
Lost Profits Damages – Controversial Issues

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The numbers don't lie
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Topics

- Controversial issues in lost profits damages

“It is not unusual for the opinions of the experts to differ by a factor of ten. It is, therefore, not surprising that courts have evidenced frustration with this process.”

The Shareholders' Appraisal Remedy and How Courts Determine Fair Value, 47 *Duke L.J.* 613, 629 (1998)

“Accordingly, perhaps I should consider myself fortunate, since the experts in this case vary by a factor of only about five (\$9 million at bottom; \$48 million at top).”

Kaplan v. First Hartford Corp. --- *F.Supp.2d* ----, 2007 WL 973941 (D.Me. Apr 02, 2007)

The courts are exercising their gate-keeping role

- In 2007, 41% of all challenges to financial experts were successful at excluding the expert's testimony in whole or in part.
- 70% of exclusions target plaintiff's experts
 - *2000-2007 Financial expert witness Daubert study* by PricewaterhouseCooper (PwC), http://www.pwc.com/en_US/us/forensicservices/assets/2000_2007_daubert_study.pdf

Fee pressures in the face of exploding evidence

Does the following “protect” the expert from exclusion (and advance the case)?

- A report that expresses a limitation on your opinion.
- An opinion that relies on management’s representations.
- An opinion that “assumes” cause.

Legal guidance

- FRE 702
- FRCP

- Trilogy of *Daubert*, *Joiner* & *Kumho*

14 states still follow *Frye* in whole or in part. 20 others either expressly reject *Daubert*, refer to their state rules of evidence, or something else entirely, accept *Daubert* only in part, or have not yet addressed it.

Basic Legal Predicate for Expert Exclusion

Federal Rule of Evidence 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.

Documents & Spoliation

- Rule 26(a)(2)B)(ii)FRCP: “data or other information considered by the witness in forming his or her opinion”
 - Broad interpretation of the word “considered”
 - Drafts
 - Of single expert --discoverable
 - Comments by counsel--discoverable
 - Among multiple experts--discoverable
 - Notes—by jurisdiction
 - Attorney-expert communication--discoverable
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Documents & Spoliation

- Volume of documents can quickly get out of control
- Document Policy
 - ❑ Your policy cannot trump FRCP
 - ❑ Document logs
 - ❑ Bates stamp

Distinction between...

- Misapplication, missed, or mis-used factual data
 - Tends to go to **weight** of testimony
- Pulling out of thin air (speculation, conjecture, unsupported conclusions)
 - Greater tendency toward **exclusion**

Why does controversy regarding issues in LP damages exist?

- Broadly speaking among experts:
 - 1. Jurisdictional differences
 - 2. Different expert opinions regarding methodology
 - In any particular case:
 - 1. Different legal arguments
 - 2. Different factual assumptions (opposing counsel's primary fodder for deposition and trial)
 - 3. Different expert opinions regarding methodology
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Where do we start

- With the complaint
 - Make sure you read and understand the complaint, the alleged actions of the defendant, and the remedies
 - What constitutes sufficient financial evidence to support the claim?

Exclusion based on reliance on plaintiff with no verification of facts

- Expert took as fact assertions of owner of this metal manufacturer **without independent verification**; the court excluded, finding no independent investigation to verify whether the facts were accurate or not.
 - *Champagne Metals v. Ken-Mac Metals*, 458 F. 3d 1073 (10th Cir 2006)

Exclusion based on lack of independent analysis by expert

- Calculations were based solely upon projections in an agreement between the parties. The expert did not perform any independent market analysis to verify the reasonableness or accuracy of the projections or compare the projections with actual results achieved by other, similar enterprises

Otis v. Doctor's Associates, Inc., 1998 U.S. Dist. LEXIS 15414, *3 (N.D. Ill. 1998).

