# DAMAGES FOR LOSS OF BUSINESS OR BUSINESS OPPORTUNITY

## LEGAL DAMAGE PRINCIPLES

In a case in which an expert is asked to determine the amount of financial damages, certain legal issues guide the manner in which the damages are calculated. While the lawyer in the case may be well aware of these legal issues, the financial expert may not be as well versed in them, leading to a disconnect between the lawyer's case and the expert's calculation of damages. For example, if the expert says something on the stand that indicates he/she didn't rule out other possible causes of the loss, it could undermine the attorney's case. Similarly, it is important that the expert be prepared to offer the "best available proof" for their damage calculation, as well as be aware that "reasonable certainty," a lower standard employed by the courts in measuring the *amount of damages* as compared with the *fact of damages*, is not a license to calculate losses liberally and without strong support.

Therefore, we start with a review of some basic principles of lost profits claims of which it is important the financial expert has some knowledge.

### The Proximate Cause Rule

Recovery of damages for lost profits requires that the damages be *proximately caused* by the wrongful acts of the defendant. This principal governs the recovery of all compensatory damages and is expressed in numerable cases. As financial experts, we routinely examine the causes of the financial losses, both those claimed by the Plaintiff, and other possible causes that are within the financial expert's area of expertise to analyze.

### The Reasonable Certainty Rule

Damages must be proved within a *reasonable degree of certainty*. By using the term "reasonable," courts have acknowledged that computing damages with absolute certainty may not be possible, and so something less than absolute certainty is acceptable. The principal of reasonable certainty is expressed in a number of cases and is irrefutable.[1]

It has generally been recognized by the courts that the "reasonable certainty" rule applies only to the *fact* of damages, not to the *amount* of damages. If the plaintiff's proof demonstrates that it is reasonably certain there would have been some profits, the *fact* of damages has been proven. Less certainty is required in proving the *amount* of damages because, as a practical matter, every lost profit estimate will have some underlying uncertainty. To require the plaintiff to prove the amount of damages with certainty would make the recovery of damages impossible in most cases. Therefore, while the proof of the

[1] See Robert Dunn, *Recovery of Damages for Lost Profits*, 6th ed. (Westport, Conn.: Lawpress Corp.) 2005, 16-24.

*fact* of damages must be certain, proof of the *amount* may be an estimate, uncertain, or inexact.

Although the reasonable certainty rule allows for some level of uncertainty as to the amount of economic damages, the estimate of damages can not be pure conjecture either, as there must be a *reasonable basis* for the damages calculation. This is also sometimes referred to as the *rational standard*.

A different, often-stated formulation of the standard of proof is that the plaintiff is required to supply the "best available proof" or the "best evidence available" to establish a claim of lost profits damages.

However, this still results in wide variability in experts' interpretation of "best available proof." The range of acceptability is broad and the damage expert is permitted to use the damages methodology most fitting to the unique requirements of each case, as the Supreme Court of Kansas stated in *Vickers v. Wichita State University:*

> "As to evidentiary matters a court should approach each case in an individual and pragmatic manner, and require the claimant furnish the best available proof as to the amount of loss that particular situation admits."[2]

In *Sun Insur. Marketing Network, Inc. v. AIG Life Insur. Co*., decided in Florida district court in March 2003, the plaintiff claimed as damages the value of its entire business. The plaintiff's expert determined the value of Sun's business by simply discounting to present value ten years of revenue projections. In its decision, the court stated that Florida law requires that assumptions used to support conclusions be "reasonably certain," not mere best case scenario predictions: and that Sun's projection of lost profits was based on several assumptions that were "not grounded on known facts, but speculation and conjecture on what might have happened."

**The Foreseeability Rule**

In contract claims, in order to be recoverable the damages must have been foreseeable as the natural and probable result of a breach of contract at the time the contract was made. Foreseeability is a contract principle. When lost profits damages are claimed in a tort action, no demonstration of foreseeability is required. Most courts today apply a foreseeability rule taken from the famous English decision in *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854), which ruled that lost profits were not recoverable because damages resulting from late shipment of an iron shaft necessary to run the mill were not within the contemplation of the parties.

