

Subrogation damages: It's about foresight *and* hindsight

By Jim Stavros

Why is it that the amount an insurance carrier pays out to settle a business income/inventory/contents/property claim is many times far greater than the amount recovered in a subrogation suit against the party, given liability? Why does this gap, which could total millions of dollars depending on the size of the loss, often exist at all, and what, if anything, can be done to close it?

The simple answer lies within the venue; the immediate first party claim is paid pursuant to a contract — the insurance policy, with specific inclusions, exclusions, coverage limits, time period and valuation methods. The subrogation suit, filed to recover the amounts paid in the first-party action, is brought pursuant to state law, where different methods of determining damages are required. The insurance company typically (and understandably) will try to recover all amounts they paid to the insured; however, they must apply different damage valuation formulas to the components of the claim to make their recovery under state law. The difference between damages determined according to the insurance policy and those under state law can be significant.

Let's look at a typical case. A flood after a tropical rainstorm severely damages an office complex resulting in building, contents, equipment, valuable papers and inventory losses for a business, including significant lost-business income and extra expenses totaling more than \$5 million.

The insurance company responds immediately by hiring a variety of experts and adjusting the loss according to policy terms, which require replacement cost values for all property and equipment. The defense hires its own damages experts and finds most of the property was old and outdated, and comes up with a \$3 million loss

amount. How could a \$2 million difference happen? The general answer is that the equipment and property damaged was old and depreciated with a lower fair market value (FMV) and the insured received replacement cost values for the items lost — although there are likely many more details to explore.

Foresight versus hindsight explains one reason for the difference between a first party and third party claim. The experts hired by the defense have the benefit of time and hindsight in making their damage calculations, whereas adjusters and other experts in a first-party claim are making projections and dealing with the immediacy of the loss. Third-party experts have the time to calculate the actual costs to rebuild or replace destroyed property since the subrogation suit usually is in discovery several years after the event. The carrier, on the other hand, must pay the claim quickly on the basis of estimates and proposals since time is of the essence. The difference between cost estimates and actual costs often is significant. But most important, the valuation methods are different between what the policy will pay and what is allowed under state law.

The following sections highlight some key issues, valuation points and some pitfalls in determining money damages in subrogation suits. By proactively addressing many of the points listed below, the parties bringing the subrogation suit will have a more sustainable and credible damage estimate.

Subrogation action

Most claims from carriers come in two forms: straight subrogation to recover the amount paid out to honor the policy, and an additional claim by the insured to recover the difference between the amount received and any residual replacement costs. The claim by the insured thus needs to be

identified separately from the claim by the subrogee carrier. The latter action happens frequently when the insured:

- Is underinsured or uninsured;
- Has a high deductible or co-insurance clause;
- Was unhappy with the claim settlement or has a loss greater than the policy term; and
- Has a valuation method in the policy which does not reflect the true value of the loss.

Preparation

Although the use by the subrogee of the same expert reports employed in the first-party claim may save some money, this is usually a mistake. As noted above, the claim as quantified in the insurer's expert reports uses formulas and assumptions in the insurance policy that are not necessarily the same as those in state law. If these variations are not proactively identified and adjusted, the subrogee plaintiffs risk an embarrassing examination by the defense which may impair their credibility in other areas of the damage claim.

Actual invoices and copies of cancelled checks evidencing the cost of items will be compared to the original estimates used to pay the first party claim. Many times that "estimate" will not agree with the "actual cost" incurred. Simply put, an estimate of the cost to rebuild a building is not sufficient proof when actual invoices and payment data are available. Also, too often a claim is based on what was purchased to replace, not what was actually lost. Mounds of invoices typically are provided evidencing what was purchased to replace damaged items, but little or no information is provided about what actually was lost. In a third party claim, the focus is on what was lost first versus what was purchased to compensate the insured. This "documentation" gap between first- and third-party claims needs to be proactively reconciled.

Building/contents claims

Building or contents claims are probably the biggest loss item in a catastrophic claim. Based on the age and condition of the building or contents, the difference between the insurance payments at the replacement cost and the FMV at the time of the accident can be significant. For example, a recent case involved the partial destruction by fire of an old restaurant completely renovated in the 1950s with the original structure dating back almost 100 years. The capital improvement budget indicated the rugs, tables and rooms were old and outdated and the restaurant was not in compliance with local safety and building codes. The claim, including calculations for the building, stored equipment, inventory, contents, extra expenses and a business income loss, exceeded \$5 million. The building and contents portion of the claim were paid based on estimated values for replacement costs and building code improvements according to policy formulas, not on the actual expenditures by the insured.

