, a successful plaintiff is entitled to recover reasonable attorney's fees provided the final judgment is equal to or greater than the amount of damages claimed by the plaintiff in the plaintiff's last written offer to the defendant prior to the filing suit.[7] In Oklahoma, the prevailing party is entitled to recover reasonable attorney's fees in addition to court costs and interest in cases seeking damages for negligent or willful injury to property.[8] However, the defendant can make a written offer of judgment pursuant to the Oklahoma statute that, if rejected and the judgment ultimately rendered is equal to or less than the defendant's offer, will preclude the plaintiff from recovering attorney's fees.[9]

Statutory offer of judgment provisions are prevalent throughout the United States and many are patterned after Rule 68 of the Federal Rules of Civil Procedure.[10] These statutes generally provide that if a plaintiff rejects an offer of judgment made by a defendant that satisfies the applicable statutory requirements and the final judgment is

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[6] **AK—**Alaska R. Civ. P. 82.

[7] **MT—**Mont. Code Ann. § 25-10-303.

[8] **OK—**Okla. Stat. tit. 12 § 940;

See also **US/OK—**Rockwood Ins. Co. v. Clark Equip. Co., 713 F.2d 577, 579 (10th Cir. 1983).

[9] **OK—**Okla. Stat. tit. 12 § 940.

[10] *See, e.g.*:

AL—Ala. Civ. P. Rule 68;

AR—Ark. R. Civ. P. 68;

DE—Del. R. Com. Pl. Ct. Civ. Rule 68;

DC—D.C. Super. Ct. R. Civ. P. 68;

HI—Haw. R. Civ. P. 68;

ID—I.R.C.P. 68;

IN—Ind. R. Trial P. 68;

KS—Kan. Stat. Ann. § 60-2002;

KY—Ky. R. Civ. P. 68;

ME—Me. R. Civ. P. 68;

MA—Mass. R. Civ. P. 68;

MS—M.R.C.P. 68;

NE—Neb. Rev. Stat. § 25-901;

RI—Super. R. Civ. P. 68;

SC—S.C. Code Ann. § 15-35-400;

TN—Tenn. R. Civ. P. 68;

VT—Vt. R. Civ. P. 68;

WA—Wash. Super. Ct. Civ. R. 68;

WV—W. Va. R. Civ. P. 68.

equal to or less than the offer, then the plaintiff must pay the costs (which can include attorney's fees) incurred by the defendant after the offer was made.

Some states have similar statutes that, if properly invoked, allow a plaintiff to recover costs (which can include attorney's fees) if a defendant rejects a settlement offer and the final judgment against the defendant is less favorable to the defendant than the settlement offer.[11] Jurisdictions define "less favorable" in different ways. In Texas, if a final judgment in favor of a plaintiff is more than 120% of the rejected offer, then the plaintiff is entitled to recover costs from the defendant.[12]

In the context of property subrogation claims, the recovery of attorney's fees is most often an issue in breach of contract claims, especially when the contract contains a specific provision allowing for the recovery of attorney's fees. Even in the absence of an attorney's fees provision in the contract, many states allow for the recovery of attorney's fees in a breach of contract claim when the statutory requirements for presenting the claim are met.[13]

[3] Proving Attorney's Fees

In addition to satisfying any applicable statutory or contractual requirements, a

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[11] **AK—**Alaska R. Civ. P. 68; Alaska Stat. Ann. § 09.30.065;

AZ—Ariz. R. Civ. P. 68;

CA—Cal. Civ. Proc. Code § 998;

CO—Colo. Rev. Stat. Ann. § 13-17-202;

CT—Conn. Gen. Stat. Ann. § 52-192a;

FL—Fla. Stat. Ann. § 768.79;

MI—Mich. Ct. R. 2.405;

MN—Minn. R. Civ. P. R. 68.01, *et seq.*;

NV—Nev. R. Civ. P. 68;

NJ—N.J. Ct. R. R. 4:58-1, *et seq.*;

NM—New Mex. Rules of Civil Procedure for the District Courts Rule 1-068 (N.M.R.A. Rule 1-068);

NY—N.Y. C.P.L.R. 3221;

ND—N.D. R. Civ. P. 68;

PA—Pa.R.C.P. No. 238;

SD—S.D. Codified Laws § 15-6-68;

TX—Tex. Civ. Prac. & Rem. Code § 42.001, *et seq.*;

UT—Utah R. Civ. P. 68;

WI—Wis. Stat. Ann. § 807.01;

WY—Wyo. R. Civ. P. 68.