Unless the plaintiff explicitly communicates the anticipation of damages to the defendant at the time of the defendant's actions, the courts are often charged with determining what was *within the contemplation of the parties*. This means that if the defendant is capable of understanding how its actions might have an adverse effect on the plaintiff, then they are within the contemplation of the defendant.

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[2] *Vickers v. Wichita State University*, 213 Kan. 614, 620, 518, P.2d 512, 517 (1974).

## ADMISSIBLE EVIDENCE

A comparison of the experience of the plaintiff's business before and after the damage act provides perhaps the best evidence of lost profits, and is demonstrated by the Before-and-After Approach, discussed later in this paper.

Evidence of subsequent experience may be useful when there is either no earlier experience, as is the case with an unestablished business, or when the prior operating history is brief. In these instances, it may well be the "best available evidence."

There are several older cases which refused to permit use of subsequent experience to prove lost profits of an unestablished business, resting on the rule applicable in these jurisdictions at the time that lost profits damages of an unestablished business are not recoverable. These cases must be distinguished from cases where a plaintiff offers evidence of subsequent experience of an established business, or when the plaintiff is seeking to prove lost profits in a jurisdiction that permits damages for an unestablished business when properly proved.

In general, evidence of the plaintiff's experience at other locations is admissible to prove lost profits given the plaintiff can demonstrate that the other location is comparable to the experience it would have had at the location affected by the damage act. When it is not admissible, it is generally as an extension of the new-business rule (beyond reasonable justification) that lost profits damages of an unestablished business are not recoverable.

The great weight of authority tells us that evidence of another's experience in operating a comparable business is admissible to prove lost profits damages. A good case study can be found in *Smith Development Corp. v. Bilow Enterprises, supra.* When such comparable experience is excluded, however, it is generally for one of two reasons: (1) using the new business rule will exclude evidence of the experience of others when offered to prove lost profits of an unestablished business, or (2) when the plaintiff fails to demonstrate comparability or to adjust for non-comparability. However, no modern case has sought to lay down a rule of law that evidence of comparable experience of others is inadmissible to prove lost profits damages.

In cases where it seems logical to equate the defendant's subsequent gains with the plaintiff's losses, courts have accepted this evidence. The types of cases in which this evidence may be useful include cases of unfair competition, breach of a covenant not to compete, and breach of an exclusive distributorship by a manufacturer. However, a substantial number of cases have held that defendant's gains may not be a measure of plaintiff's losses in a breach of a covenant not to compete.

Although the courts are divided on whether industry averages are permissible to prove lost profit damages, this type of evidence having been both sustained[3] and denied[4] by the court in various decisions. If using industry averages, the practitioner should use caution that the data is from a reputable source, includes companies that are comparable to the subject, and measures financial indicators in a manner consistent with the measurement of damages.

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[3] See Robert Dunn, *Recovery of Damages for Lost Profits*, 6th ed. (Westport, Conn.: Lawpress Corp.) 2005, 457-459.
[4] See Robert Dunn, *Recovery of Damages for Lost Profits*, 6th ed. (Westport, Conn.: Lawpress Corp.) 2005, 460-461.

The courts have generally, but not always, upheld profit projections made by the defendant – typically during the planning stages of a new franchise or distributorship with the plaintiff – as admissible evidence and have given them substantial deference. Plaintiff's own projections, prepared prior to the dispute, are also admissible if properly substantiated, although they may not have the same impact as defendant's projections.

## RECOVERY IN CONTRACT CASES

### Contract Cases

The majority of commercial damage cases for valuators arise from contract litigation. Damages resulting from contract disputes arise when one party does not live up to their contractual obligations, resulting in another party being financially harmed. The measure of damages in contract cases is intended to place the plaintiff in the same position had the contract been honored. Cases are generally divided among those involving: (a) sales, (b) breach of warranty, or (c) other contract cases. Sales cases relate to a buyer or seller's lost profits. Breach of warranty cases are divided between express and implied warranties. Other contract cases include construction contracts, leases, covenants not to compete, exclusive agency, franchise, distributorship agreements, insurance contracts, and contracts to render services or lend money.