When the matter was subrogated, several problems arose. State law required application of the lesser of the repair/replacement costs or the decrease in fair market value of the property caused by the destruction. The first-party claim for reconstruction had included significant betterments, an expansion of the facility. Construction experts and forensic accountants were needed to calculate damages. The construction expert provided a valuation for the construction needed to restore the restaurant to its former state resulting in a several million-dollar difference below the amount claimed by both the carrier and the insured. The insured was not put back to its pre-fire condition of an older and somewhat outdated facility. An appraiser was retained to provide an FMV opinion to the contents claimed (tables, chairs, rugs, etc.), which resulted in an amount several hundred thousand dollars less than claimed. Some of the documents and issues to be considered in evaluating property loss include:

- Historical cost and maintenance;
- Original and reconstruction blueprints, diagrams and layouts;
- Insurance appraisals or other estimates of fair market value;
- Age of items and remaining useful life;
- Accuracy, reliability and condition of accounting/business recordings documenting items claimed;
- Capital expenditure budgets and history;
- Construction records including engineering document contracts; and
- Actual invoices and proofs of payment.

If the insured has expanded or improved the building or the money paid by the carrier for one purpose was used for another, the defense will likely argue the insured is entitled to be made whole and nothing more. The destruction of an old building and its aged contents may be compensated for on the basis of replacement costs that may actually improve the position of the insured who now has a new building and contents. Under New Jersey state law and according to *525 Main Street Corp. v. Eagle Roofing Co.*, 34 NJ 251 (1961), and *Rempfer v. Deerfield Packing Corp.*, 4 NJ 135, 72 A.2d 204 (1950), the general computation of property damages is based on the *diminution in value* of the property, which could be measured by repair costs or replacement costs. Property valuation is another tool to assess damages since the measure of loss is the diminution in value of the property.

Equipment claims

Equipment claims are valued in a manner similar to building or contents claims. Maintenance logs, accounting usage and historical information usually are kept for large pieces of equipment. These documents must be analyzed to help determine the condition and useful life of the equipment before arriving at the FMV. For older and very specialized machinery, there often is a big difference between the FMV, the actual cash value (ACV) and the cost of repairs. ACV has been defined by most carriers to be the replacement cost of an item reduced by some depreciation factor.

Office equipment such as printers, computers, servers, copiers, fax machines and other business machines can be found in a typical claim. These items depreciate rapidly with their FMV significantly being reduced over a short period of time. Certain publications or contents experts can assist in determining the FMV of these items. A recent case involving the loss of more than 100 personal computers and other electronic equipment totaling more than \$2 million was valued at replacement cost, which was in accordance with the insurance policy. The company actually benefited from the claim because most of the machines were four or more years old. The company's fixed asset ledger showed many of these machines with little accounting book value. In the subrogation suit and pursuant to state law, an equipment expert calculated the FMV loss to be approximately 10 percent to 20 percent of the claimed loss, or \$300,000. The \$2,000 personal computers purchased four years before the loss were only worth about \$350 apiece.

Inventory claims

The difference in valuation methods between the insurance policy and state law also can be startling in the area of inventory losses. Establishing the very existence of the inventory can be a problem following catastrophic destruction. Proof that the quantities and qualities of lost inventory listed in the claim actually existed can be hard to establish, especially if the destroyed inventory cannot be counted. In the absence of the goods themselves, perpetual inventory, shipping, receiving and historical physical counts reports need to be utilized.

The process of valuing inventory is complicated by the fact that inventory can exist in various forms such as raw materials, work in process (WIP) and finished goods. Each inventory type has different valued components. Both WIP and finished goods contain labor and materials costs as well as company overhead; raw materials, on the other hand, typically have only their acquisition and delivery cost. Inventory is recorded on the balance sheet at actual or standard cost. Destroyed finished goods inventory, however, are typically valued at sale price less selling costs for most insurance claims. Thus, the method of valuing different classes of inventory is uniform for accounting purposes (for example, at cost), but different for the insurance claim. In subrogation, since inventory is property, inventory loss is likely to be valued at the lesser of the repair/replacement cost or the decrease in FMV for all inventory. Therefore, finished-goods inventory would not be valued at sale price, but more likely at actual cost. The difference between valuing finished goods at sale price or cost can be significant and depends largely on the company markup or gross profit.

