

**Attorney
CLE Series**



Economic Damages: Lost Profits Determinations

UNDERSTANDING THE FUNDAMENTALS

Spring 2014

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GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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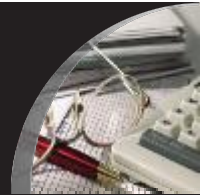
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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. He is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA) and served as an adjunct professor for Duquesne University's MBA program. Bob has also written many articles for several area business publications and professional trade journals.

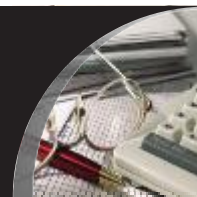
After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board. Currently Bob is the Chair of NACVA's Professional Standards Committee; he previously chaired its Education Board.

Bob received the NACVA "Thomas R. Porter Lifetime Achievement Award" for 2013. One award is presented annually to a single member, from the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period of time.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held many offices and directorships in various not-for-profit organizations. He received PICPA's 2003 Distinguished Public Service Award and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.



Melissa A. Bizyak, CPA/ABV/CFF, CVA



Melissa has practiced in public accounting for nearly 20 years and has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Her experience is diverse, with clients including both private and publicly-held companies in a wide variety of industries.

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Her professional affiliations include the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA), as well as the Estate Planning Council of Pittsburgh. She is also a member and serves on the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is a mentor for women business owners in Chatham University's MyBoard program and serves on Robert Morris University's Professional Advisory Council.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



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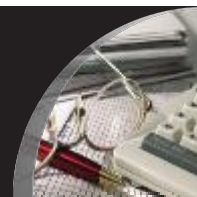


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Economic Damages: Lost Profits Determinations

Chapter I – *Introduction*

The successful representation of a party to a case where lost profits are at issue requires a carefully-crafted partnership. The attorney's education, experience and understanding of the guiding law must be joined with the expertise and experience of a financial expert.

From the prospective of this partnership, lost profits determination is an issue of financial evidence. As such, the focus of this phase of any case is how to best collect and gather, as necessary, any and all "relevant" information; properly analyzing the collected information to discern its meaningfulness to the lost profits calculation; and, finally, developing a methodology for the presentation in a legal setting of the expert's findings that is clear and as concise as possible.

Keep in mind that the roles in this partnership assume that legal counsel, in their capacity as advocates for their clients, will always lead the case. The financial expert, on the other hand, will generally render his or her services at the request of legal counsel, but on an independent and objective basis. As with any use of an expert that may become a witness in a potential litigation matter, it is critical that the expert maintain this independence and objectivity to garner credibility in his or her opinions and conclusions before the judge, jury or other finder of fact.

Certain critical elements and legal principles guide recovery of damages, including lost profits, as listed below:

- The Proximate Cause Rule
- The Reasonable Certainty Rule
- The Foreseeability Rule

As is well known among the attendees to today's program, much of the guidance offered by and surrounding these rules has developed through judicial interpretations of governing statutes, specific-party fact patterns and economic sensibilities. Each of the overriding legal principles could easily serve as the foundational topic for a full-day program, as they are fraught with complexity, and due to the sheer number of cases available for consideration. Unfortunately, time does not permit such a discussion.

Moreover, as financial experts generally called upon to provide lost profits calculations and computations, the authors of today's program are somewhat ill-equipped to lead a thorough and in-depth analysis of these principles. They are the primary domain of those with legal backgrounds – in both education and experience.

While the authors of these materials presume some level of familiarity with all of these principles among today's attendees, with many having an in-depth understanding of the legal ramifications of the rules because of their background, we do wish to summarily address them. It is our intent, by doing so, to provide some limited exposure of those



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rules to those that may not have the aforementioned “in-depth” knowledge, so that they may better understand those relevant concepts when we later move to the mechanical aspects of the lost profits calculations.

It is proper that we mention the source materials used for the purposes of preparing this program handout. Such mention not only ensures that due credit is given, but also provides a reference to what we believe are two of the more important treatises available on lost profits.

Perhaps the most prolific author on this topic, and an attorney of great expertise in this area, Robert L. Dunn has recently completed the sixth edition of *Recovery of Damages and Lost Profits* (LawPress Corporation). Mr. Dunn’s book on these matters is accepted as one of the prominent resources available, and was a primary source of information for this handout. A second, newer source that was used for our preparation is a compendium of articles edited by Nancy Fannon, entitled, *The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys* (BVR, LLC).

Chapter II will begin with a brief discussion of proximate cause, reasonable certainty and foreseeability. Fundamental interpretations of these principles will be addressed as set forth in various legal decisions.

Chapter III will address those professional standards that are required of professional financial experts working in this area. An understanding of these standards is intended to familiarize attorneys with those rules of professional conduct with which compliance is required in performing these services.

Chapter IV will address spoliation of evidence and issues related to the discovery of electronic evidence. Both matters appear to be “front and center” issues in our experience with engagements of this type.

Chapter V will present an example of the mechanical aspects of a lost profits calculation, incorporating, albeit, rather simplistically, illustrative examples.

Chapter VI will provide case study examples of lost profits determinations.

Chapter VII will present a representational assessment of certain more current and critical judicial decisions intended to illustrate some of those key concepts set forth earlier in these materials. Please note that, as always, the cases selected in our programs are meant to emphasize key components of our discussions, as determined by the authors. The chapter is not intended as a total and complete compendium on these matters.

Chapter VIII will conclude the materials and offer practical suggestions when lost profits calculations are needed.

While it is our hope that the handout to today’s program will prove useful in your practice, it is important to note that this is a cursory discussion of lost profits calculations. It is not intended to serve as absolute guidance or as a substitute for particular knowledge related to any case, local jurisdictional rules for discovery, procedure and form in litigation and other statutory, judicial or interpretative guidance that might be applicable.



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Chapter II – *Elements of Lost Profits Damages Claims*

Lost profits, as defined in *Black's Law Dictionary*, is taken from the Uniform Commercial Code¹ in the context of a breached sales contract.

A measure of damages that allows a seller to collect the profit that would have been made on the sale if the buyer had not breached.

In reality, a recovery of lost profits can be garnered in any number of different types of cases. While breach of contract is clearly one type, torts and intellectual property infringement cases are other common types of actions that drive the need for lost profits calculations. Within each of these three areas, factual patterns over a very broad array of legal guidance can result in an almost innumerable amount of cases where damages can be measured by lost profits.

Note that lost profits are not, in and of themselves, an independent cause of action. They are simply the measure of a monetary remedy for a business that has suffered a financial detriment due to the wrongful act of another.

In the context of seeking compensatory damages for lost profits then, a plaintiff must demonstrate these key elements to enable a recovery of those lost profits. These elements are listed below and detailed in the following sections.

- That the lost profits were directly caused by opposing parties' wrongful actions,
- The lost profits were a foreseeable consequence of the defendant's wrongful conduct, and
- The lost profits can be determined and proven with reasonable certainty.

Most discussions of the legal principles related to these three elements are ordered as proximate cause, reasonable certainty, and finally, foreseeability. Because the role of the financial expert is the focus of this program, we have taken the liberty of addressing reasonable certainty last, as that element most often involves the work that a financial expert might be asked to provide.

Proximate Cause Rule

The first of these key elements requires the plaintiff to show that the damages to be measured by reference to lost profits were, in fact, "caused" by the conduct on which the claim is based. The element is more commonly referenced as the "*proximate cause rule*."

¹ *Uniform Commercial Code* §-2-708(2)



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This rule of causation requires plaintiffs to tie damages directly to the wrongful act or deeds of the defendant accused of the wrongful act. Thus, the rule requires “direct” and “proximate” causation to a “wrongful act.” Obviously, each of these terms, in and of themselves, are subject to varying interpretation, especially as they are applied over a seemingly endless variety and number of specific facts and circumstances. Moreover, we have observed jurisdictional nuances, as well, in these interpretations.

Even when a plaintiff is able to meet the burden of establishing proximate cause, there is often an ability for the defendant to counter that proof. In many jurisdictions, proving proximate cause shifts a burden to the defendant “to prove that some intervening cause, such as economic recession (for example) contributed to the damages.”² Thus, if the Court finds that the lost profits stem from intervening causes, or direct causation is simply too remote or tenuous, collection of lost profits damages will likely be limited or lost.

There are other specific circumstances where the requirements of proximate cause have been translated into rules of law that actually deny recovery of lost profits. These include the borrowing of recovery of lost profits by an unestablished business in certain transactions labeled as “collateral transactions.” Due to time limits in today’s presentation, these issues are beyond the scope of our discussion.

In projects or cases where lost profits damages are sought, legal counsel designs the case strategy to develop the proof of proximate cause as well as the counter arguments to defendants’ arguments of intervening causation. The financial expert’s role in the meeting of this element is generally limited to confirming or challenging reasonableness of legal counsel’s strategy.

Assume the following fact pattern set forth by Robert L. Dunn in *Recovery of Damages and Lost Profits*:³

Plaintiff claims to have been induced to enter into a losing transaction by a misrepresentation. “But for” the misrepresentation, plaintiff would not have gone forward. However, the cause of the plaintiff’s loss is unrelated to the misrepresentation.

As many cases demonstrate, Courts often find that there is transaction causation, but no lost profits causation. In these cases, proving transaction causation alone was insufficient to prove that recovery of lost profits were due plaintiff. However, there are also a number of relevant cases on the other side of the fence on this issue. These cases turn on the courts’ failure to recognize and distinguish transaction causation from lost profits causation, or alternatively, they noted the issue but rejected it out of hand.

² *Haven Associates v. Donro Realty Corp.*, 121 A.D. 2d 504, 503 N.Y.S. 2d 826, 830 (2d Dep’t 1986)

³ *Recovery of Damages and Lost Profits*, Robert L. Dunn, LawPress Corporation, 6th Ed., Vol 1, p 7.



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Foreseeability Rule

The second key element necessary for a recovery of lost profits requires plaintiffs to demonstrate that lost profits damages from actionable and wrongful conduct were foreseeable and probable.

