The Legal Intelligencer
THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2011
PHILADELPHIA, TUESDAY, AUGUST 23, 2011 VOL 244 • NO. 37 An ALM Publication

LITIGATION

Lost Profits Calculations Can Be a Minefield for Practitioners

DAMAGES

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Special to the Legal

Lost profits calculations can be a very tricky proposition and are not to be entered into lightly.

When presented with such a challenge, it may seem fairly simple and straightforward — net income before the incident compared to net income after the incident equals lost profits, right? But there's a lot more to it.

According to the American Institute of Certified Public Accountants' *Practice Aid 06-4, Calculating Lost Profits*, some of the things a practitioner must consider when performing a lost profits analysis are loss causation, appropriate method, saved expenses, loss period and mitigation.

LOSS CAUSATION/PROXIMATE CAUSE

Prior to calculating a loss of profits in any case, the practitioner must determine the loss was proximately caused by the alleged incident. Proximate cause has two elements that must be demonstrated: transaction causation and loss causation.

Transaction causation is the idea that "but for" the alleged incident, no damages or lost profits would have been incurred. This alone is insufficient to demonstrate loss causation. The second element is that of loss causation — the loss being alleged is directly as the result of the incident. Not only does the loss have to be demonstrated but for the alleged incident, the loss must be because of the alleged incident. Both elements must be demonstrated in order to effectively calculate a loss of profits.

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Once a loss has been determined to have occurred and been proximately caused by the incident in question, a practitioner must attempt to quantify the amount of damage. The incident in question does not have to be the sole reason for the loss, only the primary or major reason. The practitioner will be challenged to separate out the non-incident-related issues to the results of any breach, such as how a slowdown in the economy or competition affected the subject company.

For example, if a business sustains a catastrophic loss — a fire or flood — and is out of the business for a year, many other factors affecting that business — the general economy, competition, stability of customer contracts and so on — need to be assessed as well. The reason for a business' decline may not be 100 percent attributed to the incident in question, and the practitioner should thoroughly investigate all reasons for the decline.

There are a number of ways to measure a business loss and each case must be decided on its own merits. Two of the more common methods used are the yardstick approach and the before-and-after method.

YARDSTICK APPROACH

For the yardstick approach a company's performance is compared to some standard measure of profit or "yardstick" to determine how much is lost. The yardstick could be others within the industry, another division of the company, the infringing or defendant company, actual results compared to budgeted amounts, or pre-incident projections, to name a few.

Once the yardstick has been created, the actual performance of the company is measured next to the yardstick to see differences in sales, costs and profits to determine damages. When using this method it is not only important to decide this is a reasonable method, but also to decide which company, division, etc. to use as a yardstick. Careful consideration should be undertaken for both.

BEFORE AND AFTER

The before-and-after method is the comparison of the plaintiff's profits before the incident to those generated after the incident. The idea of this method is that but for the incident, no damage would have occurred and is generally performed using only the plaintiff's records.

This method can be as simple as subtracting the actual profits of the plaintiff after the incident from the actual profits before the incident, or it can be much more complex. This method assumes that historical results are the best indicator of future performance. Make sure this theory is adequately supported.

OTHER METHODS

There are other methods a practitioner may use to quantify lost profits, such as terms of the contract or calculation of defendant's profits (disgorgement theory). Sometimes several methods are used to corroborate the reasonableness of any one method and give the trier of fact a range of choices.

Any method must be determined on a case-by-case basis and have sufficient support. The idea is to select the method that best measures the lost profits of the plaintiff as caused by the alleged misconduct.

SAVED EXPENSES

In addition to the above methods for calculating lost profits, the practitioner must consider any saved expenses. Any expenses not incurred by the plaintiff could reduce the amount of profit lost.

For example, in a catastrophic loss, the nonpayment of rent, utilities and salaries would be saved, while in a breach of contract matter fixed and operating costs have to be examined to determine any variation due to the incident of question. Any saved expenses would be a direct reduction of the calculated amount of lost profits and could be a significant element in the calculation of damages.

LOSS PERIOD

After correctly determining that a loss occurred, the next question is to ask: "For how long?" The plaintiff cannot claim lost profits for an indefinite period and must provide proof indicating the length of time the lost profits were to be expected.

For contract disputes, the period is sometimes the length of the contract (i.e., one year for most insurance policies), while for other types of disputes it may be the period until the plaintiff returned to normal operations or recovered from the alleged wrongful act. Either way, a sufficient basis must exist for any period of loss; arbitrary periods of say, 5 or 10 years into the future are frequently wrong because they are not supported. The practitioner is challenged to continually assess when the subject company is made whole and recovered from the incident.

Calculating lost profits may seem fairly simple and straightforward. But there's a lot more to it.

MITIGATION

After considering all of these elements, you might think you are done and have appropriately calculated the complete amount of lost profits sustained by the plaintiff. The plaintiff has a duty to mitigate or limit its damages by any reasonable method.

Did the company rent temporary space after the fire? Rebuild in a timely manner? Hire a company for clean-up? Seek out new customers after a salesman left with the biggest one?

A business has to make decisions and find reasonable ways to lessen the business loss, given the breach or catastrophic loss event. Some of these decisions will be subjective and may be questioned by others later.

There are two reasons mitigation is an important factor: One, the plaintiff cannot recover damages that could have reasonably been avoided, and two, failure to mitigate is an affirmative defense that can be used against the plaintiff.

SEVERAL ELEMENTS

For the practitioner to appropriately determine the lost profits resulting from the defendant's alleged misconduct, several things must be considered, including the cause of the loss, the method used to calculate damages, whether or not there are any saved expenses, the length of the loss and the plaintiff's own attempt to mitigate the claimed loss.

Failure to properly consider any of these elements could lead to an incomplete analysis and result in an unsupported calculation of the lost profit damages, along with a lot of questions from the opposing expert. So, in the minefield of lost profits calculations, follow all of these steps and tread lightly. •

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