

Lost Profits Damages

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Legal Principles of Proving Lost Profits Damages

- *Transaction Causation* – “But for” the defendant’s actions or failures to act, no damages would have been incurred.
- *Loss Causation* – Plaintiff must prove that their loss is related to the breach or wrongful act.
- *Foreseeability* (contract damages only) – Lost profits recoverable only if reasonably foreseeable by the breaching party at the time of contracting.
- *Reasonable Certainty* – Lost profits must be proven by the plaintiff to be based on reliable factors without undue speculation.



Breaches of Contract That May Lead to Lost Profit Claims

- Substandard quality, untimely performance.
- Breaches of express or implied warranties.
- Covenants not to compete.
- Employment contracts.
- Failures to pay or to provide contracted-for services.
- Franchise agreements.
- Insurance contracts.
- Sales of businesses.



Torts That May Lead to Lost Profit Claims

- Acts of simple or gross negligence.
- Conversion or theft of funds.
- Damage to income-producing property.
- Defamation.
- Fraud.
- Intentional interference with business or contractual relationships.
- Patent, trademark or copyright infringement.
- Professional malpractice.
- Unfair trade practices.



Proving Causation/Liability

- Whether a lost profits claim relates to a tort or a breach of contract, the plaintiff must prove the defendant's actions caused the damage to the plaintiff.
- Only that portion of the decline in plaintiff profits attributable to the defendant's wrongful actions is recoverable.
- In most business litigation, the plaintiff's counsel presents evidence and testimony to establish the defendant's liability.
- Beware of multiple causes, e.g. a fire vs. the opening of a competing store across the street weeks before the fire.



Rules of Recovery

- Buyers of Goods: damages measured by the difference between the purchase price and the market price of the goods at the time the buyer learns of the breach.
- Sellers of Goods: damages measured by the difference between the resale price and the contract price, incidental damages such as charges incurred in stopping delivery, transporting goods after the breach, or in connection with the resale of the goods. If seller is not in same position as performance by the buyer would have placed him, the seller is entitled to the profit it would have made from full performance by the buyer.



Rules of Recovery (continued)

- Breach of warranty relating to a defect in the goods sold: damages are measured as the difference between the value of the goods accepted and the value if they had been as warranted. Lost profits, are recoverable, if foreseeable.
- Covenants not to compete/unfair competition: difficult to determine damages due to the breach. Defendants assert that plaintiff's lost profits are attributable to other factors such as general economic conditions. Plaintiff's loss sometimes measured by the defendant's gain.



Rules of Recovery (continued)

- Breach of fiduciary duty by employees, officers, directors, partners, agents: all foreseeable damages, including lost profits, may be recoverable.
- Fraud: “Out-of-pocket cost” rule; put plaintiff in the same position it was in before the fraud occurred, plus all out-of-pocket costs incurred. Other jurisdictions follow the “benefit-of-the-bargain” rule, which also allows the plaintiff to recover profits lost due to the defendant's fraud.



Determine the Known Facts and Assumptions of the Case

1. Assumptions About the Facts
2. Assumptions Involving the Opinions of Other Experts
3. Economic and Financial Assumptions



Assumptions about the Facts

- Depending on the circumstances of the case, the CPA will obtain certain information that is purported to be factual and be asked to assume it is correct.
 - Guidance generally provided by Plaintiff's counsel, based on the complaint, discovery, depositions & trial testimony.
 - May need to be verified.



Assumptions Involving the Opinions of Other Experts

Some other experts who might be employed on a case include:

- Appraisers, who determine the value of equipment or real estate;
- Industry experts, who may testify on the practices and standards of the industry or the existence of trends in the industry;
- Engineering experts, who may testify concerning the structural integrity or efficiency of an equipment design; or
- Economic experts, who may testify as to market size, market penetration or other microeconomic or macroeconomic activities.

It is generally the CPA's job to consolidate these opinions into an overall conclusion of the amount of damages.



Economic and Financial Assumptions

CPA experts make general economic and financial assumptions during their analyses. Such assumptions are usually the result of the expert's knowledge, training, and experience, and any analysis done for the case in question.



Information Requests

1. The plaintiff's petition, the defendant's answer, all counterclaims, and all third-party demands.
2. The answers to all interrogatories and requests for production of documents of all parties to the proceeding.
3. Transcripts of the deposition testimony of all parties and witnesses.
4. The plaintiff's financial and tax information for a period of five years before the breach or tort occurred and for all subsequent periods through the present. This information could include—
 - a) Quarterly and annual financial statements (audited, if available).
 - b) Income tax returns.
 - c) Payroll tax returns.