The foreseeability being considered must be a natural and probable result of the wrongful act at the time it was committed. In matters of contract breach, the conduct deemed wrongful must go beyond the determination that the conduct was likely to cause lost profits damages. In these situations, the foreseeability rule requires something more – the need for the parties to the contract to have “contemplated” lost profits damages at the time they entered into the contract.⁴

Pursuant to *Ashland*,⁵ the court will look to the contract to determine the parties’ contemplation, including wording of the contract, and “the nature, purpose and particular circumstances of the contract known by the parties ... as well as ‘what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it is assumed, when the contract was made.’”⁶

Lost profits arising from breach of contracts being subjected to proof under the foreseeability rule dates back to English law in *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854). While the case is dated and no longer available for review and observation, the decision includes some enlightening verbiage that actually partitions foreseeability into two varying forms, as described below.

Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things from such breach of contract itself; or such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it.

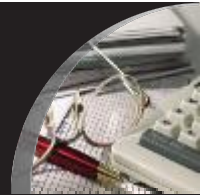
Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

The first sentence advocates recovery of damages that are proximately caused, i.e., “such as may fairly and reasonably be considered ... arising naturally,” subject to an objective standard of foreseeability. Note that the rule does not require

⁴ *Ashland Management Inc. v. Janien*, 624 N.E. 2d 1007, 1010 (N.Y. 1993)

⁵ *Id.*

⁶ *Kenford Company Inc. v. County of Erie*, 537 N.E. 176, 179 (N.Y. 1989)



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that either party, or both, actually foresaw or anticipated the possibility of lost profits that might later arise as the result of a wrongful act with respect to the contract. Rather, the rule questions whether it “may reasonably be supposed to have been in contemplation of both parties.” In other words, the question arises as to what the parties “supposed” the lost profits damages might be at the outset of the contract.

Objective foreseeability is very often applied in lost profits recovery cases. Plaintiffs are not required to prove that the defendant actually knew of the likelihood of lost profits, but rather, those lost profits resulted from a wrongful act under facts and circumstances in which it could be reasonably assumed that the parties contemplated those losses when they entered into the contract.

The second sentence of the Hadley⁷ narrative sets forth a different test. This test notes that if the “special circumstances” of the contract were *actually made known* to the defendants, the lost profits damages resulting from the wrongful act will be recoverable “under these special circumstances so known and communicated.” Thus, to the extent the defendant is informed of the special circumstances when entering the contract, the lost profits may be recoverable. This rule has come to be known as the “*subjective foreseeability test*.”

Certain courts have applied a subjective foreseeability test as the exclusive test of foreseeability. More often, however, the subjective foreseeability test is offered as proof of the objective foreseeability test. Oftentimes, the subjective foreseeability test is used to bolster legal strategies or arguments where evidence of objective foreseeability is not strong, or where lost profits damages sought under the objective standard may not be considered objectively unforeseeable. Subjective foreseeability has also become an issue when lost profits damages are alleged to have arisen from collateral matters associated with the contract.

Another way in which the body of law developed from the Hadley case is often explained is in its creation of two types of damages. Generally, these are described as “general damages” and “special (or consequential) damages.”

General damages, including lost profits, are those that flow directly and necessarily, or are a natural result of the wrongful act (objective foreseeability).

Special or consequential damages, on the other hand, are those that arise from the wrongful act’s impact on collateral matters, so long as the plaintiff is able to prove that the special or specific provisions or circumstances from which the lost profits arose were actually committed to or known to the defendant (subjective foreseeability), or those were matters which the defendant should have known about at the time he or she entered into the contract or agreement.

⁷ *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854)



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As with the proximate cause rule, legal counsel interprets all aspects of the contracts and/or agreements, develops and leads the process in addressing the principle of foreseeability in the lost profits case. Rarely is the financial expert called upon for material assistance in making any recommendations in the area of this rule.

Reasonable Certainty Rule

The final key element critical to a recovery of lost profits damages is the “*reasonable certainty rule*.” Under this principle, clearly set forth in a significant number of cases, the lost profits damages must be proven with reasonable certainty. As with many legal concepts, there is some level of ambiguity and latitude in interpretations of the term “reasonable certainty.” However, certain cases have addressed the meaning of reasonable certainty and just what is contemplated by that phraseology.

In a Maryland case, *M & R Contractors and Builders v. Michael*, 138 A.2d 350, 355 (Md. 1958), the Court noted:

Courts have modified the “certainty” rule into a more flexible one of “reasonable certainty.” In such instances, recovery may often be based on opinion evidence, in the legal sense of that term from which liberal inferences may be drawn.

In *Ashland Management, Inc.*, 624 N.E.2d at 1010, the court analyzed reasonable certainty and set forth the following conclusion in its opinion:

The ... requirement, that damages be reasonably certain does not require absolute certainty. Damages resulting from the loss of future profits are often an approximation. The law does not require that they be determined with mathematical precision. It requires only that damages be capable of measurement based upon reliable factors without undue speculation.

Finally, in *Brevard County Fair Association, Inc. v. Cocoa Expo, Inc.*, 832 So. 2d 147, 153 (Fla. App. 2002), it was noted by the Court:

The standard for degree of certainty requires that the mind of a prudent impartial person be satisfied with the damages.

While these cases illustrate a softer interpretation of the certainty requirement, it does not preclude the critical importance of providing quality, well-developed and documented evidence as to the determination of lost profits damages.



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In *Texas Instruments, Inc. v. Teletron Energy Management, Inc.*, 877 S.W.2d 276, 279-80 (Tex. 1994), the court sought to qualify the definition of reasonable certainty by stating:

This does not mean; however, that the “reasonable certainty” test lacks clear parameters. Profits which are largely speculative, as from an activity dependent on uncertain or changing market conditions, or on chancy business opportunities, or on promotion of untested products or entry into unknown or unviable markets, or on the success of a new and unproven enterprise, cannot be recovered. Factors like these, and others which make a business venture risky in prospect, preclude recovery of lost profits in retrospect.

In *Atlas Copco Tools, Inc. v. Air Power Tool and Hoist, Inc.*, 131 S.W. 3d 203, 206 (Tex. App. 2004), the court advised:

A party seeking to recover lost profits must prove a loss through competent evidence with reasonable certainty.

The court’s opinion adds,

While this test is a flexible one in order to accommodate the myriad circumstances in which claims for lost profits arise, at a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits can be ascertained. [Citations omitted.] In other words, “reasonable certainty” is not demonstrated when the profits claimed to be lost are largely speculative or a mere hope for success, as from an activity dependent on uncertain or changing market conditions, on chancy business opportunities, or on promotion of untested products or entry into unknown or unproven enterprises. [Citations omitted.]

Fact vs. Amount of Damages

A most critical consideration in the discussion of reasonable certainty is the application of this standard to the fact of lost profits damages versus the amount of those damages. In lost profits cases, it is necessary to prove, with reasonable certainty, that, excepting the wrongful act, the plaintiff would have realized some profits. Obviously, if such were not the case, there would be no basis for finding the recovery, in any amount, appropriate.

Generally, once the *fact* of lost profits has been established with reasonable certainty, less certainty may be required in establishing and proving the *amount* of lost profits. Often courts have found that the amount may be somewhat uncertain or inexact, so long as the determination is based on a “reasoned conclusion”⁸ or by a “reasonable estimate.”⁹

⁸ *Palmer v. Connecticut Railway & Lighting Co.*, 311 U.S. 544, 561 (1941)

⁹ *Hill v. Republic of Iraq*, 328 F. 3d 680 (D.C. Cir. 2003)



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By way of example, two other cases provide insight into the issue by distinguishing between the proof of fact versus proof of amount as the reasonable certainty rule applies to lost profits.

In *Mid-America Tablewares Inc. v. Mogi Trading Co.*, 100 F. 3d 1353, 1367 (7th Cir. 1996):

The requirement that future profits must be proved with reasonable certainty particularly applies to the fact of damages... It is particularly in the area of quantifying the amount of lost profits, that courts impose the risk of uncertainty on the breaching party whose breach gave rise to the uncertainty.

Another case, *Ameristar Jet Charter, Inc. v. Dodson International Parts, Inc.*, 155 S.W.3d 50, 55 (Mo. 2005), notes:

The claimant must establish the fact of damages with reasonable certainty, but it is not always possible to establish the amount of damages with the same degree of certainty. In some cases, the evidence weighed in common experience demonstrates that a substantial pecuniary loss has occurred, but at the same time it is apparent that the loss is a character which defies exact proof. In that situation, it is reasonable to require a lesser degree of certainty as to the amount of loss, leaving a greater degree of discretion to the court or jury. This principle is applicable in the case of proof of lost profits.

Finally, to illustrate further, in *Gould v. Mountain States Telephone & Telegraph Co.*, 309 P.2d 802, 805 (Utah 1957):

The rule against recovery of uncertain damages is generally directed against uncertainty with respect to cause rather than to measure or extent, so that a party who has broken his contract will not ordinarily be permitted to escape liability because of uncertainty in amount of damage resulting, and the fact that the full extent of damages for breach of contract must be a matter of speculation is not a ground for refusing all damages.

Reasonable Certainty and the Uniform Commercial Code¹⁰

The Uniform Commercial Code (U.C.C.) considers the doctrine of reasonable certainty in a comment to U.C.C. §2-715, the section dealing with recovery of consequential damages by the buyer of goods on the seller's default. Comment 4 to U.C.C. §2-715 states:

The burden of proving the extent of loss incurred by way of consequential damage is on the buyer, but the section on liberal administration of remedies rejects any doctrine of certainty which requires almost mathematical precision in the proof of loss. Loss may be determined in any manner which is reasonable under the circumstances.

¹⁰ *Recovery of Damages and Lost Profits*, Robert L. Dunn, Lawpress Corporation, 6th Ed., Vol 1, p 31.



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The “section on liberal administration of remedies” referred to is U.C.C. §1-305 (formerly numbered §1-106). Section 2.1 reads:

§1-305. Remedies to Be Liberally Administered

(a) The remedies provided by [The Uniform Commercial Code] must be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed, but neither consequential or special nor penal damages may be had except as specifically provided in [the Uniform Commercial Code] or by other rule of law.

(b) Any right or obligation declared by [The Uniform Commercial Code] is enforceable by action unless the provision declaring it specifies a different and limited effect.

