Reasonable Certainty in Lost Profits Calculations

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Our goals today -

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- Discuss Reasonable Certainty standard as it applies to lost profits and other economic damages
- Discuss types of financial information needed to prove damages
- Discuss best practices in proving damages calculations

The Reasonable Certainty Standard

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- Employed in every U.S. jurisdiction, but not a set of rules
- A totality of the circumstances test
- Is it fair to allow *this* plaintiff to recover *this* much money on the basis of *this* evidence?

Elements of Lost Profits Damages Claims

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- Caused by Defendant
  - What's the link?
- Foreseeable by Defendant
  - Should Defendant have known that damages would occur?
- Reasonably Certain
  - Is the ***fact*** of damages (not necessarily the ***amount*** of damages) reasonably certain?

Reasonable Certainty

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- Damages are not rendered uncertain because they cannot be calculated with absolute exactness. It is sufficient if a reasonable basis of computation is afforded, although the result be only approximate.
  Eastman Kodak Co. v. Southern Photo Materials, 273 U.S. 359 (1927)

- Once an injured party proves that it has been damaged, the amount of the damages need not be proved with certainty or mathematical precision. After the fact of damages has been established, less certainty is required with regard to the amount of the damages.
  Waggoner Motors, Inc. v. Waverly Church of Christ, 159 S.W.3d 42 2004 Tenn. App.

Reasonable Certainty

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The Supreme Court of Michigan discusses the concept of reasonable certainty –

> Do 'uncertain' profits differ in kind from 'certain' profits? The answer is assuredly, No. There is little that can be regarded as 'certain', especially with respect to what would have happened if the march of events had been other than it in fact has been. Neither court nor jury is required to attain 'certainty' in awarding damages; and this is just as true with respect to 'value' as with respect to 'profits'. <u>Therefore, the term 'speculative and uncertain profits' is not really a classification of profits, but is instead a characterization of the evidence that is introduced to prove that they would have been made if the defendant had not committed a breach of contract</u>.

- **In other words, reasonable certainty will have been attained when the <u>amount has been proven with a reasonable basis and sound methodology</u>.**

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Factors Considered by the Court in Determining Reasonable Certainty

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- How confident is the court that the estimate is accurate?
- Does the plaintiff have a track record?
- How many hard-to-quantify risks are there?
- How broad is the possible range of damages?

Data Provided to the Expert

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Damages experts often rely upon information supplied by client management or other company personnel when performing economic damage calculations. This information may take a number of different forms, including, but not limited to,

- historical financial statements;
- projections of financial performance – including lost revenues, associated costs, loss of value, out-of-pocket costs, and so on;
- assumptions regarding growth rates, pricing, financing opportunities and cost structure;
- business information – such as markets served, competitors, market share and industry trends; or
- technical information – such as product features and specifications, and how those features and specifications contribute to the operation of the product

Courts' Assessment of Expert's Opinion

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Court opinions address the issue of a damages expert's reliance on the client's representations and information, and the courts consider a number of key issues when evaluating the admissibility and weight of the expert testimony, including but not limited to

- the qualifications of client personnel supplying information;
- expert acceptance of client data, with and without testing;
- the reliability of projections provided by the client;
- the reliability and reasonableness of assumptions used to develop client projections; and
- the context or motive (or both) within which projections were prepared.

Courts have explicitly placed the burden on the expert to support and defend the sufficiency and reliability of the information used before the trier of fact.

The Factors Considered Are:

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- the court's confidence that the estimate is accurate;
- whether the court is certain that the injured party suffered at least some damage;
- the degree of blameworthiness or moral fault on the part of the defendant;
- the extent to which the plaintiff produced the best available evidence of lost profits;
- the amount at stake; and
- whether there is an alternative method of compensating the injured party.

Methods of Proving Lost Profits

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- The before-and-after method
  - Compare the plaintiff's performance before the breach with its performance after
  - Preferred because it uses verifiable data from the plaintiff's business
- The yardstick method
  - Compare the plaintiff with a comparable business
  - Courts have held that a similar business operated by the plaintiff at a different location is an adequate yardstick
- The sales projection method
  - The expert uses estimates of the plaintiff's projected performance

Before and After Calculations

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- Based on time series data
- Compares profit before bad act to profit after bad act
- Typically more suited to stable businesses or contractual relationships
- Did other things change during that time?
- Link between causation and damages suffered

Confidence that the estimate is accurate

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- The theory is that but for those damaging acts, the plaintiff's profits during the two periods would have been similar.
- The before-and-after method is preferred because it uses verifiable data from the plaintiff's business to make the estimate. The business has a track record.
- One common error is the failure to rule out other potential causes of the differential in profits between the two periods.

