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The 'Lesser of Two' Rule

The Application of the New York Collateral Set-off Rule to Property Claims Brought in the September 11 Litigation

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Over the past decade, there have been a number of air crashes that have resulted in substantial damage to property on the ground. On September 11, 2001, the World Trade Center was destroyed when American Airlines flight 11 and United Airlines flight 175 crashed into the World Trade Center towers. Two months later, American Airlines flight 587 crashed into a neighborhood in Queens, New York, destroying multiple homes. Then, in February 2009, Continental Connection flight 3407 crashed into a home in Buffalo, New York.

Each of these crashes presents common questions: What is the proper measure of damages for a property owner for the destruction of property on the ground? Are the victims of property damage or business interruption entitled to the diminution in market value of the property on the date of loss or replacement value?

Judge Alvin K. Hellerstein addressed these questions through protracted dispositive motions in the September 11 litigation, where a number of property insurers and owners filed suit against the airlines and the security companies they employed (aviation defendants). They sought damages for the destruction of property on the ground and business interruption, alleging that the aviation defendants had negligently screened passengers at security checkpoints, permitting hijackers armed with prohibited deadly and dangerous weapons to board, hijack, and crash two commercial jets into World Trade Center towers one and two.

In the September 11 litigation, plaintiff World Trade Center Properties (WTCP) originally claimed that WTCP was entitled to recover $12.3 billion, which constituted the alleged replacement value of towers one, two, four, and five. An examination of the aviation defendants' motion for summary judgment and the trial court's ruling provides much clarity as to precisely what remedies are available to victims of property damage seeking to be made whole. What follows is a discussion of the application of the New York collateral set-off rule to property claims brought in the September 11 litigation.

The Purchase of World Trade Center Properties

Fifty-five days before September 11, WTCP and the port authority entered into 99-year net leases for World Trade Center towers one, two, four, and five. WTCP was selected after a worldwide competitive bidding process involving some of the most sophisticated owners and managers of commercial real estate globally. The net value of the leaseholds was $3.211 billion, of which, $395 million was applied to a retail mall that was leased by another management company, with $2.805 billion being allocated to the towers. J.P. Morgan, the port authority's consultant, determined the consideration was fair. WTCP valued its net leaseholds to towers one, two, four, and five at $2.84 billion in its own internal record system.

Following the tragedies of September 11, WTCP recovered an aggregate of approximately $4.4 billion for ground damage from its own property insurers in other litigation. Many of these property insurers are subrogation plaintiffs in the September 11 litigation, who sought their legally recoverable losses from the aviation defendants, pursuant to Judge Hellerstein's rulings that the aviation defendants' duty extends not only to passengers, but also to property damage claimants: "The duty of an air carrier [is] to provide service with the highest possible degree of safety in the public interest. 49 U.S.C. §§ 44701(d)(1)(A), 44702(b)(1)(A). The air carrier's duty extends, beyond those aboard the aircraft to 'individuals and property on the ground,'" stated within *In re September 11 Litigation*, 594 F. Supp. 2d 374, 380 (S.D.N.Y. 2009). This description appears in *Williams v. Trans World Airlines* 509 F.2d 942, 946 (2d Cir. 1975): "This duty has both a statutory and common law basis." *In re September 11 Litigation*, 280 F. Supp. 2d 279, 296 (S.D.N.Y. 2003) held that aviation defendants could have foreseen that "death and destruction on the ground was a hazard that would arise should hijackers take control of a plane." Later proceedings stated that "The natural and probable consequence of an aviation disaster are deaths and injuries of people in the airplane and in the area of a crash, and the injuries and destruction of property in and around the area" (see *In re September 11 Litigation*, 2009 WL 118057 (S.D.N.Y. 2009); an example can be found at *In re September 11 Litigation*, 280 F. Supp. 2d 279, 291 (S.D.N.Y. 2003)).

Aviation Defendants' Motion for Summary Judgment Dismissing WTCP's Claims

WTCP originally sought in the September 11 litigation to recover $12.3 billion, which constitutes the alleged replacement value of towers one, two, four, and five. In 2008, the aviation defendants moved for summary judgment on WTCP's claims, alleging that WTCP's measure of damages was improperly seeking to recover both replacement costs and lost profits. In their motion, the aviation defendants argued that even if WTCP were able to establish the liability of the aviation defendants for the terrorists' destruction of the World Trade Center, its damages would be governed by the same property loss rule that has applied to every other New York property owner for more than 100 years, i.e., that the measure of damages for injury to real property is the lesser of the diminution in market value or the cost of replacement, commonly known as the "lesser of two" rule, as in *Hartshorn v. Cahddock*, 135 N.Y. 116, 122 (1892).