### Tort Cases

In tort cases, the intention is to place the plaintiff in the position they would have been had the tort not been committed. Tort cases can generally be categorized as: (a) negligence (unintentional), (b) intentional torts, or (c) strict liability torts. Commercial unintentional torts involve claims of negligence that cause a business to be interrupted for a period of time, thereby resulting in lost profits. These include personal injury, property damages (fire, water, etc.), and professional negligence. Commercial intentional torts involve claims of unfair competition, fraud, and other business interference.

### New or Unestablished Business

The "new business rule" is a legal doctrine that effectively prevented "unestablished" businesses from claiming damages based on the theory that any estimate of the future losses of an unestablished business would be unduly speculative. The court's position on new businesses has evolved dramatically over the years. Today, the "new business rule" has been effectively overturned in most state and Federal jurisdictions, and is continuing to erode as a legal doctrine. This old rule of law has been replaced with the modern standard of *evidentiary sufficiency*, which allows for damages that are within a reasonable degree of economic certainty. This evolution is consistent with today's sophisticated economic forecasting models, which are more capable of providing satisfactory evidence of lost profits than were earlier models.

In the absence of past profits, actual profits of similar business or subsequent profits by a defendant may be sufficient proof to estimate damages in a new or unestablished business. Proxy firms should be similar in many relevant respects to the plaintiff, such as product line, size, capitalization, and so forth, to derive a growth rate and some information about sales volume and profitability. The risk that the new or unestablished subject company may fail should also be incorporated into the analysis. Industries that feature many similar firms

selling nearly identical products, such as fast food franchises, are easier candidates for a failed-new-business analysis.

Whereas expert testimony may be invaluable in establishing commercial damages in general, it is particularly useful in cases involving new or unestablished businesses because of the inherent difficulty in projecting damages when a limited business history is available. A combination of both damages and industry experts can be particularly effective. In *Larsen v. Walton Plywood Company*, the court relied on expert testimony to bridge the gap resulting from the limited data available for newly-established businesses. Specifically, the court stated:

> "Experts in the area are competent to pass judgment. So long as their opinions afford a reasonable basis for inference, there is a departure from the realm of uncertainty and speculation. *Expert testimony alone is a sufficient basis for an award for loss of profits."*[5]

For case law relating to damages recoverable for new or unestablished business, see Robert Dunn, *Recovery of Damages for Lost Profits*, 6th ed. (Westport, Conn.: Lawpress Corp.) 2005, 374-412.

## CALCULATION OF LOST PROFIT DAMAGES

### Link Between Business Valuation and Lost Profit Damages

Calculating lost profits is a natural extension of business appraisal skills. Just like a business appraisal, a lost profits calculation involves an in-depth knowledge of the company, its products, markets, and competition. It also involves understanding the industry in which the company operates and the factors that drive that industry which would have an impact on the company's performance during the forecast period. Further, it involves understanding the economic forces that impact the financial outlook for the company. Calculations are also a quantitative exercise in economic and financial measurement for which the business appraiser is well-equipped.

### Benefit of Hindsight

One significant difference between estimating the value of a business and estimating economic damages is that, in a business valuation, the analyst only considers that which was known or could have been known as of the date of the appraisal, while in a financial damage calculation the analyst has the benefit of hindsight. For example, the analyst would have the benefit of knowing what the industry actually did during the damage period rather than having to rely on forecasts. They would know important facts like how the competition fared, whether the economy went into or came out of a recession, and any other factors that could have impacted the company's financial results. All of this information can be built into the financial model to arrive at a predicted level of cash flow or income.

### Methods of Calculation

Lost profit damage calculations typically require the analyst to place the plaintiff in a "but for" world. That is, what would the plaintiff have been able to achieve "but for" the damaging act? This analysis necessarily involves a prediction of what might have happened

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[5] *Larsen v. Walton Plywood Co.*, Wash. 2d 1, 16, 390 P.2d 677, 687 (1964), 396 P.2d 879.

under given conditions. The Discounted Cash Flow Method is probably the most common method used to calculate a plaintiff's lost profits. The amount of lost profit is then the present value of the difference between the "but for" profit, and the profit that actually existed during the damage period.