- the court cites a lengthy list of problems that permeate the expert's work

Exclusion based on lack of independent analysis by expert

- The court found the opinion “wholly unreliable [because] ‘the entrepreneur’s “cheerful prognostications” are not enough.’”
 - Improperly assumed the truth of the plaintiff’s own revenue projections and/or placed undue weight on the alleged decrease in plaintiff’s estimate of merger synergies

Celebrity Cruises, Id. (quoting *Schonfeld v. Hilliard*, 218 F.3d 164, 173 (2d Cir. 2000)).

Exclusions based on failure to provide independent analysis

- “Courts must consider the factual basis of an expert’s testimony when considering its reliability.”
- The expert relied exclusively on data provided by the plaintiff, made an estimate of growth rate without any basis, made an assumption of a comparable market, and failed to analyze other factors regarding the sale of the product in question.

Ellipsis, Inc. v. The Color Works, Inc., 428 F. Supp. 2d 752, 760 (W.D. Tenn. 2006).

Exclusions based on ignoring unfavorable data

- Expert testimony was excluded where the expert ignored data in favor of data more favorable to the expert's client.

Children's Broadcast Corp. v. Walt Disney Co., 245 F.3d, 1008, 1018, 1022 (8th Cir. 2001).

Exclusions based on failure to deal with inconsistent facts

- Expert failed to deal with inconsistent facts or where the expert assumes the fact his or her opinion is intended to prove.

First Savings Bank, F.S.B. v. U.S. Bancorp, 117 F. Supp. 2d 1078, (D. Kan. 2000)

Calculating lost profits—alternately:

1. Actual damages for a limited number of years in the past (beginning with the date of breach, and ending at the time the company recovers from the loss);
2. Actual damages for a period of time in the past, and anticipatory damages for a limited number of years into the future (beginning with the date of breach, and ending at the time the company is expected to recover from the loss); or,
3. The loss of the entire business (as of the date of the breach, assuming the company is a total loss and is never expected to recover).

Calculating Lost Profits

- Damage calculation will either be historical or anticipatory
 - With benefit of hindsight
 - If historical, with pre-judgment interest
 - If anticipatory, with discounting

“Methods” for calculating lost profits damages

- ❑ Before and after
 - ❑ Yardstick
 - ❑ Sales projection
 - ❑ Market model (or market share)
- These “methods” are merely alternatives for gathering and presenting evidence

■ *Is but-for a method?*

Use of hindsight

- Note that hindsight is used throughout lost profit calculations:
 - Cause
 - Determination and application of method
 - Mitigation

Some analysts make this distinction:

- “Ex-ante” (measure to date of injury, only use information known as of date of injury)
- “Ex-post” (measure to date of trial, use all available information)

Hindsight

- “...if years have gone by before the evidence is offered... Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within.”
- *Sinclair Ref. Co. v. Jenkins Petroleum Co.*, 289 U.S. 689, 698-99, 53 S. Ct. 736, 77 L. Ed. 1449 (1933).

The second case in the Daubert/Joiner/Kumho trilogy of cases that form the basic legal predicate for expert exclusion

■ **Joiner** (1997)

- A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered.
- *Emphasizes the **need for a connection between the method and opinion**, which is more likely a basis for excluding an expert than the Kumho decision*

General Electric Co. v. Joiner, 522 U.S. 136, 146 (1997).

Use of hindsight in causation

- The court found three “separate and distinct causes” that contributed to plaintiff’s loss of sales and that it did not account for in its damages calculation: 1) increased competition; 2) the bankruptcy of a primary supplier; and (3) a major construction project near the entrance to its store.
- *Penn Mart Supermarkets, Inc. v. New Castle Shopping, LLC*. No. 20405-NC (Del. Chan. 2005)

Causation

- “The damages must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes.”
 - *Coastal Aviation v. Commander Aircraft*, 937 F. Supp. at 1064.
- “Expert testimony may be excluded when the expert fails to consider other causes for the lost profits such as market saturation and reduced prices of alternate products”
 - *Isaksen v. Vt. Castings, Inc.* 825 F.2d 1158, 1165 (7th Cir. 1987).

And as we’ve already said...with the use of hindsight...