Pursuant to the Air Transportation Safety System Stabilization

Act (ATSSSA), 49 U.S.C. §§ 40101, et seq., the law governing such suits was to be the law of the state where the crash occurred (i.e., New York), unless preempted by or inconsistent with federal law. The aviation defendants' applicable insurance limits their potential liability to the extent of that insurance.

The aviation defendants' motion for summary judgment sought rulings that would limit WTCP's potential recovery on the following issues, outlined within *In re September 11 Litigation*, 590 F. Supp. 2d 535, 546-547 (S.D.N.Y. 2008):

- whether WTCP was entitled only to fair market value of the destroyed towers, rather than the higher replacement value
- whether WTCP was entitled to recover, in addition to market value or replacement value, its lost rental income, plus expenses in preserving such rental income
- whether the fair market value of WTCP's leaseholds of the World Trade Center complex, as of September 11, 2001, was $2.8 billion, the amount WTCP agreed to pay in April, 2001, or some different value yet to be determined
- whether, pursuant to N.Y. C.P.L.R. §4545, WTCP's claim for damages for market value was diminished, and offset, by the $4.1 billion in insurance payments, and other payments, that WTCP has received

The record in support of the aviation defendants' motion for summary judgment contained incontrovertible evidence demonstrating that on July 16, 2001, after conducting a worldwide competitive auction involving bids from the most sophisticated commercial real estate developers in the world, the port authority leased the World Trade Center Complex to WTCP through a transaction wherein it was agreed that the present value of the leasehold was $2.8 billion. Thus, by anyone's measure, the alleged replacement cost of over $8.4 billion posited by WTCP far exceeded the fair market value of the destroyed buildings.

Moreover, New York law requires property damage recovery to be reduced by collateral source payments, as stated in N.Y. C.P.L.R. § 4545(c). Accordingly, in *In re September 11th Litigation*, 590 F. Supp. 2d at 546-47, the aviation defendants argued that, because the insurance proceeds received by WTCP as a result of the attacks on the WTC buildings (over $4.4 billion) far exceeded the highest possible loss in market value ($2.8 billion), WTCP had already been fully compensated and indemnified for its alleged loss.

Additionally, WTCP responded to the aviation defendants' "lesser of two" argument by maintaining that they were entitled to replacement value because the World Trade Center qualified as a "specialty property." Under New York law, as indicated in *Rochester Urban Renewal Agency v. Patchen Post, Inc.*, 379 N.E.2d 169, 171 (N.Y. 1978), where property is of a type "seldom traded" and for which there is no "market price," a different kind of valuation must be used. A property is considered a "specialty property" when the market value cannot be measured, and replacement cost is considered the proper measure of fixing damage. Churches, hospitals, clubhouses, and spaces held by non-profit organizations for use as community centers often fall within this category. Additionally, as to its $3.9 billion claim to recover the present value of its lost rentals since September 11, 2001, WTCP argued that since its tenants stopped paying their rents because the buildings were destroyed, they were entitled to recoup these losses.

Fair Market Value as Proper Measure of Damages

Judge Hellerstein, citing *Hartshorn*, 135 N.Y. at 122, granted in part and denied in part the aviation defendants' motion for summary judgment holding that New York follows the "Lesser of Two" rule. The court emphasized that this rule applies even when the property in question has been completely destroyed, citing *Sandoro v. Harlem-Gennesee Market & Nursery, Inc.*, 105 A.D.2d 165 (N.Y. App. Div. 1984).

