

# Inside

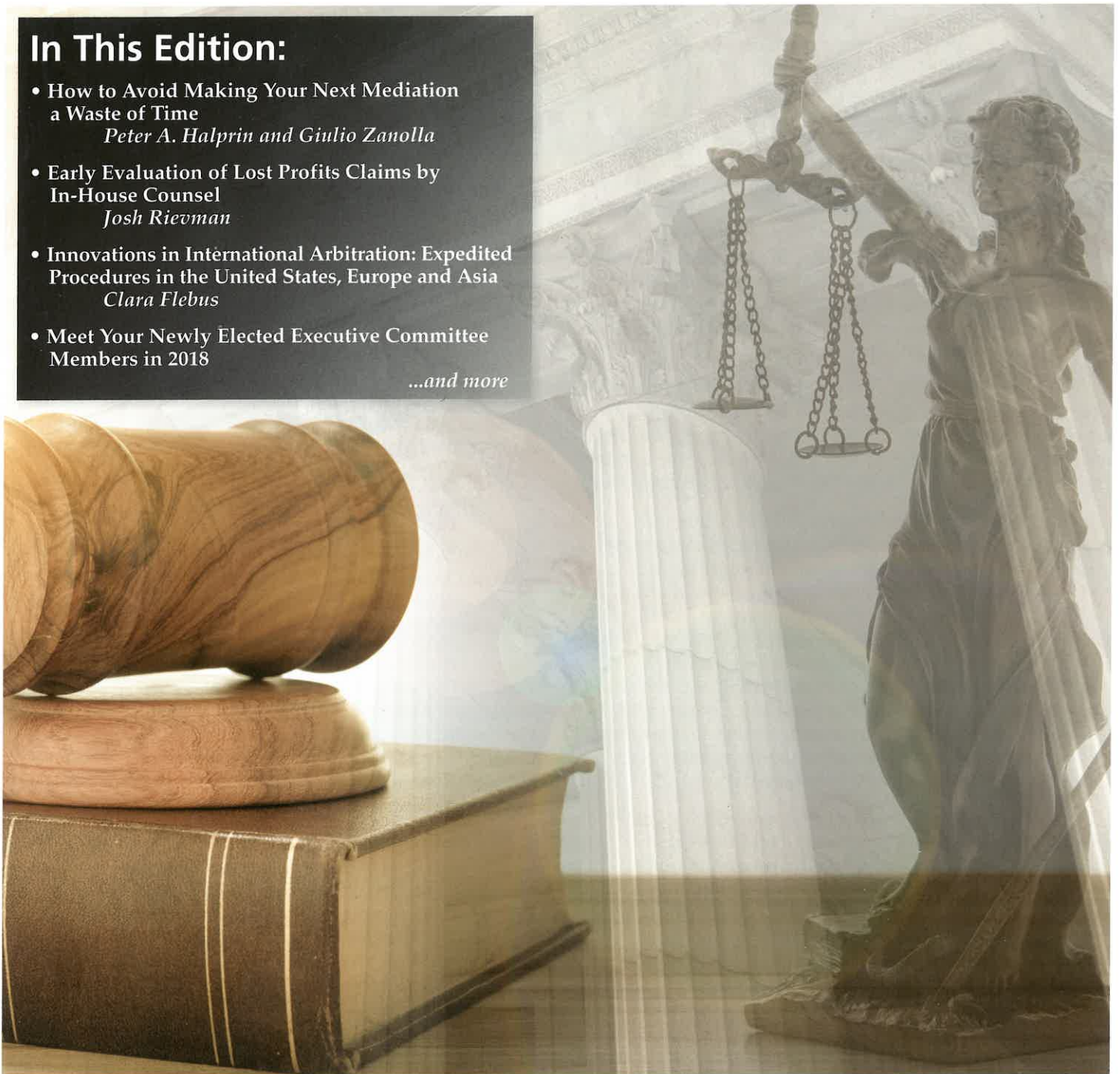


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# Early Evaluation of Lost Profits Claims by In-House Counsel

By Josh Rievman

An important element of conducting a business efficiently is to control the flow of legal disputes that invariably emerge in the course of a company's activities. The ability of in-house counsel to make early assessments of the value of such disputes provides management with an invaluable tool to evaluate a dispute's potential impact. Whether as potential plaintiff or defendant, an understanding of what damages are at stake is vital to inform the course of action the company should take: to prosecute or defend a lawsuit, seek resolution through mediation, or defuse the situation informally. Of all the categories of damages at stake in business disputes, lost profits are perhaps the most common and least understood.