Link to causation—failure to identify other factors that contributed to loss

- The court affirmed exclusion of lost profits expert's testimony because the **testimony was not sufficiently tied to appellee's possible conduct.** The expert had instead assumed that appellee was liable for all counts charged and no other factors contributed to loss profits.

In *PharmaNetics, Inc. v. Aventis Pharmaceuticals, Inc.*, 182 Fed. Appx. 267, 272-73 (4th Cir. 2006).

Link to causation—failure to consider other factors

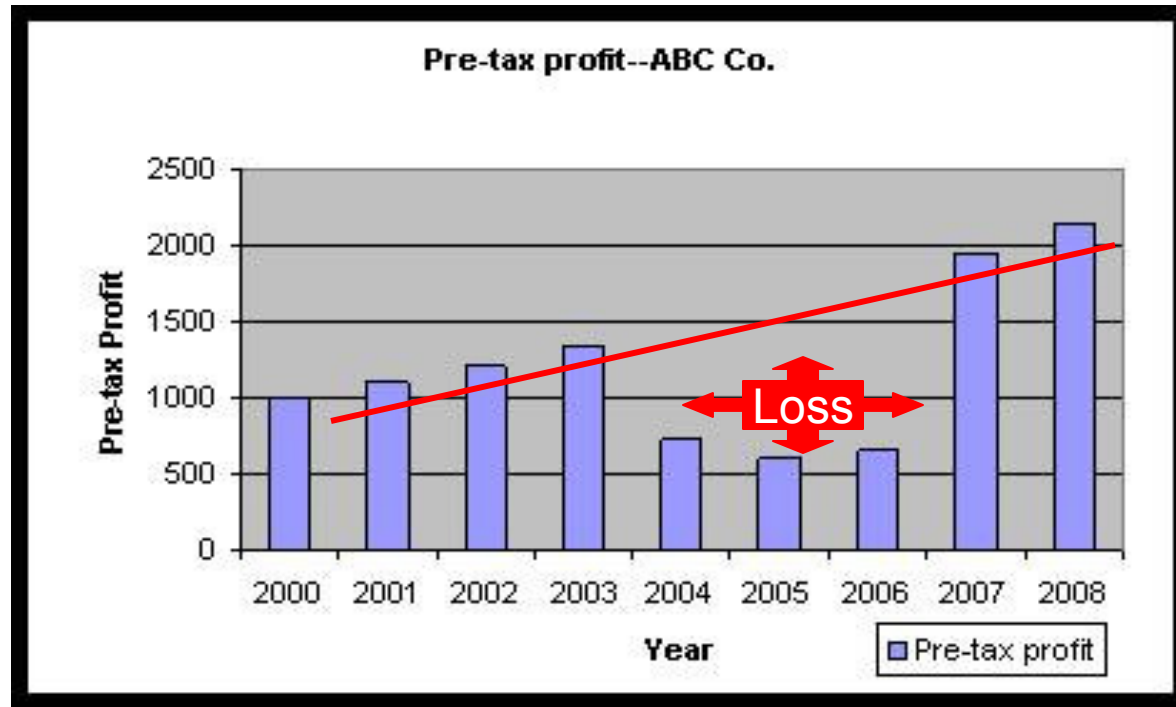
- Where there was testimony that over seventy factors could affect radio revenues, and the expert attributed all the lost profits to one tortious act **without considering the other factors**, the testimony was excluded.

Whitby v. Infinity Radio, Inc., 951 So.2d 890, 899 (Fla. Dist. Ct. App. 2007)

Accepted methods explicitly consider hindsight

- “Before and after” by definition, requires the expert to obtain evidence before breach; during period of the breach, and then post-breach
- “Yardstick” requires measurement to comparable peers or benchmark during damage period (i.e., post-breach)
- Sales projection—ground projection in economic reality (pre and post-breach, as appropriate under the circumstances)

Consider causation in a typical application of “before and after” method...