[12] **TX—**Tex. Civ. Prac. & Rem. Code § 42.001, *et seq.*

[13] **AZ—**Ariz. Rev. Stat. Ann. § 12-341.01;

TX—Tex. Civ. Prac. & Rem. Code § 38.001, *et seq.*

claimant seeking recovery of attorney's fees must generally establish that the fees were reasonably incurred and necessary to the prosecution of the case.[14] In doing so, the claimant should not rely solely on having entered into a contingent fee agreement that compensates his attorney with a percentage of the judgment.[15]

Instead, a claimant should ask for a specific dollar amount based on the lodestar method and factors considered by most courts. The lodestar method calculates attorney's fees by multiplying the number of hours reasonably spent on the case by a reasonable hourly rate. This figure can then be adjusted for certain factors known as multipliers, such as contingency and the quality of the work performed, to arrive at a final fee. Under the lodestar method, the most important multipliers are the time and labor required.[16]

Expert testimony from the attorney handling the matter will generally be required to prove the number of hours reasonably spent on the case. Depending on the circumstances and the amount of fees claimed, it may also be desirable to retain a disinterested attorney to provide expert testimony regarding fee issues. Timesheets and other records detailing hours spent on a matter can help establish (and may be required to establish) the reasonableness and necessity of attorney's fees, but they are not required in every jurisdiction.[17]

There are a number of non-exclusive factors that a claimant should be prepared to present evidence on in order to establish the reasonable hourly rate.[18] They include:

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[14] **TX—**Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 819 (Tex. 1997).

[15] **TX—***Arthur Andersen*, 945 S.W.2d at 818–819.

[16] **GA—**Friedrich v. Fidelity Nat'l Bank, 545 S.E.2d 107, 109 (Ga. Ct. App. 2001).

[17] **US—**Hensley v. Eckerhart, 461 U.S. 424, 437, 103 S. Ct. 1933, 1941, 76 L. Ed. 2d 40 (1983);

US/TX—Copper Liquor, Inc. v. Adolph Coors Co., 684 F.2d 1087, 1094 (5th Cir. 1982), *overruled by* Int'l Woodworkers of Am., AFL-CIO & its Local No. 5-376 v. Champion Int'l Corp., 790 F.2d 1174 (5th Cir. 1986), *overruled by* J.T. Gibbons, Inc. v. Crawford Fitting Co., 790 F.2d 1193 (5th Cir. 1986);

TX—Air Routing Int'l Corp. (Canada) v. Britannia Airways, Ltd., 150 S.W.3d 682, 692 (Tex. App. 2004).

[18] **US/CA—**Kerr v. Screen Extras Guild, Inc., 526 F.2d 67, 70 (9th Cir. 1975);

US/GA—Johnson v. Georgia Highway Exp., Inc., 488 F.2d 714, 717 (5th Cir. 1974);

AZ—Associated Indem. Corp. v. Warner, 694 P.2d 1181, 1184 (Ariz. 1985);

CA—Ketchum v. Moses, 17 P.3d 735, 741 (Cal. 2001);

FL—Florida Patient's Comp. Fund v. Rowe, 472 So. 2d 1145, 1150 (Fla. 1985); Standard Guar. Ins. Co. v. Quanstrom, 555 So. 2d 828 (Fla. 1990);

MA—Linthicum v. Archambault, 398 N.E.2d 482, 488 (Mass. 1979);

MI—Smith v. Khouri, 751 N.W.2d 472, 478–481 (Mich. 2008);

TN—Connors v. Connors, 594 S.W.2d 672, 676–677 (Tenn. 1980);

TX—Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 818 (Tex. 1997);

WA—Mahler v. Szucs, 135 Wash. 2d 398, 433–434, 957 P.2d 632, 651 (Wash. 1998).

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(1) the customary fee charged in the community for similar legal services;

(2) the time and labor required to perform the legal service properly;

(3) the likelihood that the acceptance of the particular employment will preclude other employment by the lawyer;

(4) the experience, reputation, and ability of the attorney performing the services (*e.g.*, whether the attorney is a partner or an associate);

(5) the novelty and difficulty of the issues involved in the case;

(6) the skill required to perform the legal service properly;

(7) the amount of money involved and the results obtained;

(8) the time limitations imposed by the client or by the circumstances;

(9) the nature and length of the attorney's professional relationship with the client;

(10) the undesirability of the case;

(11) whether the fee is fixed or contingent; and

(12) fee awards in similar cases.

These factors derive in large part from professional responsibility rules and are substantially the same in both state and federal courts. However, the way in which courts analyze these factors varies by jurisdiction. Whether the court or the jury will determine the amount of recoverable attorney's fees also varies by jurisdiction and the circumstances of the case.