Comment 1 to the section amplifies its intent and expresses a rule in line with the case law:

The third purpose of subsection (a) is to reject any doctrine that damages must be calculable with mathematical accuracy. Compensatory damages are often at best approximate: they have to be proved with whatever definiteness and accuracy the facts permit, but no more.

Again, guided by counsel, the financial expert may have a limited role in proving the fact of damages. However, that role is significantly expanded in conjunction with the determination of the amount of lost profits damages.

Often encompassing a knowledge of accounting (both historical and forensic), tax, economics, finance, statistics and business valuation, these determinations can become exceedingly complex, depending on the facts and circumstances surrounding the case.

The job of the financial expert, then, is to provide the attorney with an analysis that is as accurate as possible, prepared with a focus on clarity and simplicity, and on an independent and objective basis. Procedures undertaken in the process must be in the hands and at the discretion of the financial expert to protect his or her objectivity. Finally, all work performed by the financial expert must be undertaken with an eye to presentation in a court of law in the event an explanation needs to be communicated in such a venue.



Economic Damages: Lost Profits Determinations

Chapter III – *Role of Financial Expert & Professional Standards*

At the inception of an engagement there should be an understanding by all parties of the services to be performed by the expert/consultant. The expert/consultant may be engaged to provide consulting services, act as an expert witness or provide services in some other capacity including court-appointed expert, mediator or arbitrator.

As with any case in which a financial expert is engaged by an attorney, the financial expert in a lost profits setting can serve as a consulting expert or as an independent expert. Performing the work as an independent expert is most common, and as long as all work is undertaken in an objective matter, the expert will later be able to testify and express an opinion in a formal hearing or trial, if necessary.

- *Consultant:* A consultant's services are typically protected by the applicable state or federal attorney work product doctrine. Usually the expectation is that a consultant will not provide expert testimony but will assist the attorney in issue identification, managing discovery, making alternative calculations, critiquing an opposing expert's opinions, and in forming various litigation strategies. In the event that the consultant's role is subsequently expanded to that of an expert, his or her work will generally be discoverable by the court.
- *Testifying Expert:* A testifying expert is expected to provide testimony in court to the trier of fact regarding his or her conclusions and opinions. Testimony may be presented at a deposition, in court or in arbitration. This role includes those duties performed by a consultant, but likely will not include attending strategy meetings related to the specific case.

A testifying expert's work is discoverable under federal and most state rules of civil procedure and can be used by opposing counsel to cross-examine the expert. The expert should seek the advice of counsel regarding discoverability of information at the inception of the engagement and remain cognizant of the requirements during the performance of the engagement. As summarized herein, amendments to the Federal Rules of Civil Procedure will impact testifying experts going forward, and specifics should be addressed with legal council at the outset of the engagement.

Professional Standards

In assessing the appropriate expert for a lost profits determination, attorneys will recognize that certain credentialed professionals must comply with professional standards promulgated by the governing organizations. (Links to certification requirements and professional codes of conduct for each group are included at the end of this chapter.)



Economic Damages: Lost Profits Determinations

For those professionals carrying the certified public accountant (CPA) designation, the American Institute of Certified Public Accountants (AICPA) is the primary guiding organization. Under AICPA rules, computing lost profits is a consulting engagement. The standards for consulting engagements are contained in *Statement on Standards for Consulting Services (SSCS) No. 1, Consulting Services, Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100), issued by the AICPA. The professional must also comply with the AICPA Code of Professional Conduct, as well as the relevant standards established by state boards of accountancy or other licensing agencies and professional organizations to which the practitioner may belong.

Where the CPA is being hired as an independent expert, Rule 102 of Professional Code of Conduct requires:

In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

Practitioners should be cognizant, however, that they do not act as advocates for the client. The practitioner should be an advocate for his or her opinions and conclusions, and must maintain objectivity in his or her analysis.

In addition to professional standards, the practitioner must also be aware of and comply with applicable case law and evidentiary standards regarding the admissibility of expert testimony. The law and standards will be dependent upon the venue of the litigation; state law and standards may be different from federal standards and law, and state law and standards will vary from jurisdiction to jurisdiction. The practitioner should discuss the case law and evidentiary standards applicable to the engagement with legal counsel to ensure compliance with these requirements.

For non-CPAs such as economists, statisticians and other financial experts, there is no governing body or governmental licensing board mandating compliance with ethical behavior or overseeing the practice of these individuals. However, just like CPAs, if these individuals join a professional member organization requiring compliance with certain ethical rules and other standards, those that are members will be obliged to do so.

For instance, the National Association of Forensic Economics, a member organization consisting primarily of economists, has a *Statement of Ethical Principles and Principles of Professional Practice*. That document covers its members when providing an expert opinion for use as evidence by a trier of fact.

Section 3 of the document states:

Diligence

Practitioners of forensic economics should employ generally accepted and/or theoretically sound economic methodologies based on reliable economic data. Practitioners of forensic economics should attempt to provide accurate, fair and reasonable expert opinions, recognizing that it is not the responsibility of the practitioner to verify the accuracy or completeness of the case-specific information that has been provided.



Economic Damages: Lost Profits Determinations

Section 4 of the document states:

Disclosure

Practitioners of forensic economics should stand ready to provide sufficient detail to allow replication of all numerical calculations, with reasonable effort, by other competent forensic economics experts, and be prepared to provide sufficient disclosure of sources of information and assumptions underpinning their opinions to make them understandable to others.

Other examples of member organizations whose professionals are hired as testifying experts are the National Association of Certified Valuation Analysts (NACVA), the Institute of Business Appraisers (IBA), the American Society of Appraisers (ASA), the CFA Institute and the Association of Certified Fraud Examiners.

In addition, unlicensed experts who have an academic background frequently rely on the practices of academia to establish standards of practice and proper conduct. A key practice in academia is reliance on published research that has been generally accepted in a scientific or technical community. In academia, proof of general acceptance is generally based on publication in a quality academic journal. The publication criteria in these types of journals usually focus on whether the research has passed anonymous peer reviews by a panel of experts.

Financial experts may also recognize the methods that their applicable professional literature describes as standards of practice. However, one should consider the quality of the journal and evaluate whether an article represents only one person's opinion or a practice that has been peer-reviewed by a panel of experts.

Conclusion

The opinions of a testifying expert and the credibility of the individual may be judged by a trier of fact based on whether the work that went into the expert's opinions met the professional standards of practice in the relevant technical community. These standards may be on technical matters or rules for ethical conduct.

Further, professional organizations and associations may establish standards of practice. These groups might be government regulators or industry groups. In addition, standards of practice might arise from practices described in a profession's literature. Beyond professional standards of practice in a technical community, judicial rules may also apply to the opinions of experts and their related disclosures.



Economic Damages: Lost Profits Determinations

Links to Requirements for Certifications, by Organization

AICPA (American Institute of Certified Accountants)

- CPA (Certified Public Accountant) – requirements set by state in second link
 - <http://www.aicpa.org/BECOMEACPA/LICENSURE/Pages/default.aspx>
 - <http://www.aicpa.org/Advocacy/State/StateContactInfo/Pages/StateContactInformation.aspx>
- ABV (Accredited in Business Valuation)
 - <http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/Pages/OverviewoftheAccreditedinBusinessValuationCredential.aspx>
- CFF (Certified in Financial Forensics)
 - <http://www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/Pages/Overview%20Certified%20in%20Financial%20Forensics%20Credential.aspx>

ASA (American Society of Appraisers)

- AM (Accredited Member)
 - <http://www.appraisers.org/Membership/join-asa>
- ASA (Accredited Senior Appraiser)
 - <http://www.appraisers.org/Membership/join-asa>

IBA (Institute of Business Appraisers)

- CBA (Certified Business Appraiser)
 - <http://www.go-iba.org/certification/certifiedbusinessappraisers.aspx>
- MCBA (Master Certified Business Appraiser)
 - <http://www.go-iba.org/certification/mastercertifiedbusinessappraisers.aspx>

NACVA (National Association of Certified Valuation Analysts)

- CVA (Certified Valuation Analyst)
 - http://www.nacva.com/certifications/C_cva.asp
- MAFF (Master Analyst in Financial Forensics)
 - http://www.nacva.com/certifications/C_maff.asp



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CFA Institute

- CFA (Chartered Financial Analyst)
 - <http://www.cfainstitute.org/CFAPROGRAM/Pages/index.aspx>

Association of Certified Fraud Examiners

- CFE (Certified Fraud Examiner)
 - <http://www.acfe.com/cfe-qualifications.aspx>

NAFE (National Association of Forensic Economics)

- No designation
 - <http://nafe.net/about-nafe/>

CICBV (Canadian Institute of Chartered Business Valuators)

- CBV (Chartered Business Valuator)
 - <https://www.cicbv.ca/?page=Overview>

Chartered Accountants of Canada

- CA (Chartered Accountant)
 - <http://www.cica.ca/becoming-a-ca/index.aspx>



Economic Damages: Lost Profits Determinations

Links to Professional Standards/Codes of Conduct, by Organization

ASA (American Society of Appraisers)

- Principles of Appraisal Practice and Code of Ethics
 - <http://www.appraisers.org/About/professional-standards-ethics>

IBA (Institute of Business Appraisers)

- Professional Standards
 - http://www.go-iba.org/files/iba_s_new_professional_standards_effective_6-1-2011.pdf

NACVA (National Association of Certified Valuation Analysts)

- General and Ethical Standards
 - http://www.nacva.com/association/new_pro_stand.asp#ethical_standards

CFA Institute

- Code of Ethics and Standards of Professional Conduct
 - <http://www.cfapubs.org/toc/ccb/2010/2010/14>

Association of Certified Fraud Examiners

- CFE Code of Professional Standards
 - <http://www.acfe.com/standards.aspx>

NAFE (National Association of Forensic Economics)

- NAFE's Statement of Ethical Principles and Principles of Professional Practice
 - <http://nafe.net/about-nafe/nafes-ethics-statement.html>

CICBV (Canadian Institute of Chartered Business Valuators)

- Code of Ethics
 - <https://www.cicbv.ca/code-of-ethics>

Chartered Accountants of Canada

- CICA Standards and Guidance Collection
 - <http://www.cica.ca/publications/cpa-canada-handbooks/index.aspx>



Economic Damages: Lost Profits Determinations

Chapter IV—*Spoliation of Evidence, Expert Admissibility & Electronic Discovery*

Spoliation of Evidence

Litigants have a duty to preserve documents that may be relevant to pending or imminent litigation. Spoliation is defined in *Black's Law Dictionary* as:

The intentional destruction, mutilation, alteration, or concealment of evidence usually a document. If proved, spoliation may be used to establish that evidence was unfavorable to the party responsible.