“Post-hoc ergo propter”—*After this, therefore, because of this*

- Also known as “coincidental correlation” or “false cause”, a logical fallacy *well recognized by the courts as an improper and unreliable method for demonstrating causation.*

- Did the price of oil drop during the same period?
- What happened to the stock market?
- Was tourism up or down?
- Did the exchange rate effect revenue?
- What was the weather during this time period?
- How did the company’s advertising change?
- What other customers did they lose?

Hindsight and lost business value

- Still need to consider hindsight when considering causation and mitigation
- When considering the method to use (typically the forecast for the DCF), consider whether or not subsequent information is relevant or not under the facts and circumstances-
 - Is this a *legal*, or an *economic* question?
 - Remember—this is a legal remedy—not a valuation being done for estate and gift tax purposes.
 - Who said fair market value was the legal remedy?

Lost profits as a remedy

- “Lost profits are not an independent cause of action. Rather, they are a damages remedy that a business can recover when a legal wrong has caused it to suffer lost profits.”
 - (Dunitz, *Comprehensive Guide* Ch. 1, p. 1)
- Where does lost value fit into that remedy?
 - As a measure of permanent lost profits—the goal of which is to make the plaintiff whole.

Definition of value

- In some matters, because the loss of future profits extends into perpetuity, the courts have found loss of business value is the proper measure of the loss.
 - “the purpose of compensatory damages for lost *business value* is to place an injured party in the same position as it would have been in had there been no injury; that is, to compensate for the injury actually sustained”
 - (*Action Marine, Inc. v. Continental Carbon*, 481 F.3d 1302 (11th Cir. 2007))
 - “This is no different than the purpose of compensatory damages for lost profits: the amount necessary to “make the defendant whole” and “place it in the same position it would have been but for [the defendant’s breach].”
 - (*Sierra Wine and Liquor Co. Heublein, Inc.*, 626 F.2d 129, 132 (9th cir. 1980))

Standards of value are largely legal constructs

- And have legal definitions.
 - Fair market value is a hypothetical construct for estate and gift and some divorce matters.
 - Fair value is for courts of equity, including dissent, oppression, and some divorce.

Which brings us to Standard of Value for lost profit engagement

- Fair market value?

- The price that a property would change hands between a **hypothetical willing** buyer and a **hypothetical willing seller** when **neither is under compulsion** to act and **both are informed** of all material facts.

Loss of business value

- Four key areas to consider:
 - ❑ (1) Definition of value,
 - ❑ (2) Use of hindsight,
 - ❑ (3) Deduction of income tax from the benefit stream, and
 - ❑ (4) Discount rate.

Loss of business value

- The analyst should consider whether a loss of business value calculated under a fair market value or any other standard should be modified, in order to place the injured party in the same position as it would have been in had there been no injury.
- See jurisdictional precedent, if any
- Is this a *legal*, or an *economic* question?

Lost profits v. lost value

- Lost profits:
 - Losses of limited duration
- Lost value:
 - Permanent losses
- The corporation (technically) cannot lose value in itself
 - Notwithstanding this economic reality, courts have found corporation to be proper claimant for loss of value

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- “definitive” state law (Mississippi) holds that an action for diminution in stock value belongs to the corporation, not the shareholder. Accordingly, the plaintiff tire company was the proper party to recover for any damages to its stock value.
 - *Cooper Tire & Rubber Co. v. Farese*, 2008 WL 5188235 (N. D. Miss.)(Dec. 9, 2008)

Deduction for income tax

- What happens if you have a really long damage period (for which no tax is deducted)

vs.

- A permanent loss calculated as a business value (for which tax is deducted)
- Would loss calculation come out the same?
 - Think about who the claimant is; if tax deduction is appropriate—it may not be.

Speaking of really long damage periods...

- What “guiding principal” might help decide length of period?
- “reasonable certainty”
 - Applies to entire damage period—not just first year
- What might you do if you have a long period?
 - Consider demonstrating alternate or continuous periods for trier of fact to consider

Principles & method—”exceedingly long” period

- lost profits calculations involved a seventy-seven year period after a single flood, the court concluded that the time was “exceedingly long”
 - *Acker v. Burlington*, 347 F. Supp. 2d at 1031.
- “Reasonable certainty” probably an issue at 77 years...