A careful analysis of the quantity lost that includes shrinkage, accounting adjustments and obsolescence also needs to be made. These items are not always addressed in the first-party claim and require access to the company's accounting records and possibly to those of the outside auditor as well.

Obsolescence refers to the relative fair market value of inventory based on technological change, decline in demand, age and useful life of the asset. Some companies argue that obsolete inventory still has some value and are reluctant to record a write-down and expense adjustment on the income statement. Many times during the first-party claim a negotiated agreement is made with respect to old inventory; the third-party claim typically has more time address this issue.

Business interruption

First-party business interruption losses are typically paid partly on estimates where the period of loss and the quantum of lost sales are projected into the future. Many times, the period of loss is dictated by the policy limit or by the period required for building reconstruction. In a subrogation matter, however, the accounting expert can look back at the actual results.

Nevertheless, expected sales absent the incident still need to be projected. The expert must determine whether the actual loss period was the same as the loss period claimed. The expert must also examine the books and records, perform independent research as appropriate and be careful to separate extra expense costs from the insured's accounting records.

One should never assume the decrease in sales and profits and increase in costs are solely attributable to the loss event, unless it is a total loss. Several other factors unrelated to the loss event such as the timely entry of a substantial competitor, a rise or fall of costs of key materials, a labor strike or a pre-incident decreasing sales trend could have impacted the company during he loss period.

For instance, any sales decline must be carefully analyzed to distinguish that part attributable solely to the loss event. The insured typically attributes the whole decline to the loss event. The appropriate valuation method to determine business income losses is lost profits and not lost sales. Both sales and costs need to be projected and analyzed to measure lost profits. In addition, "saved expenses" or costs that would have been incurred but for the incident also need to be quantified and factored into the loss model. Hindsight is a distinct benefit in determining business income losses.

Extra expenses are generally defined as expenses incurred to reduce the amount of business income loss. These expenses must be checked to see if they, in fact, exist and are relevant to the claim. It is very important to determine how extra expenses are being recorded in the financial statements of the insured and to isolate operating expenses in the income statement. Double counting could occur if the extra expenses are recorded as normal operating expenses and separately compensated by the carrier.

Category	Policy Valuation	Typical State Law Valuation
Building	Replacement cost, repair cost or actual cost value, estimates	Repair, replacement or decrease in FMV, actual costs
Equipment	Replacement cost, repair cost or actual cost value, estimates	Repair, replacement or decrease in FMV, actual costs
Contents	Replacement, historical cost, repair cost, actual cash value, estimates	Repair, replacement or decrease in FMV, actual costs
Inventory	Replacement cost, historical cost, sales value	Replacement or decrease in FMV
Business	Future estimates, some actual results, policy limit	Hindsight, actual results, focus on various reasons for sales decline at 12 months

The table above shows the different valuation methods used by a typical insurance policy and contained in a typical state law.

Fraud

Fraud committed in businesses is an element that can be present in any claim. Insureds in financial distress or who are underinsured are more likely to submit overly aggressive claims and even commit fraud. False or altered invoices, overly aggressive sales forecasts, non-existent contents or inventory, false or unrealistic estimates for reconstruction or repair are always a possibility in any claim. The instinct for corporate financial survival is strong and a catastrophic loss may tempt honest but financially distressed owners to file an inflated claim. The financial expert needs to be aware of these possibilities and be ready to ask the right questions and request the right documents. We have seen instances of altered invoices submitted in the first-party claim that were later caught in the third-party claim.

Conclusion

In the end, it is impossible to close the gap completely between the amount paid out under a policy and the amount awarded by the various state courts in subrogation cases because the playing field is different. The different valuation methods employed to meet the terms of the policy and the requirements of the courts will still produce two different results. Nevertheless, some narrowing of the gap is possible with the use of more complete and accurate documentation and hindsight. "Monday morning quarterbacking" or hindsight as it applies to decisions made, costs incurred and actual versus estimated or projected costs and sales, can have a substantial impact on the quantity of loss amounts determined. Since time is not always of the

essence in a subrogation claim, more attention can be focused on issues not always fully addressed in the first-party claim. Obsolescence of inventory, the financial condition of the company, completeness of documentation and a comparison of the "projected" and "estimated" sales and costs to the actual sales and costs incurred subsequent to the loss event can all be closely analyzed in the subrogation matter and are frequently omitted in the first-party claim. Our experience shows the differences in only one claim can be in the millions of dollars.

Both plaintiff and defendant must do their homework in quantifying damages in subrogation matters in order to avoid the pitfalls that can damage credibility and negatively impact their claim. ☺



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