A party can be sanctioned for spoliation of evidence only if the party had a legal duty to preserve it. The trial court determines the appropriate sanctions on a case-by-case basis.

The duty to preserve documents attaches when a lawsuit arises, however the filing of a lawsuit is not always the earliest date the duty is triggered. The duty can arise when a party is on notice that litigation is likely in the future. The facts specific to each case will guide the decision of when the duty to preserve evidence is triggered.

Once a party has notice of future litigation, it must institute a “litigation hold” to preserve evidence. Routine document retention and destruction policies are halted, as well as computer systems programmed to purge information. Further, there is an ongoing responsibility to provide all available information in response to discovery requests.

Testifying experts may be required to disclose the documents/information given to prepare their opinion, even if they ultimately do not rely on it. Disclosure is dependent upon the particular jurisdiction. Testifying experts do not have the obligation to keep every piece of paper created during the course of the project; however, documents that are helpful in understanding the expert’s opinion (and development thereof) should be retained. Further, documents should be retained that the opposing party might use in cross-examination.

Trial experts should track the specific documents that they receive, as in many instances the entire document discovery is not turned over to an expert. Since the trend is towards a “paperless” environment, documents are typically stored on a network of CDs, and experts typically have electronic data retention policies. These policies, at a minimum should be in line with Federal Rules of Civil Procedures, which often leads to separate document retention policies for litigation matters in a firm/practice providing other types of services.

The Civil Rules Advisory Committee’s primary focus now appears to be on exploring each of the major elements of a preservation Rule: (1) when the preservation obligation is triggered, (2) the scope of the preservation obligation, and (3) developing a nationwide standard of appropriate sanctions for loss or spoliation of information. The Subcommittee’s original charge was to focus on the triggers for the preservation obligation, and support was expressed for more-specific trigger language than “reasonably foreseeable,” as well as better defining the scope of the obligation.



Economic Damages: Lost Profits Determinations

Federal Rules of Civil Procedure Rule 26

Those that serve as testifying experts in Federal Court are subject to Rule 26 of the Federal Rules of Civil Procedure. The form of the existing Rule 26 was established in 1993. It was amended at that time, to eliminate the prior regime that provided work product protection to testifying experts. Subsequent interpretations of Rule 26 since 1993 have evolved towards the total discoverability of communications between testifying experts and legal counsel retaining the expert, including, draft reports, e-mails, notes from meetings and discussions.

On December 1, 2010, Rule 26 was updated by several important amendments. The outcome of these amendments is likely to enhance the ability of experts to collaborate with legal counsel to develop and refine theories and opinions. Prior to the amendments, many practitioners expressed that Rule 26 inhibited meaningful communications between legal counsel and expert witnesses, which ultimately, in some circumstances, impacted the quality of the expert's opinion.

The 2010 amendments were intended to strike a balance between two extremes by restoring protection to certain aspects of the communications between experts and retaining counsel. The following table provided by the AICPA (www.aicpa.org), is a summary of the critical changes to Rule 26:

Amendment To:	Existing Rule	December 2010 Amendments	Intended Change
Drafts of expert reports	Virtually all drafts shared with counsel are discoverable regardless of form.	Drafts are generally no longer subject to discovery.	More refined and persuasive reports as well as the reduction or elimination of time spent examining an expert about the development of opinions.
Communications with counsel	Virtually all communications are discoverable.	Protected regardless of form with three exceptions (see bullets below this table).	Reduce or eliminate the need to avoid the creation of a discoverable record, including retention of both testifying and consulting experts.
Information Considered by an expert	Experts were required to disclose "Data or other information" considered.	Experts will be required to disclose only "Facts or data considered."	The broad interpretation of "other information" will be limited.



Economic Damages: Lost Profits Determinations

Draft Reports

Rules 26(b)(3)(A) and (B) protect drafts of any report or disclosure required under Rule 26(a)(2), regardless of the form in which the draft is recorded. The term, “any report or disclosure” creates uncertainty as to whether it includes notes of legal counsel if they reference facts or assumptions. Since the Rules do not provide absolute protection, a draft may still be discoverable if the opposing party can prove that the document would be discoverable and demonstrates undue hardship in recreating the document. This would be a circumstance where an opinion has evolved over time, and the opposing party demonstrates the need for information from that perspective. Experts should be circumspect until the courts interpret the impact of this amendment.

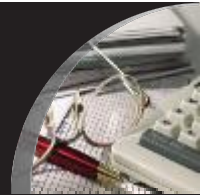
Communications with Counsel and Information Considered

An expert has no obligation to keep every paper created during the course of an engagement. Experts are required to retain only those documents that are helpful in understanding the expert opinion or that the opposing party might use in cross-examination. Experts must disclose the “data or other information considered” by the witness in forming his or her opinion. However, the word “consideration” has a broad interpretation in federal courts.

Rules 26(b)(3)(A) and (B) protect communications between the party’s attorney and any witness required to provide a report under Rule 26(a)(2)(B), regardless of the form of the communications, except to the extent that the communications:

- (i) relate to compensation for the expert’s study or testimony;
- (ii) identify facts or data that the party’s attorney provided and that the expert considered in forming the opinions to be expressed; or
- (iii) identify assumptions that the party’s attorney provided and that the expert relied on in forming the opinions to be expressed.

It appears that this amendment will promote broader communications between expert and attorney. The authors of this material expect that it will take the courts some time to interpret the Rule and define its breadth. As previously noted, the word “considered” (as used in subsection ii) has a broad interpretation, which could be problematic. Opposing counsel will continue to retain some avenues to discover communications between experts and retaining counsel, although the Civil Rules Advisory Committee recommended that these avenues be restricted to rare use, for example, due to “undue hardship.” The protections afforded Rules 26(b)(3)(A) and (B) are not absolute, and therefore, there are circumstances where communications are discoverable. It would be in the best interests of experts to be circumspect in those communications until courts begin interpreting the Rule.



Economic Damages: Lost Profits Determinations

Expert Admissibility

In commercial litigation matters, an expert witness often offers an opinion regarding the magnitude of lost profits and/or economic damages suffered by a plaintiff as the result of some allegedly wrongful action by a defendant. Valuation analysts, economists, financial advisers and forensic accountants often provide such expert testimony regarding the lost profits and/or economic damages.

In addition to professional standards, financial experts must be aware of and comply with applicable case law and evidentiary standards regarding the admissibility of expert testimony. The law and standards will be dependent upon the venue of the subject litigation. State law and standards may be different from federal standards and laws. Additionally, state law and standards vary from jurisdiction to jurisdiction. The financial expert should discuss applicable case law and evidentiary standards with legal counsel to ensure compliance.

Financial experts are required to establish the following:

- He/she has the requisite knowledge, skill, training and experience in his/her field of practice.
- He/she must provide the facts, assumptions, information and other considerations relied upon when reaching his/her conclusion.
- He/she must provide the methodology employed in reaching his/her conclusion.

Starting in 1993 with *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579, and later in the 1999 case, *Kumho Tire Company, Ltd. v. Carmichael*, 526 U.S. 137, federal judges are charged with serving as the gatekeeper for the admissibility of testimony of nonscientific experts including financial experts. The Federal Rules of Evidence (“FRE”) provides guidance to a federal judge in determining whether the expert’s testimony meets minimum standards. The following sections of the FRE are relevant:

- **Rule 702. Testimony by Experts** – If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.
- **Rule 703. Bases of Opinion Testimony by Experts** – The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence in order for the opinion or inference to be admitted. Facts or data that are otherwise inadmissible shall not be disclosed to the jury by the proponent of the opinion or inference unless the court determines that their probative value in assisting the jury to evaluate the expert’s opinion substantially outweighs their prejudicial effect.



Economic Damages: Lost Profits Determinations

Based on the Supreme Court Daubert decision, the four factors that trial courts should consider in determining expert testimony reliability and relevance are:

1. Whether the theory at issue can and has been tested,
2. Whether the theory has been subjected to peer review and publication,
3. Whether there is a known or potential error rate, and
4. Whether the theory has been generally accepted within the scientific community.

An expert should prepare and present an analysis that he/she can defend to a group of his/her peers.

To receive a judicial award of economic damages, the plaintiff must prove the occurrence of damages with certainty. What the plaintiff must prove with certainty is that the damages were the result of the defendant's wrongful actions. There is an important distinction in the evidentiary burden related to:

1. The measure of proof necessary to establish the fact that a petitioner has sustained some economic damage, and
2. The measure of proof necessary to establish the amount of the economic damages.

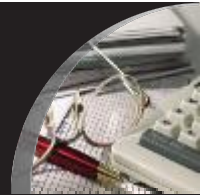
At times when expert testimony regarding economic damages is excluded, it is due to the trial judge's determination that the testimony relates to damages that are not attributable to the alleged damaging act. Expert testimony that describes economic damages that are definitely attributable to the wrongful action, but only uncertain with respect to the amount of such damages, should not be excluded.

Often a Daubert motion involves a challenge to more than the professional practices, standards, theory and methodology of the expert. In preparing the expert report, the testifying expert typically provides full disclosure as to the theories and methodology employed. This is because the testifying expert may not have an opportunity to supplement an expert report that provides insufficient disclosure.

The testifying expert, as part of his or her due diligence, should consider whether, based on the report, another expert in the same field could duplicate the expert's work. Some obvious objections can be avoided when the expert witness specifies, in the report, the reasons for not employing alternative techniques or methodologies. Finally, the expert report may also explain why the testifying expert did not rely on some of the data that was disclosed to the expert.

Electronically Stored Information

As part of the initial disclosures under Federal Rules of Civil Procedure ("FRCP"), all parties must produce electronically stored information ("ESI"). The Rules strongly encourage the requesting party to specify the format in which it would like to receive ESI. Some states have defined electronic discovery rules, while others refer to the federal rules as guidance.