Mitigation

- Analyst also considers subsequent events, and whether and to what extent the plaintiff took steps to mitigate the loss
 - Defendant bears burden
 - Requires plaintiff to take “reasonable steps” to mitigate damages
 - Does not require unreasonable or impractical steps
 - Is decision to calculate mitigation a *legal*, or an *economic* question?
-

Mitigation

- Breach of contract—what product or services was the plaintiff able to substitute post-breach
 - *Mississippi Chem. Corp.*, 287 F.3d at 372.
 - And at what cost?

- Maritime—”reasonable effort to locate a substitute vessel”
 - *Navieros Inter-Americanos, S.A. v. M/V Vasilias Express*, 120 F.3d 304, 318 (1st Cir. 1997).

Deducting expenses—owner compensation

- Know local rules
- Depending on circumstances, owner compensation could be any of:
 - Variable
 - Fixed
 - Normalized
- Different jurisdictions have handled this question differently.

Deducting expenses—owner compensation

- Plaintiff sued for \$1,030,000 in lost profits, including lost wages of its anesthesiologists under terms of a contract that the anesthesiology practice had with the hospital. The trial court awarded only \$14,883, representing lost income of the practice, net of expenses saved.
- “We therefore conclude that professional corporations must be treated like other corporations for purposes of calculating damages. Unpaid salaries of corporate shareholders ought to be treated as saved expenses.”
 - Anesthesiologists Associates of Ogden v. St. Benedict’s Hospital 884 P.2d 1236 (Utah 1994)

Deducting expenses—owner compensation

- In a Texas decision, the court accepted the expert's theory that deficiencies in owner salaries over the loss period should be added into the total lost profits amount
- The court found that where a significant portion of plaintiff's net income was distributed to its owner through compensation, a reduction in compensation due to the defendant's conduct was a valid measure of lost profits.

Spring Windows Fashions Division, Inc. v. The Blind Maker, Inc., No. 03-03-00376-CV (Tex. App. 3 Dist. [Austin] 2005)

Discounting lost profits damages

- Choices:
 - Risk-free
 - Risk-adjusted
 - Reinvestment rate

- Any one of these *could be* appropriate for a specific set of facts and circumstances

- May tend to differ by jurisdiction
 - There are few (one or two) jurisdictions that have a *discount rate* set by statute

- Of note: few exclusions relating to selection of discount rate—but is mentioned in some.

Risk free rate

- If no rate is applied, courts will generally apply a risk free rate
- Choice of a discount rate is a “question of fact to be determined by the trier of fact.”
 - (*PSKS, Inc. v. Leegin Creative Leather Product, Inc.*, 171 Fed Appx. 464, 470 (5th Cir 2006))
- As a result, courts have declined to exclude experts who have used a risk free rate, and appeals courts have been reluctant to overturn verdicts.
- (*Comprehensive Guide to LP*, p. 10-14).

Risk-adjusted rate

- “We do not hold that in every case a risk-adjusted discount rate is required”
 - (*Energy Capital v. United States*, 302 F.3d at 1333)
 - Said in reference to *Northern Helix v. U.S.*, which applied a risk-free rate where the profits were virtually risk-free.

- Numerous verdicts based on experts who applied plaintiff’s cost of capital (some combination of its debt and equity)
 - (*Comprehensive Guide* pp. 10-18 & 19)

 - Note this is similar to the result of a reinvestment rate

Concluding thoughts...

- Financial experts offer specialized knowledge to assist the trier of fact to understand the evidence or determine a fact in issue.
 - To assist the trier of fact, we have to know the evidence.
 - Most expert exclusions are ultimately based on flaws in the expert's knowledge and/or use of the evidence

In a setting like this...

- Many of the things experts might differ on are “jurisdictional”
- Many others will find cases going this way—and that way...
 - Be familiar with case law—ask attorney if you don’t know
- Some other things experts might disagree on are “legal” decisions.

Audience issues and questions?