In holding that market value was the appropriate measure of damages, the court relied on the recent New York Court of Appeals decision, *Fisher v. Qualico Contracting Corporation*, 779 N.E. 2d 178 (N.Y. 2002), which affirmed the "Lesser of Two" rule. In *Fisher*, the plaintiff's Victorian home in Long Island was destroyed in a fire due to the negligence of a contractor hired by the plaintiff. The plaintiff received $1,000,050 from his insurers, who then subrogated and sued the defendant for negligence and prevailed. At trial, the subrogated plaintiff demonstrated that replacement cost was $1,033,000, but that the diminution in the market value was $480,000. The court instructed the jury to award $480,000, the lesser of the two amounts. On appeal, the Court of Appeals affirmed, holding that "[r]eplacement costs and diminution of market value are simply two sides of the same coin." *Id.* at 181-82. It continued, "each is a proper way to measure lost property value, the lower of the two figures affording full compensation to the owner" while "avoiding uneconomical efforts." *Id.*

In applying the "lesser of two" rule, the court held that market value of the four towers as of September 11, 2001, was the limit of WTCP's permissible recovery and that the value fixed by the parties a few months earlier was probably, but not necessarily, the market value of the leaseholds as of September 11, 2001. Judge Hellerstein held that this case presented a narrow question of fact as to what the market value was, and that an issue of diminution of recovery pursuant to N.Y. C.P.L.R. § 4545 presented additional issues of fact, and ordered further proceedings allowing for final determination, as recorded within *In re September 11 Litigation*, 590 F. Supp. 2d at 547.

In its ruling, the court rejected WTCP's argument that they were entitled to replacement value because the World Trade Center qualified as a "specialty property." In granting the defendants' motion, the court ruled that the World Trade Center complex was not specialty property, stating in pertinent part:

The World Trade Center buildings were filled with a variety of commercial tenants, law firms of every size and character, large national and international public accounting firms, investment banking, insurance and financial institutions of every description, public restaurants, clubs and gyms, and the like. Thousands of visitors frequented the retail shops and restaurants throughout the day. Clearly, the price WTCP paid for the 99 year leases it acquired from the Port Authority reflects a full and fair market price for the property. If WTCP is entitled to recover, recovery of the property's market value would fully compensate it. WTCP is not entitled to recover the larger value of replacement costs. Id. *at 547.*

The court held that WTCP's claim for lost rental payments was "without merit," stating that the price that WTCP paid to the port authority included the value of anticipated rentals and that "the price it paid fully reflected the present value of those rental streams." *Id.* at 544. The court concluded that WTCP could not recover twice—once in the form of the property's market value, which fully includes the rental streams reasonably expected from the property, and again for the separate value of the rental streams. According to the court, "since damages measured by market value take rental value into account, where a building is totally destroyed there is no separate allowance for damages for loss of rent." *Id.*

As to the diminutions of recovery under § 4545(c), the court dismissed WTCP's argument that § 4545(c) cannot be applied until there is a judgment of recovery or verdict as an unimportant technical distinction, "for the issue of diminution can be tried and determined immediately following the jury verdict, on the same or a supplemental record." *Id.* at 548. The court directed the parities to inquire into the nature of the insurance recoveries,

how they are to be applied, and how they compare to clarify the record on this issue.

Final Order Denying WTCP's Motion for Reconsideration

In a December 2008 order, Judge Hellerstein granted WTCP leave to conduct further discovery that could demonstrate the market value of World Trade Center Complex as of the date of loss exceeded the $4.1 billion in insurance money they received. WTCP filed a "supplemental submission" on March 31, 2009. Although not styled as such, the court ruled on April 29, 2009, that it was essentially a motion for reconsideration of the court's December 10, 2008 order, stated within *In re September 11 Litigation*, 2009 WL 1181057, at *1-2. The court denied the motion because it failed to present the grounds for granting reconsideration and because it lacked merit. *Id.* At *4.

In denying the motion, the court reiterated that since the record created by the defendants' motion for summary judgment may have been insufficient with regards to the property's value as of September 11, 2001, the court had previously given the WTCP plaintiffs leave to file papers by February 28, 2009, to show that the values may have changed in the weeks between July 16 and the early hours of September 11, noting that market values can fluctuate and be affected by the change from public to private ownership and management. The court found that the WTCP plaintiffs' "Supplemental Submission" failed to provide that information. Instead, the court determined that the filing was an attack on the court's prior opinion, seeking to correct "errors of fact and law" and "unfounded and incorrect assumptions." *Id.* at *1.