Economic Damages: Lost Profits Determinations

Electronic Discovery

Electronic discovery (also called e-discovery or ediscovery) refers to any process in which electronic data is sought, located, secured and searched, with the intent of using it as evidence in a civil or criminal legal case. The purpose of discovery is to permit parties to access information that will enable fact finders to determine the outcome of civil litigation. The revisions of The Federal Rules of Civil Procedure that took effect in December 2006 made practical changes to discovery rules to make it easier for courts and litigating parties to manage electronic records.

Electronically stored information differs somewhat from hard copy documents because ESI can be easily altered or destroyed. Email can be automatically deleted and an email sent to a party can be altered simply by opening it. However, the same factors apply to paper documents and ESI. Financial experts will look to legal counsel for the parallels between hard copy or paper documents and ESI. Counsel is responsible for understanding the client's computer system and structure in order to determine where ESI resides and its accessibility.

Parties who destroy ESI advertently or inadvertently by failing to take reasonable measures (in good faith) to preserve it are likely to face spoliation sanctions.

There are issues that certain privilege information can be inadvertently disclosed due to the substantial amounts of information that are involved in electronic discovery. There is substantial time and cost required to screen the volume of information for attorney work product and other privilege information. Additionally, a computer forensics expert may be called to testify relative to issues related to ESI.

In order to be admitted into evidence at trial, ESI must be relevant to the issues at hand; be authenticated to ensure reliability; meet the best evidence requirement; not be excluded by a rule of evidence; and have probative value that outweighs its prejudicial value.

It might be helpful to engage a financial expert on a consulting basis to assist during e-discovery. The expert can identify search terms for retrieving the client's ESI relating to damages. Additionally, the consulting financial expert could assist in drafting discovery results directed to the opposing party's ESI.

A financial expert who prepares a report or testifies in court must be furnished with ESI necessary to base his or her opinion. An expert should be aware that ESI used to support his or her opinion, which is not permitted into evidence, could likely impact the admissibility or weight of the opinion. A testifying expert should also be aware and avoid creating ESI evidence, including email correspondence, which could be discovered and used during cross-examination.

E-discovery is an extremely "hot" and important topic. The impact of electronic discovery will only become greater as technology continues to advance. The authors of this material are not aware of any rules that specifically address electronic discovery in Pennsylvania. Legal counsel and their financial experts will work together on cases in this area as it evolves, and ESI that must be considered during economic damages cases proliferates.



Economic Damages: Lost Profits Determinations

Chapter V – *Lost Profits Calculations*

As noted in Chapter III, a financial expert may be engaged to provide credible opinions regarding lost profits damages in a legal setting. Legal counsel can be advocates of their client's position however, financial experts are tasked with demonstrating integrity and objectivity when presenting their professional opinions. This chapter will provide an overview of the approaches, methods and procedures used by the financial expert to calculate lost profits economic damages.

Defining Lost Profits

Lost profits are based upon the alleged harm suffered by the plaintiff as a result of a wrongful act of the defendant. Lost profits are calculated as the amount necessary to place the injured party in a position that he/she would have been in, had the injury or incident not occurred. Lost profits calculations determine the amounts that are potentially recoverable due to the defendant's specific actions, inactions or incidents.

Economic damages include lost "net" profits, which are defined as lost revenues less the avoided cost, and are usually included as an element of economic damages in a litigation matter. Typically, net lost profits are computed by estimating the gross revenue that would have been earned if the alleged acts had not occurred. This amount is then reduced by the avoided costs, or those costs which were not incurred because of the lost revenue.

$$\text{Lost revenues} - \text{Avoided costs} = \text{Net lost profits}$$

While it is possible, lost profits typically will not equal the harmed party's gross profits. Gross profits without a deduction for expenses are not recoverable; however net profits are able to be recovered.

Each lost profits situation is different and unique. The specific facts and circumstances surrounding the economic damages calculations govern the approach and methods employed. It is imperative that the financial expert clearly defines the facts and assumptions on which he or she has based the calculations.

The calculations should be credible and serve to aid a trier of fact in the particular matter. The expert's calculations should provide relevant and reliable information and use approaches, methodologies and analytical procedures that specifically relate to the given situation. Testifying experts must tie their conclusions to the underlying cause of the damages; if not, courts will exclude an expert's testimony on the basis of irrelevance or unreliability (or both).



Economic Damages: Lost Profits Determinations

Elements Requiring Analysis When Calculating Net Lost Profit Damages

The following items must be considered by a financial expert when calculating credible net lost profit damages. There may be additional factors, depending on the facts and circumstances of the case.

- Cause of loss
- Factual basis for claim
- Determination of evidence supporting the financial claim
- Estimation of lost revenues
- Incremental (avoided/saved) costs associated with lost revenues
- Net lost profits associated with lost revenues
- Deposition testimony
- Answers to interrogatories
- Economic/industry outlook and impact on claim
- Selection of appropriate methodology
- Actual performance during historical damages period/anticipated performance in future damages periods
- Length of damages period
- Level of discount rates applicable to future damages periods
- Prejudgment interest relevant for jurisdiction/venue, if applicable
- Independent research conducted by expert of support calculation
- Other expert reports, workpapers, analyses

Sufficient workpapers, calculations and documentation that support the above-noted elements are necessary in preparing an adequate economic damages calculation.

Due to the reasonable certainty standard, lost profits calculations cannot be based on mere speculation, as damages are recoverable only if the plaintiff establishes legally sufficient proof that the calculated damages are reasonable and the expert has used reliable factors in his or her calculations.



Economic Damages: Lost Profits Determinations

Reasonableness of Expert Input and Assumptions

The fact of damage, in a damages case, must be proven with reasonable certainty; meaning that the plaintiff must prove the acts of the defendant caused damages to the plaintiff. The defendant's acts do not need to be the sole cause of damages, but they must be a significant or material factor in the cause of the plaintiff's lost profits. However, other causes for the plaintiff's losses should be considered in the calculation prepared by the expert. An expert may consider (but is not limited to) the effect of the following on their damages calculations:

- Economic, industry, and company-specific factors
- Financial position of company
- Costs of production
- Impact of competition
- Capacity constraints on business
- Relevant market share
- Workpapers prepared in connection with purchase price allocations and goodwill impairment
- Depositions of fact and expert witnesses
- Other legal filings in the case
- Publicly available documents related to subject company
- Intangible assets, including trademarks, trade secrets, patents and customer lists
- Non-compete agreements and their impact on damages
- Outlook for the economy/industry
- General and specific business risks
- Geographic or geopolitical issues
- Available technology
- Regulatory and environmental issues and constraints

As previously noted, this is not an exhaustive list; there may be other relevant considerations which will be dependent upon the specific facts and circumstances of the case.



Economic Damages: Lost Profits Determinations

Failing to carefully address relevant factors, an expert could fail to meet the “reasonable certainty” standard of proof despite preparing an otherwise (mathematically) correct analysis. It is imperative that the expert understands that when calculating net lost profits, the reasonable certainty standard applies to the entire damages claim, not just the first year. Sufficient evidence must support forecasts for future years, as factors referenced above can become more speculative over time.

Limitations on the Period of Recovery

Both sides of the litigation should discuss the appropriate start date from which to base their calculations; typically this date is the date on which the harmful act occurred. On the other hand, the end date of the loss period will not likely coincide with the trial date. Damages will be projected to the point when the plaintiff’s operations return to “normal.”

Any damages model for lost profits has the goal of bringing the company to a position equivalent to that which it would have been in had the wrongful conduct or act not occurred, or to a position that considers the changes that would have otherwise occurred during the damages period, absent the alleged actions.

Lost Profits Damages Calculations

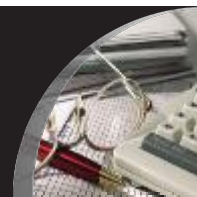
Typically a financial expert would use one of two approaches to calculate lost profits:

- *One-model approach* – calculation of only the incremental lost revenues and related avoided costs
- *Two-model approach* – taking the difference of the net profits the business would have attained “but-for” the damaging event, and the actual financial results attained over the given period

Estimating Lost Revenue

The first element in the determination of lost profits is the calculation of lost revenues. Lost revenues can be quantified employing the normal methods used in lost profits calculations.

There are four methods typically used by a financial expert to determine lost revenues and profits: the before-and-after method, yardstick method, sales projection method and the market mode, which are briefly detailed on the following pages. Each of these methods provides the expert with a framework within which to gather empirical and evidentiary support for projections of what would have happened “but for” the damaging actions. Depending on the case at hand, an expert may use one or more of the methods mentioned.



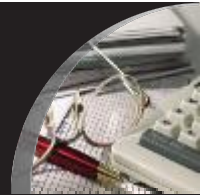
Economic Damages: Lost Profits Determinations

- **Before-and-After Method**– This method determines economic revenues for the damages period by comparing the performance of the business before the alleged actions and after the effects of the damaging event are over. This method, sometimes referred to as “book ends,” is a commonly-accepted method used to calculate lost profits. The underlying theory of this method is that “but for” the defendant’s action, the plaintiff would have experienced similar revenues and profits after the event as the plaintiff experienced before the event. The following is a simplistic example of the before-and-after method.

	<u>Before</u>		<u>After</u>		
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Revenues	\$550,000	\$575,000	\$220,000	\$195,000	\$475,000
Costs	<u>240,000</u>	<u>250,000</u>	<u>175,000</u>	<u>165,000</u>	<u>225,000</u>
Net Profits	\$310,000	\$325,000	\$ 45,000	\$ 30,000	\$250,000
Average Net Profits Prior to Event	\$318,000				
Lost Profits			\$273,000	\$288,000	\$ 68,000
Discount Rate (15%) Factor			1.00	0.87	0.76
PV of Lost Profits			\$273,000	\$250,560	\$51,680

The before-and-after method may be best applied to an established business with a historical track record of profitability. Historical financial results are generally subject to dispute less than other components of the calculation. Another instance in which this method can be used is when a financial expert can prove that a business was harmed and would have performed with similar results before and/or after the event. A defendant could also use this method to illustrate that the plaintiff did not suffer any harm. It is important for the expert to consider other factors that may have contributed to harm or loss during the damage period.