To the extent that the value of the business as a capital asset has also suffered, such loss is also taken into account. However, damages should not be duplicated in such situations.

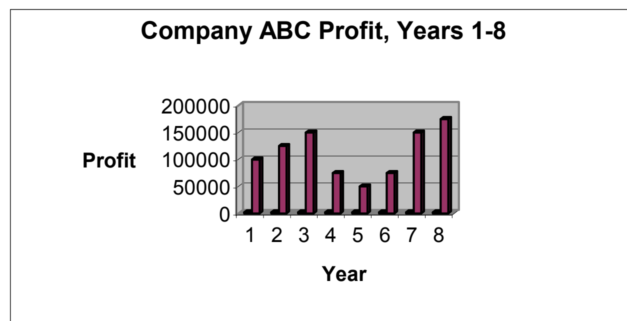
**Methods**

Lost profits may be calculated by use of a Before-and-After Method, a Yardstick Method, a Market Model Method, or a Market Share (percent of total market) Method. *Often a combination of methods will be used*, depending on the data available in a particular case. It is important to note that, since federal and state laws provide different remedies depending on the type of claim brought by the plaintiff, the most applicable measure of damages might be dictated by federal or state statute. However, in most instances, the calculation is guided by the particular facts and circumstances of the given case.

**Before-and-After Method**

Using this model, the damage expert predicts what would have happened during the damage period based on what the business was able to achieve both before and after the occurrence of the damaging act.

The following is a simplified example, similar to what one might actually see in practice, for which using this approach would be appropriate. In this example, the "damaging act" occurred in Year 4:



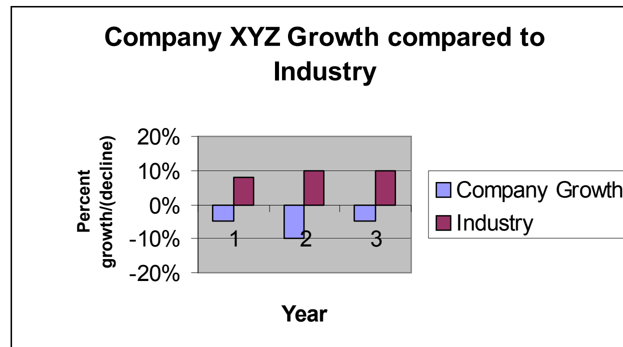

As this chart shows, there is a clear pattern of profitability both before and after the damage period. Something caused the profits to be dramatically reduced in Years 4, 5, and 6. From a simplistic point of view, it appears that the company "recovered" by Year 7 or 8, as that is the point at which they returned to their previous trend of profitability. However, one needs to consider other factors that might have influenced the company's financial results, such as what was occurring in the industry and the economy during that period.

**Yardstick Method**

The Yardstick Method attempts to measure the financial results the company would have achieved if they had followed the trends of comparable companies for the damage period. That data can be from industry sources, comparable companies, market data, or any source

that could be expected to reasonably predict what the results of the company would have been through the damage period but for the damaging act.

For example, assume the analyst determines that before the damage period the company closely followed the industry in terms of revenue growth. The analyst chooses to rely on those industry trends during the damage period to determine what the revenue of the plaintiff would have been. This can be illustrated by the following chart:




Again, an oversimplification, but the inference could be made that the company *should* have been able to increase revenues at the same rate as the rest of the industry and, if so, that provides a starting point for predicting what profitability would have been.

### Market Model Method

Using the Market Model Method, the damage expert builds a profit projection for the damaged business based on assumptions about how the plaintiff would have performed but for the alleged damaging act of the defendant. Assumptions are built into the analysis using data developed from the company, the industry, and the economy. These "but for" results are then compared to the actual results of the plaintiff during the damage period to determine the lost profits.