Information Requests (continued)

- d) Customer contracts.
- e) Detailed revenue records.
- f) Monthly data for seasonal businesses.
- g) Accounts receivable and accounts payable subsidiary ledgers.
- h) Depreciation schedules and other fixed asset reports.
- i) Business plans and financial forecasts.
- j) Loan documents and agreements.
- k) Contracts involving sales of assets.
- l) Lease agreements.
- m) Employment contracts.
- n) Minutes of director and shareholder partnership meetings.
- o) Shareholder or partnership agreements.



Information Requests (continued)

Additional information can usually be obtained in a variety of ways, such as the following:

- a) Interviews with client personnel and, if possible, officers and employees of the opposing party.
- b) Research on industry trends, comparable companies, competitors, historical events, background, etc.



Lost Revenues Before Trial

- There are three generally accepted “methods” to estimate lost revenues:
 - a. “Before and After”
 - b. “Yardstick”
 - c. “Market Model” (or market share)
- Common error in expert reports and as a result in the courts: “But-for” is not a method . . . It is a premise underlying each method:
i.e., what would have happened “but for” the defendant’s damaging action?
- To determine this, the expert supplies evidence by applying the most appropriate of the above noted methods (or some combination thereof) based on the facts and circumstances.



The “Before and After” Method

- The expert compares plaintiff's revenues before the alleged breach or tort to the revenues after the event.
- Any reduction in revenues after the alleged breach or tort is presumed to be caused by the event. This, of course, assumes that the plaintiff's operations before and after the complained-of event were comparable.
- The expert must usually analyze important aspects of the business before and after the event to ensure comparability.
- Important differences should be considered in estimating the amount of lost revenues that relate to the event.
- The expert must also ensure that the plaintiff's operations are reported in a consistent manner.
- For closely held businesses not run in an arm's length manner, the expert may need to adjust the plaintiff's results of operations to make valid comparisons.



Illustration of “Before and After”

- Assume Mr. X breaches his employment contract with ABC by establishing a competing company, XYZ.
- Mr. X 's contract contained a three-year non-compete clause.
- Assume ABC 's gross revenues were \$14 million in the year before Mr. X began competing and dropped to \$10 million in the following year.
- Further assume ABC hired X's replacement in year 2 and revenues returned to \$14 million.



Illustration of “Before and After” (continued)

- Under this fact pattern, it appears that Mr. X's actions caused ABC to lose \$4,000,000 of revenues in the year Mr. X began competing.
- Damages in subsequent years were mitigated by the new hire.
- The “before and after” method provides a quick and easy approximation of the amount of revenues lost by ABC as a result of Mr. X's breach of contract.
- This assumes however, that all else remained constant during this time.



The “Yardstick” Method

- To estimate revenues lost by the plaintiff, comparisons are made to similar businesses or products.
- The best yardstick for a closely held business is a business of similar size and nature in the same geographic area as the plaintiff.
- In the previous example, assume XYZ’s revenues were derived from former customers of ABC. These revenues may approximate the revenues lost as a result of the breach.
- If the plaintiff has multiple locations, the expert can compare a related entity’s results of operations to the plaintiff’s.
- Courts are becoming more stringent in the acceptance of comparability.



“Market Model/Market Share Method”

- The “before and after” and “yardstick” methods may fail to consider other factors that would tend to increase or decrease the amount of the plaintiff’s lost earnings, such as:
 - Product life cycle and market demand.
 - Competition and the plaintiff’s competitive position, including current market share and market share trend; (is it gaining or losing share?).



The Use of Regression Analysis in “Market Model” Method

- Uses one or more items—called independent variables—to predict a dependent variable.
- For example, a regression analysis might use historical data on unit prices and volumes as a basis for predicting future revenues.
- Segregate those factors not caused by the defendant.



Mitigation of Damages

- The plaintiff has a duty to mitigate its damages. [*Culligan Rick River Water Cond. Co. v. Gearhart*, 443 N.E. 2d 1065 (2nd Dist. 1982)].
- Proof of mitigation of damages requires only a showing that the plaintiff took reasonable steps to cut its losses, not that the plaintiff did what the defendant would have had it do.
- Nor is the plaintiff required to pursue what in hindsight seems most effective to reduce the defendant's damages. [*Berge v International Harvester Co.*, 142 Cal. App. 3d 152, 190 Cal. Rptr. 817 (1983)]



Period of Recovery

- Because the plaintiff has a duty to mitigate damages, the plaintiff cannot expect to be awarded lost profits from the date of the harmful event until the end of time. As one court ruled, a plaintiff cannot expect to retire for life from the taking of his business.
- The plaintiff is entitled to recover earnings lost as a result of the defendant's actions for that period of time “causally linked” to those actions.