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This article aims to assist the in-house practitioner by examining what lost profits are recoverable, the legal standard necessary for proving such a loss, the types of proof courts require, and some common methodologies and practical considerations concerning proving and debunking projected lost profits.

## What Are Lost Profits?

Lost profits are lost net profits. More specifically, lost profits are lost revenue, directly attributable to the complained-of conduct, net of what is known as "avoided costs," over a reasonable time period. Avoided costs are those that would not be incurred because of the lost revenue opportunity, and are generally variable, rather than fixed, costs.

## What Is the Legal Standard for Proving Lost Profits?

When evaluating a case early in the dispute resolution process, it is important to recognize what is required to prove an entitlement to lost profits. Generally, lost profits are proven by comparing a company's profitability before the alleged wrongdoing with its profitability during the period after it. By their very nature, lost profits are almost always unknown, because they are the profits that did not happen. Consequently, they cannot

be known with certainty and must be estimated or projected.

Courts do not allow an aggrieved party free rein to claim any amount of lost damages it can justify, subject only to a defendant's cross examination. Instead, courts require plaintiffs to estimate lost profits based on objective facts, figures, and data, from which the amount of the loss can be determined with reasonable

certainty. The lost profits must be directly traceable to the breach and are neither remote nor the result of intervening causes. And because lost profits are generally consequential damages and must therefore have been within the reasonable contemplation of the parties.

To be clear, while the lost profits estimate must be reasonably certain, it need not be exact. Although a plaintiff cannot recover lost profits that are hypothetical or hopeful, neither can a defendant defeat a lost profits claim on the ground that the amount cannot be perfectly calculated. What is acceptable proof lies somewhere in the middle: a projection based on documentary and testimonial evidence, adduced by acceptable methodology and reasonable assumptions, capable of withstanding cross-examination. Where a business is new and has a paucity of profits history, courts will hold that business to an even higher level of scrutiny.

The party trying to establish lost profits must also consider and eliminate other potential sources of harm. Only damages that were proximately caused by the defendant's conduct can be recovered. An examination of similar competitors and similar markets over the same time period is crucial to determine the extent to which the loss of profits resulted from the conduct in question.

## What Sort of Factual Evidence Is Necessary to Establish Lost Profits?

A lost profits calculation is generally the subject of expert testimony. Any expert, however, needs evidence on which to base his or her opinion. In addition to the



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testimony of key business leaders, including the CEO, CFO and business development heads, experts will need to examine and base their analysis on several categories of business documents, including financial statements, management projections and business plans, documents recording past performance, budgets, competitive or market analyses, analyst and industry reports, analyses of the relevant economic factors such as projected growth, availability of capital and credit, and even, in certain instances, geographic, climate and political forecasts.

### What Are Common Methods for Calculating Projected Lost Profits?

In order to make a preliminary estimate of what a lost profits claim might be worth, in-house counsel should also be aware of the primary methods for presenting a lost profits projection. There are four primary methods for estimating lost profits: the before-and-after method; the yardstick method; the lost market-share method, and, where a contract provides for an ascertainable level of commerce, an analysis of the contract terms.

**Before-and-After:** This method compares profits before the complained of behavior with the level of profits that follow the behavior. The before-and-after method, of course, requires a record of historical profits and an ability to adjust for other factors that might affect profits in the later period. This method also requires the plaintiff to choose a point by which the profits are expected to recover.

In the illustration below, actual profits are represented by the dark line while the light line represents the projection of what profits would have been in the period

2012-2018, absent the complained-of behavior. In this example, the profits had trended upward for ten years, before falling off dramatically and taking four years to stabilize and begin to recover. By 2018, once profits begin to recover, the analysis ends.

**Yardstick:** The yardstick method is a comparative approach that relies on actual performance of comparable companies as a benchmark for what performance would have been, absent the behavior in question. This method is useful where there is limited earning history or when a company has been driven out of business. It is important to bear in mind that because no two businesses or industries are identical, adjustments need to be made to make the comparison as credible as possible.