Confidence that the estimate is accurate

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The extent to which the claim is supported by verifiable data

- The vast majority of courts have allowed the injured party to recover lost profits only when they supplied verifiable data, upon which the court can base its estimate of loss.
- Because courts put so much weight on verifiable data, they look favorably on the before-and-after method for proving lost profits.
- This method compares the plaintiff's profits during two periods, one during which the profits were affected by the damaging event and one during which they were not; for instance, first, the period before the defendant began its unfair competition, and then the period when the unfair competition was ongoing.

Future Lost Profits – The Yardstick Method

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- The yardstick method compares the plaintiff's performance with that of similar businesses.
- Issues
  - Comparability of the "yardstick"
  - Adjustments for differences
  - Thoroughness of explanation

Confidence that the yardstick is applicable

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Proving lost profits using the yardstick method -

- Under this method the analyst uses comparable business or industry measures, usually comparisons to similar enterprises, to estimate what the plaintiff's business would have been like but for the conduct of the defendant.
- For example, courts have held that a similar business operated at a different location is an adequate yardstick.
- The business used as a yardstick must be as nearly identical to the plaintiff's as possible.
- But if the yardstick does not have enough in common with the plaintiff's business, a yardstick calculation will not meet the reasonable certainty standard.

Sales Projection Method

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- Compares actual performance after the bad act with a forecast of performance absent the bad act
- How reliable is the forecast? Who prepared it and what is it based on?
- Can be applicable to –
  - existing company opening a new line, new product, new service
  - new or unestablished company entering business or industry

Whether the plaintiff has a track record-

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- For many years, it was accepted doctrine that a business that did not have a track record could not recover lost profits.
- "New Business Rule"
  - Even though most courts no longer apply this rule, they still give lost profits claims heightened scrutiny when the plaintiff has no track record.
- "Modern New Business Rule"
  - Meet same elements that any business must show: causation, foreseeability and reasonable certainty
  - A new business has more difficulty in meeting the reasonable certainty standard

Other issues

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- The number of difficult to quantify risks in the plaintiff's projections
  - As the number of factors that must be estimated increases, the potential error in the projection increases exponentially
  - Courts have been willing to allow plaintiff's and their experts to estimate more of the critical inputs, but
  - There are times when there are too many variables with too much potential for error
  - Because of this, courts have pointed to the number of hard to estimate variables as one of their reasons for deciding that lost profits have not been proven with reasonable certainty

Other New Business Considerations

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- The projections themselves
  - Who prepared them?
  - For what purpose were they prepared?
  - What are the sales/revenue projections based on?
    - Any actual existing contracts?
    - Actual customers?
  - What are expenses of generating the revenue based on?
  - How many estimates and assumptions in the projections?
- Management experience and expertise
  - Experience in the industry
  - General business knowledge and experience
- Thought for the defense side
  - Entrepreneurs naturally optimistic; often make great witnesses

Reasonably Certain in Other Financial Damages Matters

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- Personal injury, wrongful termination, wrongful death
  - Best available data regarding earnings, income prior to incident
  - Best available data regarding future potential earnings capacity, if any, after the incident
  - Difficult issues to deal with can include
    - age of plaintiff; education of plaintiff; children and age of children
    - W-2 wage earner or self-employed

Best Practices for Proving Damages with Reasonable Certainty

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- Use as few assumptions as possible
- For assumptions used, consider their reliability and reasonableness
- Consider limitations related to capacity
- Use the before and after method with actual client data
- Determine when to rely on client supplied data -
  - Use client supplied data prepared in the normal course of business, not for litigation, if possible
  - Use client supplied data used for internal budgeting/planning as compared to projections for financing sources or potential investors or for the sale of the company/division, if possible
  - Use client supplied data prepared by CFO as compared to CEO or sales management

Best Practices for Proving Damages with Reasonable Certainty

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- Use independent judgment when evaluating client-provided forecasts
- Use reasoned judgment when determining the damages period
- Research the discount rate in order to support its reasonableness and appropriateness
- Research the applicable industry and industry trends to determine whether management's forecast is reasonable when compared to the industry
- Consider business information such as markets served, competitors and market share
- Consider technical information such as product features and specifications and how those features and specifications contribute to the operation of a product

Best Practices for Proving Damages with Reasonable Certainty

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- Use appropriate research to determine growth rates to be applied to future cash flows
- Determine whether there are other circumstances which could have created losses during the relevant time period
- Consider steps taken to mitigate lost profits
- Consider avoided costs
- If using the yardstick method, use a comparable business as close to the subject company as possible

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