- **Yardstick Method**– The yardstick (or benchmark) method uses guideline company or industry measures to determine what the revenues and profits of the affected company would have been if the damaging event had not occurred. Experts can utilize both outside (guideline) companies as well as proxies from within the same company. At times, this information from within the company can serve as the best available evidence. Examples of potential yardsticks that might be utilized in a calculation include performance of the plaintiff at a different location; plaintiff’s actual results versus past budgets; actual experience of similar businesses unaffected by the defendant’s actions; and industry averages.



Economic Damages: Lost Profits Determinations

The yardstick method requires that the expert prove that the subject business is sufficiently similar to the guideline company/industry used. If specific attention is not given to this process, opposing counsel could easily critique use of this method. The following is a simplistic example of the yardstick method.

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Actual Revenues	\$550,000	\$575,000	\$220,000	\$195,000	\$475,000
Actual Costs	<u>240,000</u>	<u>250,000</u>	<u>175,000</u>	<u>165,000</u>	<u>225,000</u>
Actual Net Profits	\$310,000	\$325,000	\$ 45,000	\$ 30,000	\$250,000
Industry Revenue	\$2,000,000	\$2,300,000	\$2,825,000	\$3,100,000	\$3,225,000
Industry Costs	<u>960,000</u>	<u>1,050,000</u>	<u>1,350,000</u>	<u>1,500,000</u>	<u>1,725,000</u>
Industry Net Profits	\$1,040,000	\$1,250,000	\$1,475,000	\$1,600,000	\$1,500,000
Average Industry Revenue Growth	12.9%				
Indicated Revenue			\$649,000	\$733,000	\$827,000
Average Industry Net Profit Margin	51.3%				
Indicated Net Profits			\$333,000	\$376,000	\$425,000
Lost Profits			\$288,000	\$346,000	\$175,000
Discount Rate (15%) Factor			1.00	0.87	0.76
PV of Lost Profits			\$288,000	\$301,020	\$133,000

As with the before-and-after method, it is important for the expert to consider other factors that may have contributed to harm or loss during the damage period.

- ***Sales Projection Method*** – The sales projection method utilizes company-specific forecasts, preferably prepared in the ordinary course of business and prior to the damaging event. Many businesses prepare forecasts and budgets as part of their normal operating procedure. These forecasts/budgets can be the foundation of the sales projection methodology.



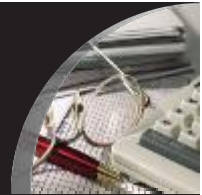
Economic Damages: Lost Profits Determinations

This method is useful, in that it allows the expert to more easily incorporate the effect other factors might have on revenues and profits. These factors could include: changes in competition, economics, technology, customer base, supplier relationships, regulations, management, market share pricing, capacity, obsolescence, behavior, etc. The expert must separate the effects of the damaging acts from those that resulted from factors outside of those acts. The following is a simplistic example of the sales projection method.

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Actual Revenues	\$550,000	\$575,000	\$220,000	\$195,000	\$475,000
Actual Costs	<u>240,000</u>	<u>250,000</u>	<u>175,000</u>	<u>165,000</u>	<u>225,000</u>
Actual Net Profits	\$310,000	\$325,000	\$45,000	\$30,000	\$250,000
Projected Revenues	\$500,000	\$555,000	\$650,000	\$680,000	\$725,000
Projected Costs	<u>220,000</u>	<u>240,000</u>	<u>275,000</u>	<u>290,000</u>	<u>300,000</u>
Projected Net Profits	\$280,000	\$315,000	\$375,000	\$390,000	\$425,000
Lost profits			\$330,000	\$360,000	\$175,000
Discount Rate (15%) Factor			1.00	0.87	0.76
PV of Lost Profits			\$330,000	\$313,200	\$133,000

One weakness of this method is identifying and measuring the effects of other factors. Additionally, it can prove to be a challenge to support the underlying projections of the business. If a company has a history of preparing forecasts that come close to meeting actual results, supporting the projections would be less challenging. Underlying all lost profits calculations is reliability and relevance rather than unduly speculative or unreasonable projections.

- **Market Model** – The final methodology used to calculate lost profits is the market model. This is the least used of the four methods included herein. According to this method, a financial expert uses the plaintiff's market share prior to the alleged act to determine lost revenues. This model is most frequently used in patent infringement cases. The following is a simplistic example of the market model method.



Economic Damages: Lost Profits Determinations

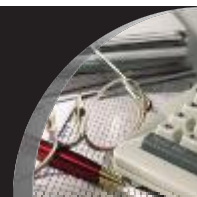
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Actual Revenues	\$550,000	\$575,000	\$220,000	\$195,000	\$475,000
Industry Revenue	2,000,000	2,300,000	2,825,000	3,100,000	3,225,000
Market Share	27.5%	25.0%	7.8%	6.3%	14.7%
Average Market Share Prior to Event	26.5%				
Indicated Revenue			<u>749,000</u>	<u>822,000</u>	<u>855,000</u>
Lost Revenues			\$529,000	\$627,000	\$380,000
Market Profitability as % of Revenue	45.0%				
Lost Profits			238,050	282,150	171,000
Discount Rate (15%) Factor			1.00	0.87	0.76
PV of Lost Profits			\$238,050	\$245,471	\$129,960

The expert that uses this model must define the market of the company and analyze the subject business' historical sales, as well as the performance of its competitors. Courts have ruled that this model can be relied upon, but the challenge lies in how to relate the performance that was impacted to the damages event.

- **Other Methods** – There are other possible methods and approaches that financial experts can use to determine lost profits including: regression method, high-low method and the increment method. If these methods are used, the expert needs to develop a calculation of avoided costs associated with the prediction of lost revenues.

Estimating Costs

After establishing the amount of lost revenues, the expert will calculate the costs associated with the generation of those revenues. Avoided costs are those costs that should be deducted from lost revenues in order to determine net lost profits. These costs would have been incurred in connection with the generation of the revenues lost/economic damages. To the extent that the plaintiff incurred costs that would not have been incurred in the absence of the defendant's misconduct, those costs should be offset against the avoided costs. If an expert fails to explain and address the reasonableness of the avoided costs, the calculations may prove to be unreliable



Economic Damages: Lost Profits Determinations

The calculation of the avoided costs in a damages case must be done through an analysis of the cost structure of the business to determine the relationship between lost revenue and the costs associated with that revenue. Specifically, a financial expert will need to determine the cost drivers and other factors that impact costs directly tied to revenue.

Typically, an expert will start by classifying all costs into one of five categories: cost of goods sold, direct costs, indirect costs, overhead costs and other expenses. Pinpointing which costs are fixed versus those that are variable is also critical. As the Delaware Chancery Court explains,

A key aspect of a lost profits analyses is to determine what portion of total costs are fixed – i.e., will be expended regardless of sales volume – and what costs are variable – i.e., will be spent only to generate additional sales volume. Only the latter are required to be subtracted from lost revenues in determining lost profits, because only the latter are saved as a result of the breach.

Many times the expert will rely upon historical financial records to determine the cost structure of a product or service. The use of ratio analysis may prove to be helpful when identifying how costs vary with changes in revenue. Additionally, the use of statistical methods such as regression analysis and attribute sampling can aid an expert in establishing cost estimates. Finally, it is important for the expert to consider factors such as seasonality and popularity of new products as these aspects may impact the calculations.

Discounting of Future Lost Profits to Present Value

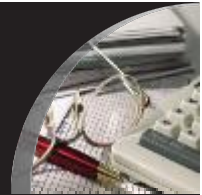
As previously noted, there can be both an historical and future component of lost profits. In the event of future lost profits, these amounts must be discounted back to present value. The challenge to a financial expert is determining the appropriate discount rate to use considering the following factors:

- **Time value of money** – many individuals would prefer to have \$1 today as opposed to waiting to earn that \$1 in the future, and would even be willing to accept a discount on that \$1 so they do not have to wait until the future. To demonstrate this concept, consider \$10,000 in profit, available 5 years from today at a 3% interest rate. The present value of this amount is calculated below:

$$\text{Present Value} = \$10,000 / (1 + .03)^5 \qquad \text{PV} = \$10,000 / 1.1593 \qquad \text{PV} = \$8,626$$

- **Risk** – As is the case in any investment, there is a trade-off between risk and reward. Thus, a future cash flow stream with higher risk requires a greater discount rate to compensate an investor for accepting the risk.

When discounting lost profits to their present value, it is critical for a financial expert to determine whether an *ex ante* or *ex post* methodology is more appropriate. An *ex ante* methodology assumes that all lost profits are future lost profits and, therefore, must be discounted back to present value. Conversely, the *ex post* methodology, assumes



Economic Damages: Lost Profits Determinations

that all lost profits are known or knowable up to the date of trial and, therefore, there are no future profits that must be discounted. A hybrid approach can also be used. In this case an expert would discount all lost profits back to the date of the breach, relying upon information available up to the date of trial.

Determining a Discount Rate

A discount rate is usually based on the subject company's cost of equity or weighted average cost of capital (WACC). The courts have been quiet with respect to what constitutes an appropriate discount rate. Some of the more common methods available to calculate the cost of capital or discount/capitalization rate for a specific investment include:

- Buildup model (BUM) method
- Capital asset pricing model (CAPM) method
- Modified capital asset pricing model (MCAPM) method
- Weighted average cost of capital (WACC) method
- Price/earnings method

Most often, practitioners preparing business valuations for privately-held entities use the buildup method, the modified capital asset pricing model or the weighted average cost of capital. The WACC is not a method for determining an equity rate, but rather, an overall invested capital rate encompassing both debt and equity capital. Due to the constraints of this program, only the buildup method and WACC method will be summarized.

- ***The Buildup Model*** – The buildup model is the most common methodology employed by valuation practitioners to estimate future cost of equity capital for a specific privately-held business. In its most basic form, the method can be expressed in the following formula:

$$K_e = R_f + R_{pm} + R_{ps} + R_{pu}$$

Where: K_e = Discount rate applicable to future cash flow

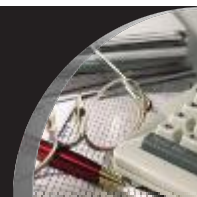
R_f = Risk-less rate (Treasury Bond rates)

R_{pm} = Equity risk premium (market over risk-less rate)

R_{ps} = Risk premium for size, and

R_{pu} = Specific industry/company risk

Of the four variables in the formula, only R_{pu} is the result of a subjective determination. The other three elements are developed through national economic data and well-accepted economic studies conducted by respected third-party sources.



