The Legal Intelligencer
THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2012
PHILADELPHIA, TUESDAY, AUGUST 7, 2012
An ALM Publication

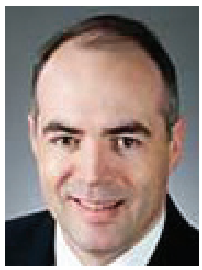
Your Income Went Down by How Much?

BY JEFF WILLOUGHBY

Forensic accountants are frequently brought in to cases where they are asked to quantify economic damages, based on the alleged acts of one or more parties, or respond to another expert's calculation. One of the first questions to be asked is, "Your income went down by how much?" To get to the answer, one will preliminarily need to examine several years of tax returns and/or financial statements to determine the trends in income and then assess changes in light of the alleged acts. This seems fairly simple so far, right? Income is down in the year of the incident, which means the damages are the amount of the decrease and last until income gets back to the same level. Well, it's not quite that simple.

The English novelist Charles Dickens once said, "Annual income 20 pounds, annual expenditure 19.6, result happiness." Unfortunately, calculating damages is not quite that simple.

One element of damages that often gets overlooked by experts is that of causation. Not only do you have to demonstrate a loss exists, but an expert needs to demonstrate the event in question actually caused the loss. *AICPA Practice Aid 06-4, Calculating Lost Profits* , states damages are only recoverable to the extent the action was the proximate cause of the loss. Proximate cause is defined as an act that results in injury as a direct consequence and without which the injury would not have occurred. In short, there has to be some direct link between the action and the damages.



JEFF WILLOUGHBY
is a senior associate at Forensic Resolutions Inc. in Haddonfield, N.J., and Philadelphia. He can be reached at jwilloughby@forensicresolutions.com.

In order to be complete and thorough, as well as remain independent, a damages expert should not assume causation. Patrick Gaughan further explains in *Measuring Business Interruption Losses and Other Commercial Damages* , "If the losses of the plaintiff are substantial, but it is not conclusive that the losses were caused by the actions of the defendant, the litigation may be pointless." For a damages expert, there are two elements of proximate cause that must be considered to properly consider proximate cause: transaction causation and loss causation. One element is a little easier to demonstrate than the other: Both elements must be present for a damages expert to properly opine on damages.

Transaction Causation

The idea behind transaction causation lies in the theory that "but for" the actions of the defendant, no damages would have been incurred. This requires the damages expert to consider the event giving rise to the alleged damages. In the case of claiming lost profits on a construction project, consideration should be given as to whether a subcontractor failed to complete its portion of a project and cause the general contractor to incur additional costs, miss a key deadline or incur penalties. In such a case, there may be transaction causation as a wrongful act occurring on the part of the defendant.

Industry publications explain that transaction causation alone is insufficient to support a claim for damages. Just because an event happened and someone experienced lower revenues, or increased costs, does not mean that event was the reason.

When an expert has evidence of a wrongful act and a decrease in revenue, earnings, net profits or some other measure, many times the wrongful act will be explained as the reason for the loss. In a typical case, the plaintiff is induced into a transaction by the defendant and but for the misrepresentation the plaintiff would not have entered into the

The Legal Intelligencer

transaction. In this case, there is transaction causation (the misrepresentation), but now it must be demonstrated the misrepresentation led to the plaintiff's losses, or loss causation.

Loss Causation

Continuing with this example, assume for a moment that transaction causation has been established and the transaction entered into by the plaintiff would not have occurred but for the actions of the defendant. Now, the plaintiff must demonstrate the misrepresentations made by the defendant are related to the losses experienced by the plaintiff.

In a recent matter, a construction company was experiencing large losses on several contracts because of the actions of a group of individuals. Based upon the review of some of the contracts, the company had bid certain projects to have very low gross margins and the contracts it had taken on were much larger than any it had done in the past. Losses were sustained when the company couldn't perform on the larger contracts and the contracts with lower gross margins were not producing enough profit, both rendering the actions of the defendant irrelevant.

Now, the case was much more involved than can be explained in a few sentences, but the bottom-line issues were transaction and loss causation. If the damages expert cannot reasonably determine the loss was caused by the actions of the defendant, he or she should not provide an opinion on damages.

That is not to say the damages must be caused solely by the actions of the defendant; they must be a significant factor in causing the loss. There may be several reasons for the losses experienced by the plaintiff. The damages expert may be able to eliminate some of those reasons in order to arrive at the damages caused by the defendant. Some of the questions a damages expert may need to address in some fashion are:

- Has the market for the product declined?
- Have customers found other resources?
- Has the product or service become obsolete?
- Has another entrant to the market taken a portion of the sales?
- Have other factors reduced the customer base or access to the business?

In the contractor case above, had loss causation been demonstrated, it may have been possible to determine additional costs due to weather, supplier issues or labor force problems, eliminating these costs from any claimed damages. A damages expert must address these factors in order to show he or she has accounted for other possible causes of the loss.

Failure of an expert to eliminate these additional factors can lead to serious problems in pleading or defending the position.

Identifying Causation

In the majority of cases, an expert will probably identify one of the items required to demonstrate proximate cause. Transaction causation is typically the easier of the two components to recognize. Incident X occurs, a claimant believes he or she incurred a reduction in income, and he or she claims the incident created the loss or damage. The component of proximate cause experts sometimes do not as easily recognize is loss causation. Not only must there be an event that creates a loss or damage to the plaintiff, but that event must be related to the loss.

There are often many reasons giving rise to a reduction of income or increase in costs that may be unrelated to the actions of the defendant. If an expert does not consider the other possible causes for a loss, he or she is doing a disservice to his or her client. By not properly considering alternatives, he or she leaves his or her opinion open to criticism that may result in problems with the effectiveness of his or her report or testimony. So, when a plaintiff says, "My income went down by ... " that is not the end of the story. Calculating damages may (will) involve a little more than determining the difference between income prior to the incident and income after the incident. Unlike for Dickens, calculating lost income is not as simple as looking at revenues and deducting costs. ••