Period of Recovery (continued)

- The shorter the period, the easier it is to demonstrate a causal link to the defendant's acts. As the period increases, other factors may be responsible for the plaintiff's losses.

These may include:

- general economic conditions,
- increased competition,
- poor business judgment, or
- the plaintiff's failure to mitigate its damages.



Variable Cost of Lost Revenues

- A CPA needs to estimate the variable costs that would have been incurred had the revenues not been lost.
- The Company's costs should be divided into fixed and variable categories.
- Fixed costs, such as rent, remain the same regardless of how much revenue a company generates.



Variable Cost of Lost Revenues

(continued)

- Cost of goods sold is generally treated as a variable cost because it is only recognized when inventory is sold, even though some components of cost of goods sold are fixed.
- In reality, many costs have both a fixed and a variable component and are referred to as “mixed” costs.



Examples of Variable Costs

- Sales commissions
- Labor costs
- Insurance (payroll-based)
- Freight
- Supplies
- Sales tax
- Repairs
- Payroll tax
- Purchases



Examples of Fixed Costs

(Short Damage Period)

- Advertising
- Auto expenses
- Bank charges
- Interest
- Insurance (non-payroll-based)
- Telephone and utilities
- Taxes (other than sales and payroll)
- Legal and accounting
- Depreciation
- Officer and staff wages
- Dues and subscriptions



Income Tax Effect

- Most lost profits calculations are based on pre-tax amounts because damage awards are usually taxable to the plaintiff.



Projected Lost Revenues after Trial

- Involves obtaining estimated future revenue and expense amounts from the plaintiff and reviewing the estimates for reasonableness.
- Most cases are not tried until years after a harmful event occurs. Because of this delay, the usual lost profit claim is for profits lost prior to trial. For this reason, the after-trial component will not be needed on all lost profits cases.
- In some cases, however, the plaintiff will continue to suffer a loss of profits after trial, even though the plaintiff has used its best efforts to mitigate its damages.



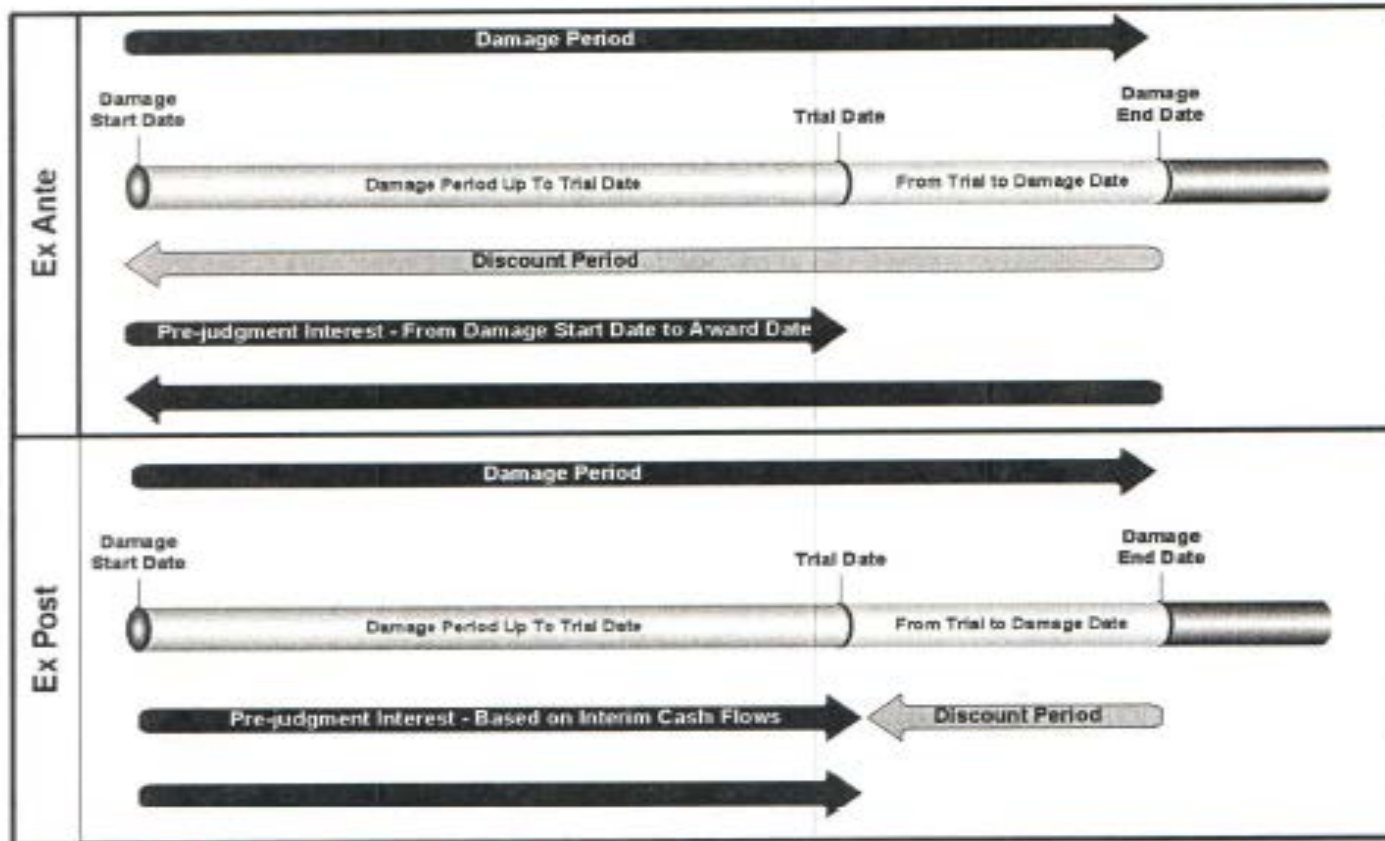
Estimating Plaintiff's Future Lost Revenues