Economic Damages: Lost Profits Determinations

Developing the Discount Rate

The rate used to discount expected future cash flows to present value is the estimated rate of return currently available in the market on alternative investments with comparable risk. As illustrated above, the estimate of the discount rate (required rate of return) is derived from market evidence and is the sum of:

- A risk-free rate; typically the 20-year U.S. Treasury Bond yield, and
- A premium for risk, which is the sum of the following:
 - An equity risk premium, which is the expected premium over the risk-free rate that investors expect to get by investing in a broad index of the common stock market (such as the Standard & Poor's 500 stock composite average),
 - An additional premium for the additional risk associated with the small size of the Company, compared with the average size of comparable public companies in the marketplace, and
 - An additional premium for other risk factors specific to the Company/Product/Service.
- *Weighted Average Cost of Capital Method* – As its name implies, the WACC method utilizes an approach that looks to a Company's overall cost of capital. A Company's total invested capital is comprised of debt capital (generally, with a fixed cost) and equity capital. The WACC computation essentially combines the cost of equity, as determined under the buildup model discussed previously, and the net "after-tax" cost of debt in those proportions that are representative of future expected debt/equity structures.

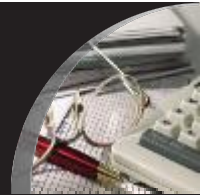
The first step in determining the appropriate WACC is to develop a cash flow discount rate applicable to the risks associated with holding an equity capital position in the Company. The second step entails identifying the Company's borrowing rate at the date of measurement. This rate will require tax affecting adjustments. Finally, an appropriate debt/equity mix for a company should be considered.

After determining the cost of equity capital under the buildup model, the second step in the determination of the WACC is to determine the company's cost of borrowing. Assume that, as of the date of measurement, the prime rate was 5.00% and the cost of debt will reflect the next dollar of financing at market rates. Applying a 35% tax rate, the after-tax borrowing rate is determined as set forth below:

$$\text{After-tax borrowing rate} = k_d (1 - t) = 5.00\% (1 - 35\%) = 5.00\% (65\%) = 3.25\%$$

Where: k_d = Cost of debt

t = Tax rate



Economic Damages: Lost Profits Determinations

The final step in the determination of the WACC is to apply the appropriate weights to the equity capital and the debt capital to produce a weighted average cost of capital. In the example below, the weights assigned to each element of capital are based on the industry standards.

The calculation of the weighted average cost of capital discount rate is illustrated below.

$$\begin{aligned}\text{WACC} &= (K_e * W_e) + [(K_{dpt} (1-t)) * W_d] \\ &= (20.00\% * 40\%) + [(5.00\% * (1 - 35\%)) * 60\%] \\ &= 8.00\% + [(5.00\% * 65\%) * 60\%] \\ &= 8.00\% + (3.25\% * 60\%) \\ &= 8.00\% + 1.95\% \\ &= 9.95\%\end{aligned}$$

Where: K_e = Cost of equity

W_e = Weight of equity

K_{dpt} = Pre-tax cost of debt

t = Tax rate

W_d = Weight of debt

Consideration must be given with respect to a mid-year versus an end-of-year discounting convention. The financial expert will need to adjust his/her discount rate to reflect whether the subject company earns/distributes profits on the last day of the year or throughout the year.

Taxes and Damages

Generally, lost profits damages are taxable as ordinary income to the party receiving the damages payment. Because of this, lost profits calculations are typically prepared on a pre-tax basis. The appropriate discount rate is usually an after-tax rate, as any lost profits in the past could have been invested at the assumed pre-tax rate, and income taxes would have been paid on the interest amount earned.

$$\text{Taxable Damage Award} = \text{Pretax Cash Flow} / (1 + \text{After-tax Discount Rate}) = 1,000 / (1 + .12) = \$892.86$$

The financial expert would likely be able to assist counsel in evaluating the tax impact of potential damage awards.



Economic Damages: Lost Profits Determinations

Mitigation

Mitigation can be a factor in a damages calculation. The financial expert must consider whether revenues and/or profits earned subsequent to the damaging event are a mitigation of the damages caused by the defendant, thereby reducing damages, or are profits that would have been earned regardless of the event.

A plaintiff is generally not permitted to recover damages that were foreseeable and could have been avoided by reasonable efforts of the plaintiff without causing undue expense or risk. The plaintiff's ability to mitigate is dependent upon several factors, including:

- Financial ability to mitigate;
- Cost to mitigate as compared to the economic damages suffered by the plaintiff;
- Technical barriers to mitigation;
- Market barriers to mitigation;
- Supply-oriented barriers to mitigation; and
- Timing issues impacting mitigation of damages.

The defendant typically bears the burden of pleading and proving mitigation, which requires the plaintiff to take "reasonable steps" to mitigate damages caused by the defendant's conduct. The attorney and financial expert should discuss and decide if the mitigation aspect of the lost profits claim should be factored into the damages calculation.

Conclusion

The calculation of lost profits is a thorough process which requires an in-depth look at the facts and circumstances of each case, as well as the financial health of the subject business. A number of issues need to be addressed including, but not limited to, those listed below. When consideration is given to these items, a financial expert can prepare a sound and defensible calculation of lost profits.

- Understanding when a specific lost profits damages model is appropriate to use,
- Adhering to applicable professional and evidentiary standards,
- Calculating lost profits with reasonable certainty,
- Developing a link between the harmful event and the requested monetary relief,
- Selecting the appropriate damages period,
- Deciding whether a one-model or two-model approach is most useful,
- Assigning the pertinent incremental costs to the lost revenues, and
- Addressing mitigation.



Economic Damages: Lost Profits Determinations

Chapter VI – *Case Study Examples*

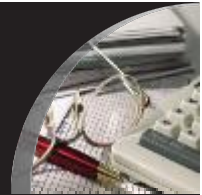
It is impossible, with the limited time we have today, to provide sufficient detail regarding any specific case to drive home all of the concepts that have been discussed. However, this chapter is intended to provide examples of nuances inherent in lost profits damages and fact patterns the authors of these materials have observed. Obviously, it goes without saying that each case is fact-specific, and a financial expert's careful and well-reasoned research and analysis will provide credibility to the underlying assessment and calculations.

- Plaintiff's calculation, in connection with damages resulting from patent infringement, included a claim for a disproportionate level of the sales of the product generated by the defendant. The issue identified with plaintiff's calculation was that defendant's sales included both domestic and foreign sales, and plaintiff did not have the capability to sell products abroad.
- In a patent infringement suit, the plaintiff's use of an alternative technology to work around the infringement issue and still differentiate its product was considered mitigation. The amount, if any, of lost profits were at issue because the plaintiff was able to maintain relatively-stable revenue levels by employing the alternative technology. Additional costs attendant to employing the alternative were considered.
- Plaintiff included most of the sales of the defendant in its lost profits calculation; however there was a material sales price differential between the products of the plaintiff and defendant. The flaw in this case was the assumption by the plaintiff that demand for the equipment was price inelastic; meaning that customers do not respond to a price change; and, therefore, the products sold at a lesser price by the defendant would have sold for nearly double by the plaintiff. The plaintiff's expert neglected to prepare an analysis to determine how much a change in price would impact the quantity demanded.
- Defendant's expert included all costs (fixed and variable) when computing net lost profits in a breach of contract case. The flaw in the calculation is that the expert failed to properly analyze expenses to isolate variable expense, fixed expenses and any expenses that could have been avoided during the loss period.
- In calculating lost profits damages in connection with a contract breach, the plaintiff used a yardstick method that included consideration of several guideline companies to serve as a proxy for what revenue and lost profits would have been "but for" the damaging event. It was determined that the operations of the guideline companies were not sufficiently similar to the affected company to serve as surrogates, as they were significantly larger (better capitalized) and had capabilities beyond that of the plaintiff.



Economic Damages: Lost Profits Determinations

- Plaintiff's calculation for lost profits included future projections of lost revenues and net profits. The projections were deemed invalid and unreliable, as they did not follow any historical trends, nor did they have any comparability to the internal budgets prepared by plaintiff's management. Furthermore, the plaintiff had a history of actual sales and profits approximating budgets as set forth by management.
- Plaintiff consultant sued for breach of contract, seeking recovery of lost profits, and used gross revenues as the measurement. Defendant argued that costs should have been deducted in the calculation. However, it was proven that the plaintiff could not have avoided the expenses, which were reimbursable under the consulting contract.



Economic Damages: Lost Profits Determinations

Chapter VII – *Critical Judicial Decisions*

The following is a sampling of cases, segregated by topics relevant in lost profits damages. Please note that this is not intended to be an all-inclusive list.

Foreseeability

As noted in Chapter II of these materials, foreseeability requires that losses resulting from a breach of contract, a tort or other actionable conduct are foreseeable and probable. Foreseeability looks beyond whether the conduct was likely to cause damage, to whether lost profits damages were within the contemplation of the parties at the time they entered into the contract. The following cases address the element of foreseeability:

- *Ashland Management Inc. v. Janien*, 624 N.E.2d 1007, 1010 (N.Y. 1993)
- *Anchor Savings Bank v. United States*, 2010 WL 786578 (C. A. Fed.)(March 10, 2010)
- *Karl J. Reeb v. Airtouch Communications, Inc.*, et al., No. B155737 (Cal. App. 2 Dist. October 15, 2003)
- *Denny Construction Inc. v. City and Co. of Denver*, 2009 WL 60507 (Colo.), Jan. 12, 2009
- *Trenhaile v. J.H. Findorff & Son, Inc.*, 2004 Wisc. App. LEXIS 384, May 4, 2004
- *Robert R. Vanderbeek, et al. v. Vernon Corporation*, No. 00SC960, Colo. June 17, 2002
- *Ho Myung Moolsan, Co. Ltd. v. Manitou Mineral Water, Inc.*, 2010 WL 4892646 (S.D.N.Y.), Dec. 2, 2010

Proximate Cause

Proximate cause requires that the plaintiff tie damages to the wrongful act that occurred and prove that the lost profits resulted directly from that act. The cases below made specific notes on the topic of proximate cause:

- *National Market Share, Inc. v. Sterling National Bank*, 392 F.3d 520, 525 (2nd Cir. 2004)
- *Beverly Hills Concepts v. Schatz & Schatz (II)*, 247 Conn. 48, 717 A.2d 724, 1998 Conn. LEXIS 341, September 15, 1998
- *WaveDivision Holdings, Inc. v. Millennium Digital Media Systems, LLC*, 2010 WL 3706624 (Del. Ch.), Sept. 17, 2010
- *Ho Myung Moolsan, Co. Ltd. v. Manitou Mineral Water, Inc.*, 2010 WL 4892646 (S.D.N.Y.), Dec. 2, 2010
- *In re Vivendi Universal, S.A. Securities Litigation*, 2009 WL 920259(S.D.N.Y.), March 31, 2009
- *Gordon Partners v. Blumenthal*, 2007 WL 431864 (S.D.N.Y. 2007)



Economic Damages: Lost Profits Determinations

Reasonable Certainty

The following cases dealt with the element of reasonable certainty. In each case, the courts considered whether the lost profits damages calculation was “capable of measurement based upon reliable factors without undue speculation.”