Specifically, WTCP's supplemental submission attacked the court's prior ruling that the presumptive value of the destroyed properties on September 11 was $2.8 billion. In denying WTCP's motion, the court re-emphasized that the purchase price was a negotiated figure as of July 16, 2001, 55 days before September 11, when the WTCP plaintiffs, prevailing in a worldwide auction, agreed to pay that value for the 99 year lease granted by the port authority. The court examined the conclusions of the experts relied upon by WTCP in their supplemental submission and determined that they failed to provide a higher figure for market value as of September 11, 2001. The court held as false WTCP's arguments that the court mistakenly treated the WTCP-Port Authority lease as destroyed, and that the court confused the value of the World Trade Center towers with the value of the leases, stating that "the properties providing value to the lease were destroyed, not the lease itself. With the destruction of the properties, the rents being paid to WTCP ended, and therefore the value of WTCP's lease ended." *Id.* at *2. Ultimately, the court held that the WTCP plaintiffs failed to submit a showing that the value of their leaseholds prior to the attack was larger than $2.805 billion, and thus no triable issues remained in relation to this aspect of the aviation defendants' motion for summary judgment. The court ruled that any recovery by the WTCP plaintiffs against the aviation defendants shall not exceed $2.805 billion.

Order Granting Motion Approving Property Damage Settlements

In 2010, 18 of the 21 property damage claimants entered into a settlement with the aviation defendants for $1.2 billion, described within *In re September 11 Litigation*, 2010 WL 2628642 (S.D.N.Y. 2010) at *1. The WTCP plaintiffs objected to the settlement. The court overruled WTCP's objections and found the settlements to be fair and reasonable, and ordered all amounts to be credited against the settling aviation defendants' respective liability ceilings. In approving the settlements, the court relied in part upon the declaration of the mediator, Judge John S. Martin (ret.), attesting to the hard-fought, arms-length, and good-faith negotiations that culminated in the steep discounting of the legally recoverable claim amounts, ultimately resulting in the settlement of the individual claims. *Id.* at *7.

In approving the settlement, the court again recognized its prior orders limiting WTCP's claims for recovery to the lesser of diminution of fair market value or replacement cost, and subject to a collateral setoff for certain insurance monies paid:

The Aviation Defendants filed motions to limit the amounts that the WTCP Plaintiffs could recover, and [Judge Hellerstein] heard briefs and arguments from both sides. In a series of opinions and orders, [Judge Hellerstein] held (1) that the WTCP Plaintiffs' recovery against the Aviation Defendants for the destruction of World Trade Center Towers 1, 2, 4, and 5 was limited to the fair market value of its net leasehold interests in the Towers at the time of their destruction, and not the much higher alleged replacement value; (2) that the WTCP Plaintiffs failed to show that the market value had changed between the time they purchased the leaseholds for $2.805 billion on July 16, 2001, and the September 11, 2001 terrorist attacks; and (3) that the WTCP Plaintiffs' insurance recovery was approximately $4.1 billion and could be the basis of a motion for collateral setoff under NY C.P.L.R. § 4545 if expert testimony were to be introduced to show correspondence with potential tort recoveries. Id. *at *1-4.*

Conclusion

Judge Hellerstein's rulings on the proper measure for property damage in the September 11 litigation are well-reasoned and premised on long-standing principles of law. As demonstrated in the September 11 litigation, victims of tortious property damage who are indemnified through collateral source insurance payments are subject to a set off. With WTCP having received over $4 billion in insurance proceeds, and the measure of tort damages for destroyed property in New York being the lesser of the diminished value of the property (i.e. the leaseholds) or its replacement value, WTCP essentially has no significant legally recoverable claim pursuant to New York law. ■

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Timothy S. Tomasik worked round-the-clock in the aftermath of the September 11 terrorist attacks in property damage litigation related to the attacks. He has served on numerous important cases since joining Clifford Law Offices, including the John Hancock Center scaffolding collapse, the airplane-related death of the younger son of NBC sports chairman Dick Ebersol, and cases involving medical malpractice, automobile injury, and police brutality. Prior to his personal injury plaintiff's work he spent eight years as a criminal trial lawyer, ultimately serving as an Assistant State's Attorney in the Bureau of Special Prosecutions. He was named an American Legion Expert Litigator in 1999 for his work as a prosecutor of gang crime and as a civil litigator. The Law Bulletin Publishing Company named him one of *Illinois' Top 40 Attorneys Under Forty to Watch*.