- A. First, a *projection* of future gross revenues, *assuming the breach of contract or tort had never occurred*, should be prepared. This projection should reflect gross revenues “**but for**” the defendant's acts.
- B. Second, a *forecast* of the future gross revenues actually *expected to be realized* should be prepared. This forecast should reflect the reduced gross revenues that result from the defendant's acts.
- C. The excess *projected* revenues in item A. over the *forecasted* revenues in item B. represent projected lost revenues after the trial.

Determining the Period of the Estimated Future Revenues

- Period of recovery should be linked to the defendant's actions.
- The longer the period of recovery, the more difficult it is to establish that the lost profits relate to the defendant's actions.
- Variable costs need to be estimated.

Ex-ante v. Ex-post Discounting



Ex-ante v. Ex-post Discounting

(continued)

- Lost *future* profits should be discounted back to present value.
- The choice of *ex-ante* versus *ex-post* discounting should be made after the attorney has advised the CPA regarding applicable statutory and case law.
- *Ex-ante* and *ex-post* discounting are not mutually exclusive; damages may be computed under both methods and presented as alternatives to be decided upon by a trier-of-fact.



Determining a Discount Rate

The discount rate used has two components:

- A rate of return for a safe investment (that is, the risk free rate).
- Factors for risk or uncertainties unadjusted in the projection of lost future profits, if any.
- Said another way, the expert can either (a) adjust for risk and uncertainty when projecting future profits or (b) adjust for risk and uncertainty when selecting a discount rate. It is also possible, and common, to use both methods jointly when adjusting for risk.



Court Cases Relating to an Appropriate Discount Rate

- *American List Corp v. U.S. News & World Report, Inc.*, 550 N.Y. 2d 590 (1989). A New York Supreme Court applied an 18% discount rate. The verdict was overturned on appeal because the discount rate was too high. "Supreme Court erred in calculating the amount of damages because in discounting to present value the total due, the court improperly considered risk that the plaintiff would be unable to perform the contract in the future."
- *Burger King Corp. v. Barnes*, 1 F. Supp. 2d 1367, (S.D. Florida, 1998). A 9% discount rate was approved for a breach of contract dispute. The rate was used to discount future net royalties over 17 1/2 years in the future.
- *Olson v. Nieman's, Inc.*, 579 N.W. 2d 299 (Iowa, 1998). A discount rate determined by a form of the build up method (see the discussion in paragraph 403.81) was approved. The rate of 19.4% included 14.4% for the rate of return on publicly traded companies and 5% for market risk.

Court Cases Relating to an Appropriate Discount Rate (continued)

- *Diesel Machinery, Inc. v. B.R. Lee Industries, Inc.*, 418 F.3d 820 (8th Cir. 2005). The plaintiff's expert applied a risk free rate. Defendant's expert applied a risk-adjusted discount rate of 17.5%. The court held that the defendant's expert's methodology was appropriate for determining the business value by discounting a stream of future income, but not for discounting to present value the damages awarded in litigation. The court said that plaintiff is not required to reinvest the award in its business.
- *Energy Capital v. United States*, 47 Fed Cl. 382, 2000 U.S. Claims, Lexis 168. "The court holds that the appropriate discount rate is the rate of return on 'conservative investment instruments.'"



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