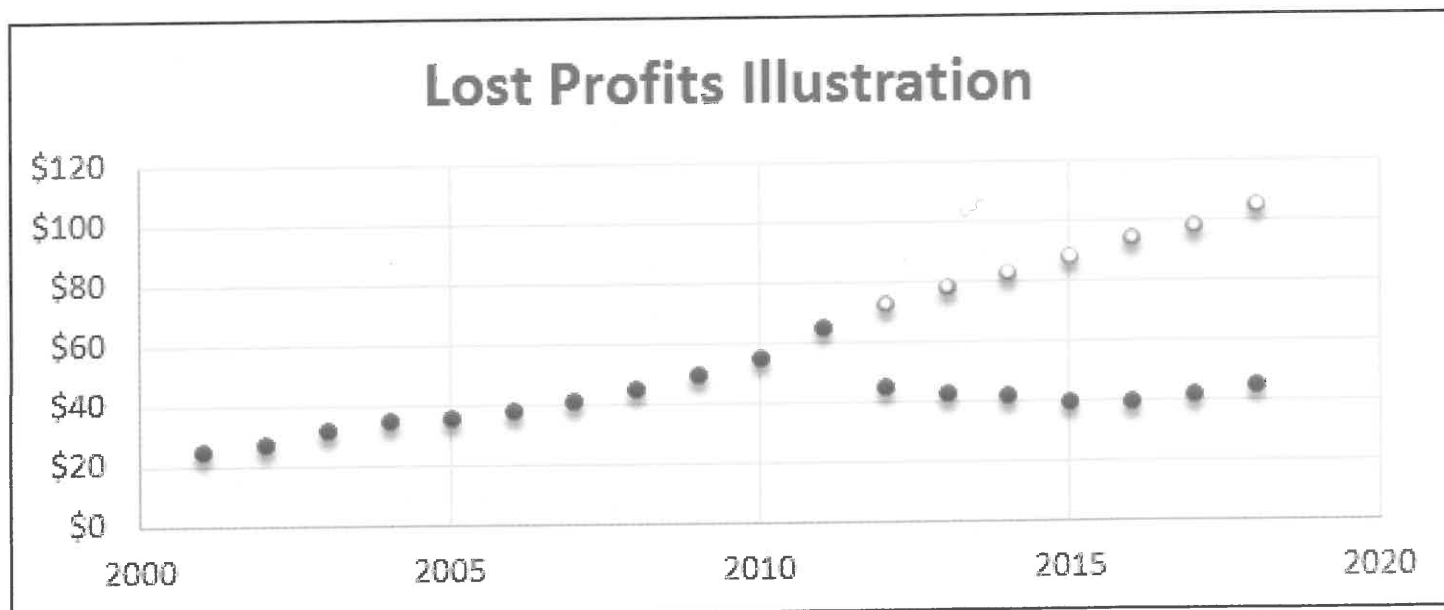
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**Lost Market Share:** This model examines the market as a whole and contemplates that the business had a consistent market share that it would have maintained but for the behavior at issue. A similar analysis can be conducted for specific opportunities lost.

**Contract Terms:** In cases in which there is breach of a contract that established a level of business to be done between the parties, a lost profits claim may be measured



by calculating the expected profit from that known level of future business.

### How Difficult Is It for a Party to Prove or Disprove Lost Profits?

Lost profits issues are regularly litigated around the county, in state and federal courts and in specialized business courts, such as the New York Supreme Court's Commercial Division and the Delaware Chancery Court. A recent Westlaw search reveals that in the first half of 2018 alone, there were nearly 600 reported decisions discussing lost profits written by courts throughout the country.

Challenges to lost damages projections can be made through such varied arguments as a lack of underlying financial evidence, or challenges to an expert's reliability, relevance or qualification under the *Daubert* doctrine. A recent study by a major accounting firm found that during 2017 financial experts were either partially or completely excluded in 48 percent of the cases in which they were proposed to testify.<sup>1</sup> While the question of the success and failure of expert presentations of lost profits projections is beyond the scope of this article, it is nonetheless important for in-house counsel at the initial stages to consider the competitive position of the company, the

quality of its financial reporting, the credibility of its potential fact witnesses and also the financial wherewithal to hire expert counsel and valuation professionals capable of prosecuting or defending against a lost damages claim.


### Endnote

1. PWC, *Daubert Challenges to Financial Experts, A Yearly Study of Trends and Outcomes, 2000-2017*, available at <https://www.pwc.com/us/en/services/forensics/library/daubert-study.html>.

**Josh Rievman is a partner at Cohen Tauber Spievack & Wagner P.C. and focuses on litigation and arbitration of commercial disputes. Josh has successfully represented clients in jury and non-jury trials in New York State and federal courts, in state and federal appellate proceedings, and in arbitration locally and internationally. Josh also counsels executive employees and employers with respect to separation, onboarding and internal investigations. In his practice, Josh represents clients on a broad range of issues, including actions arising out of domestic and international commercial transactions, breach of contract, breach of fiduciary duty, unfair competition, licensing, products liability, trademark, securities, partnerships, banking transactions, technology, professional sports contracts and bankruptcy. Josh often relies on experts to prove and disprove damages on behalf of his clients.**

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