- *Sostchin v. Doll Enterprises, Inc.*, 847 So.2d 1123, 1129 (Fla. 2003)
- *AccuWeb v. Foley & Lardner*, 2007 Wisc. App. LEXIS 61, January 31, 2007
- *Neiman v. Bunnel Hill Development, Co.*, 2008 WL 4694998 (Ohio App.), Oct. 27, 2008
- *Signature Distribution Services, Inc. v. James E. Wright, et al.*, No. COA04-645 N.C. App., May 17, 2005
- *ClearOne Communications, Inc. v. Chiang*, 2009 WL 1108800 (D. Utah) (April 20, 2009)
- *Von der Ruhr v. Immtech International, Inc.*, 2009 WL 1855986 (C.A. 7 [Ill.]

Mitigation

One critical consideration in determining lost profits damages is the plaintiff’s obligation to prevent or limit its lost profits. Under this rule, a party must mitigate its damages and may not recover for losses that it could have reasonably prevented. The following is a sampling of cases addressing mitigation.

- *Duracote Corporation v. Goodyear Tire & Rubber, Co.*, 1143 N.E.2d 184, 186 (Ohio 1983)
- *Marshall Auto Painting & Collision, Inc. v. Universal Underwriters, Insurance Company*, 2003 U.S. District LEXIS 2003 (M.D. Fla. 2003)
- *Mississippi Chem. Corp.*, 287 F.3d at 372

Discount Rates

Courts have provided minimal guidance regarding appropriate discount rates in lost profits calculations. Some courts have ruled that the discount rate used should incorporate both inflationary and risk components, while others require the use of a risk-free rate. The following is a sampling of rulings regarding discount rates.

- *American List Corp v. U.S. News & World Report, Inc.*, 75 N.Y.2d 38, 550 N.Y.2d 590 (1989)
- *Burger King Corp. v Barnes*, 1 F. Supp.2d 1367 (S.D. Fla 1998)
- *Diesel Machinery, Inc. v. B.R. Lee Industries, Inc.*, 418 F.3d 820 (Fed. 8th Cir., 2005)
- *Energy Capital v. United States*, 302 F.3d 1314 (Fed. Cir. 2002)
- *Fairmont Supply Company v. Hooks Industrial, Inc.*, No. 01-03-01129-CV
- *Knox v. Taylor*, 992 S.W.2d 40, 50 (Tex. App.–Houston [14th Dist.] 1999)



Economic Damages: Lost Profits Determinations

Spoliation of Evidence

Putative litigants have a duty to preserve documents that may be relevant to pending or imminent litigation. The following cases addressed spoliation of evidence:

- *West v. Goodyear Tire & Rubber, Co.*, 167 F.3d 776,779 (2nd Cir. 1999)
- *Green Leaf Nursery v. E.I. Dupont De Nemours and Co.*, 341 F.3d 1292, 1308 (11th Cir. 2003)
- *Silverstri v. General Motors Corp.*, 271 F.3d 583,590 (4th Circ. 2001)
- *Sarmiento v. Montclair State University*, 513 F.Supp. 2d 72, 94 (D.N.J. 2007)
- *Jimenez-Sanchez v. Caribbean Restaurants, LLC*, 483 F.Supp. 2d 140, 143 (D.P.R. 2007)
- *Louisville Gas & Electric, Co., v. Continental Field Systems, Inc.*, 420 F.Supp. 2d 764, 767

The following provides a summary of recent cases that addressed various lost profits damages disputes, including patent infringement, price discrimination and breach of contract.

Patent Infringement

Arlington Industries, Inc. v. Bridgeport Fittings, Inc., 2009 WL 2973472 (M. D. PA), September 10, 2009

- Plaintiff sued defendant for patent infringement in connection with the manufacture and design of electrical conduit fittings
- Expert was a CPA and fraud examiner with 30 years of investigative accounting experience
- Defendant challenged the plaintiff's expert, prior to trial, under Rule 702 of Federal Rules of Evidence and Daubert, claiming:
 - Expert misapplied legal standard
 - Expert was an accountant instead of a technical expert
 - Expert failed to supply proper foundation for report, relying upon third-party information
- Court addressed each of defendant's points and denied Daubert motion
 - Legal standard – “standard applied by plaintiff's expert is the standard required by the Federal Circuit”
 - Sufficient experience – expert's accounting background was more than adequate
 - Proper foundation – reliance upon such information is appropriate, if it is of the type “reasonably relied on by damages experts in patent liability suits”



Economic Damages: Lost Profits Determinations

Price Discrimination

Feesers Inc. v. Michael Foods Inc., 2009 WL 1138126 (M. D. PA), April 27, 2009

- Small, regional wholesale food distributor sued country's largest producer of egg products
- Sued companies under Robinson-Patman Act (15 U.S.C. 13), claiming that Michael Foods offered substantially lower prices on its products to world's largest food service management company
- Case was in litigation four years
- Court found that plaintiff successfully established three of the four required elements of price discrimination
- However, plaintiff was not awarded any damages, as the court found insufficient direct evidence of lost sales

Breach of Contract

Buffman, Inc. v. Lafayette Insurance Co., 2010 WL 1509363 (La. App. 4 Cir.), April 14, 2010

- Plaintiff, a nursing home located in New Orleans, was suing Lafayette Insurance Company for breach of contract plus statutory penalties for unjustified delay
- Insurance policy covered losses due to wind, but not flood or water damage
 - Plaintiff's roofer estimated repairs costing \$609,000, due to damage cause primarily by wind
 - Insurance experts found that there was minor wind damage to roof, but attributed most of the damage to the owners' efforts to rescue residents
 - Plaintiff's roofer said that repairs would take four to five months, while the building was empty
 - Insurance company said that repairs would take no more than eight weeks, during which time the facility could remain open
- Insurance company sent check for \$1,150 to nursing home, two years after storm, to cover repairs
- Plaintiff hired CPA specialist in business interruption, who produced cost reports for the home for 10+ years
 - Expert reviewed revenue and expense statements for 2004 through early 2006 (6 months after hurricane)
 - Also looked at statistics relevant to nursing home industry over the same time period
 - Estimated business losses at \$529,473
- Jury sided with plaintiff's expert, awarding nursing home \$529,573 in business interruption losses



Economic Damages: Lost Profits Determinations

Chapter VIII – *Conclusion*

In many ways, a lost profits action, wherein legal counsel is representing a plaintiff seeking to recover those profits or the defendant arguing against that recovery, can be much more complex than a business valuation engagement. The valuation of a business ownership interest, as well as a determination of lost profits resulting from a wrongful act, is, of course, a question of fact.

However, the legal issues surrounding the many principles guiding cases involving the recovery of lost profits, in the authors' experience, requires a great deal of attorney focus and strategy development. As a result of these legal complexities, there is generally a continuous interaction between counsel and the financial expert. Often this interaction will lead to a more-refined definition of the scope of the lost profits damages sought. This refinement process, ultimately, guides the calculation of lost profits.

This is not to say that legal counsel directs the calculation. Such remains solely the responsibility of the financial expert on an independent and objective basis. However, it does illustrate the need to incorporate the legal principles as an overlay to the financial expert's work, so that the final determination resulting from that work is the most correct and defensible determination possible.

From a practical standpoint, it is best to involve a quality financial expert early in the process. Those experts can provide everything from general and subjective guidance on any variety of topics that might be relevant to the case at hand; to assisting in developing a plan for discovery, including document requests; to preparing preliminary assessments of the lost profits deemed recoverable by counsel. More importantly, early involvement enhances the financial expert's understanding of the facts of the case, how it has developed and how counsel has determined those lost profits subject to recovery. All of these aspects will aid the financial expert in preparing a correct, complete and defensible determination of lost profits.

The role of Grossman Yanak & Ford LLP in lost profits engagements is that of financial expert. In almost all cases, we are engaged as independent and objective experts, so that our work can later be used at trial, supported by our testimony, if necessary.

The process by which such projects are undertaken begins with an evaluation of all of the financial and economic aspects of the lost profits claim, including, as an example, sales from the perspective of quantities, associated and relevant costs, distribution geography, pricing and supply and demand, along with the timeframe related to the claim. The analysis and assessment of this information is then subjected to rigorous statistical and economic analysis, including regression analysis, to solidify the information ultimately utilized to develop our conclusion of lost profits.



Economic Damages: Lost Profits Determinations

We are also able to act on behalf of defendant's cases in these matters, using our training and experience to challenge the assumptions, economics and calculation driving a plaintiff's expert's determination.

Recovery of lost profits can be an exceedingly complex and difficult process. The actual calculation of those lost profits can take many twists and turns, depending on the facts and circumstances of the case.

Obviously, in an introductory program such as this one, it would be impossible to address any aspect in depth. However, we hope that our session today has provided some information that will prove helpful, should you encounter such a case in your legal practice.

Should you have a specific fact pattern that may require the need of a financial expert, please feel free to contact Bob Grossman or Melissa Bizyak, both of whom welcome the opportunity to assist with your framing of your particular case.



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- Family Tax Compliance and Planning Services
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