

The Forensic Economist

An Economic Newsletter for Lawyers



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Business Losses: Legal Framework, Economic Concepts

Circumstances Leading to Business Losses

Business losses can result from a wide range of circumstances and may be an issue under contract or tort law. Tortious acts resulting in property damage and personal injury where a business entity or a key employee is the object of the act may also establish cause for business losses. Environmental contamination, unfair trade practices, fraud and interference with contract are all examples of torts that may lead to a claim for business losses.

Perhaps the most obvious circumstances in which business losses may arise involve the breach of a contract. Breach of contract circumstances arise when a party to a contract fails to perform the terms of the contract and the other party is prevented from realizing the anticipated benefits of the contract. Product liability and breach of warranty actions are two other examples of circumstances that may produce business losses under contract law.

The consequences of such events may lead to business losses without being immediately or directly observable. For example, environmental contamination of an adjacent property leads to the business owner's inability to finance an expansion plan and, as a consequence, the loss of key sales contracts.

The economic or financial expert can play two roles in a business loss case for plaintiff and defense attorneys. First, an experienced economist may be employed to examine and possibly testify to the *fact* of damages. The expert should have experience in financial and business analyses, investment analyses and/or business valuation. An expert with actual business experience can be valuable to both plaintiff and defense case management. The second role an experienced economist may play involves examining and possibly testifying to the *amount* of damages.

Legal Considerations

Case law offers well established principles governing the demonstration of lost profits in commercial litigation. However, the personal injury of a business owner and new ventures represent special cases that deserve separate attention.

In general, there are three steps to the process of proving damages. First, the plaintiff must prove that the defendant committed an illegal act violating the rights of the plaintiff—"proximate cause." This is a well-established principle of law articulated in extended lineage of related cases.

Second, it is necessary to demonstrate that the illegal actions of the defendant actually harmed the plaintiff. The general principle regarding causation is that the fact of damages must be established with

"reasonable certainness." It is a well-established concept that the fact of damages and the measurement of damages are separate issues in business loss cases. Although the specifics of a case can intertwine these two issues and cause a great deal of confusion to attorneys and courts, it is necessary to carefully separate them in the attorney's case strategy. In some cases it is further necessary to demonstrate that the effect of the actions of the defendant could have been anticipated to cause such harm. Clearly, the defendant needs only to derail one of the steps to successfully defend against a claim.

Lastly, the plaintiff must provide satisfactory demonstration of the amount of damages. The standards of proof between the fact of damages and the amount of damages are quite different. In most jurisdictions, once the fact of damages is established, the amount of damages is then subjected to a more flexible standard and can be determined as reasonable estimates or projections. Damages cannot, however, be "mere speculation or guess."

Economic Consideration

Did the defendant's actions harm the plaintiff? This is often an economic question requiring the opinion of an economist, separate and distinct from the amount of damages. A simple example is: "Did the defendant's actions have an adverse impact on the plaintiff's annual sales revenue?" Industry trends, seasonal demand patterns and cyclical economic activity may make the answer less than obvious. The company's development and financial status at the time of the events may hide the consequences of the alleged wrongful actions. An examination of historic and industry trends, and company finances, may be the minimum necessary to establish causation. Left unaddressed, economic issues of causation can make for effective cross-examination by opposing counsel and/or potential exposure to powerful points on rebuttal. If one cannot prove causation then damages may be irrelevant.

Compensatory damages may include lost profits, loss of the value of the business enterprise, increased cost, and out-of-pocket expenses incurred as a direct result of the actions of the defendant. A thorough and thoughtful understanding is required to avoid double counting any of the elements of damages--a frequent mistake by experts. For example, determination of lost profits and lost business value, depending on the methods employed by the economist, may end up counting the same dollars twice. A knowledgeable analyst knows the appropriate analytical methods to employ and how to avoid double counting.

The general principle in quantifying damages is to



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restore the harmed party to the financial condition that it would have enjoyed without the illegal act. Typically this is done by comparing the actual financial condition of the plaintiff after the illegal act with the anticipated financial condition but for the actions of the defendant. Given the importance of the relationship between causation and damages, competent economic and financial expert assistance is important to counsel whether making or defending against a commercial damages case. Future dollar amounts need to be expressed in present value terms and, depending on the jurisdiction, it may be necessary to determine accrued interest on historic losses.

Basic Concepts in Business Loss Cases

The element of value most often determined in business loss cases is lost profits of which "net" or "gross" profits may be applicable depending on the circumstances and factors in the case. However, damages may also be measured by determining loss of business value or "going concern" value. Often it is necessary to examine both profits and business value to determine the appropriate measure of losses. In such situations, great care must be taken to avoid double counting lost profits as business value is, conceptually, determined by measuring future profits. The specifics of the case and possibly jurisdictional specific requirements, may determine the approach required. In either approach the focus of analysis is, generally, on the incremental losses rather than the business as a whole. Has the matter caused damages that are close-ended or open-ended? An exception may be where a plaintiff alleges that the defendant's actions brought about the demise of an entire business enterprise.

Can lost profits arise from a situation where the defendant company has not demonstrated historical profits? Conceptually, yes. The defendant's alleged illegal acts may simply increase the losses of the company. It may appear that the more appropriate measure of damages may simply be the amount of increased expenses of the plaintiff, given the defendant's alleged actions. However, great care must be exercised to understand the financial consequences of the defendant's alleged actions on the plaintiff's business activity. Simply determining the plaintiff's added cost may not accurately measure the damages. A good example of where this may be the case is with a new business venture. The business may have been losing money at the time of the incident, but building market recognition and future sales strength. Additionally, a common mistake in calculating lost profits is to neglect the financial consequences of the assumptions regarding sales growth on the company's financial structure. For the plaintiff such an oversight can be a fatal flaw when uncovered by the opponent's expert.

Appropriate Measures of Business Losses

Two general approaches to measuring business losses are commonly employed by analysts. The specific circumstances of the case will dictate which approach is most appropriate. In

the first, incremental profits are determined by calculation of a profit margin on a unit of sales. Lost sales are then profit estimated and multiplied times the unit margin to estimate total lost profits. This approach has the advantage of being relatively simple to explain in a court room setting.

The second approach to measuring business losses involves producing two business scenarios. In the first scenario, a business' performance is modeled had there not been the alleged wrongful acts of the defendant. A second scenario is produced where the impact of the alleged wrongful act is also modeled. Increased costs and reduced sales are the usual consequences of the alleged wrongful act. The difference in financial results between the two scenarios yields lost profits and/or business value but for the alleged illegal act. Although this approach is more difficult to explain to a jury, it is intuitively logical when properly presented.

Tips

Knowledge of the relevant business and financial concepts is critical to the successful prosecution and defense of business loss cases. A dual perspective is a good way for a lawyer to prepare for the tasks necessary in managing these cases. Take time to: understand the environment in which the business operated; develop specific knowledge of how the business makes money; know where the business is in its growth cycle; know what and how regional, national and global factors influence the business.

In short, trained and experienced expert assistance may be necessary for plaintiff's attorney to both prove and quantify the business loss damages in a case. To the defense attorney, trained and experienced assistance may be necessary to help assure the defendant is not unjustly held accountable for inaccurately estimated business loss damages.

Case Assessment *Special Offer*

Our case assessment can help you formulate a plan to present or defend your client in an economic damages claim. Economic & Policy Resources has over thirty-years of experience in forensic economics involving economic damages in litigation. For a flat fee, EPR can review the aspects of your case and provide a detailed assessment of the economic damages that are involved. Call our economists today for a free initial consultation and learn more about what we can offer you and your client.

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