## ISSUES TO CONSIDER

### Length of Damage Period

An important consideration is the length of the damage period. Damages may last for the term of a contract, the technological life of a product, or until the plaintiff could reasonably be expected to mitigate continuing losses.[6] If the damage to the business is permanent, business valuation methods may be more appropriate to estimate lost profits. Often, however, economic damages do not last forever. When the business is damaged but recovers, the damage period has a beginning and an end. The terminal point is the point in time at which the company's profitability returns to the level it had achieved prior to the damage act, or, the point at which the analyst can predict the losses with a reasonable degree of certainty. This is seldom a straightforward determination. Issues such as the industry, competition, and the economy, as well as the company's own prior track record, must be assessed to determine when damages "end." An error analysts often make is to carry the damage period into perpetuity when there is in fact an end to the damage period. The

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[6] Dunn, Robert L. and Harry, Everett P., *Modeling and Discounting Future Damages*, Journal of Accountancy, January 2002.

damage expert must make assumptions both as to whether the plaintiff *can* recover, and as to *how long* it will take in the actual world to catch up to the level of profitability that the plaintiff would have achieved in the "but-for," undamaged world.

Valuing lost profits as a loss of business value presents a whole new set of issues that attorneys and experts should be aware of. For more on this complex topic, see *The Comprehensive Guide to Lost Profits Damages for Attorneys and Experts.*[7]

**Before or After Taxes?**

The calculation of lost profits should use income that is pre-tax.[8] This is because the financial damages received will usually be to the plaintiff, and to deduct taxes from the damage calculation will result in an understatement of the damages. It is critical to use the proper discount rate, discussed below, or the resulting damages will be incorrect.

**Discount Rate**

An essential step in quantifying lost profits damages is to select the appropriate discount rate, an issue on which the courts and the limited body of knowledge on this subject have offered little guidance. This is due to the fact that the selection of the appropriate discount rate in any given case is highly dependent on the facts and circumstances of that particular case.

The discount rate, meant to acknowledge the time-value of money, will either: (1) recognize the risk of achieving the profit expectations, or (2) recognize the plaintiff's use of the funds.

If the analyst is matching the discount rate with the income stream, the discount rate may vary from a rate of return on U.S. Government bonds for a secure stream of income to an equity rate of return for a stream of income that has more risk.

Alternatively, if the rate of return is used to recognize the plaintiff's use of the funds, the discount rate include the plaintiff's cost of debt, their reinvestment note (which could be represented by either the plaintiff company's weighted average cost of capital or its equity rate), or an investment rate of return for the investor as if he/she were to reinvest the funds in an alternative investment.

**Supporting the Claim**

The expert must provide appropriate proof to support their calculations. This often involves extensive discovery and document requests. However, lacking this, many courts have found experts' claims to be baseless, and excluded their testimony for lack of relevance and reliability.

**Mitigation of Damages**

Most states require the plaintiff to make efforts to mitigate its damages. This includes attempting to secure alternative sources of profits or cover expenses. If the plaintiff could mitigate their damages by substituting other business, then the profits from alternative sources should be deducted from the lost profits. However, if the plaintiff had the capacity

[7] Nancy J. Fannon, *The Comprehensive Guide to Lost Profits Damages*, Business Valuation Resources, 2009.
[8] Refer to *The Comprehensive Guide to Lost Profits Damages* for discussion of taxes when calculating lost profits as a loss of business value.

to handle *both* the substitute business as well as the lost business, the substitute business should not be considered a replacement for the lost business, and thus should not be deducted from lost profits. For example, in *Sierra Wine & Liquor Co. v. Heublein, Inc.,* the court found that a plaintiff who was a franchisee was only able to recover damages until he secured a replacement franchise based on the reasoning that the plaintiff could not hold two franchises in the same industry at the same time.[9]

The mitigation of damages should also include cost savings enjoyed by the plaintiff resulting from not having to undertake whatever activities it would have normally undertaken in order to realize the "but for" revenue stream, such as expanded facilities or a larger workforce. These cost savings should be deducted as an offset in the calculation of lost profits damages.

The burden of proof of a failure to mitigate damages lies with the defendant. The plaintiff only needs to demonstrate that it took reasonable steps to mitigate damages, not that it took all of the steps that the defendant may assert it should have taken. If there is dispute over this issue, the court will decide whether the plaintiff took reasonable and sufficient measures to mitigate its damages.

[9] *Sierra Wine & Liquor v. Heublein, Inc*., 626 F. 2d 129 (9th Cir. 1980)/

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