A Primer on Recovering Lost-Profit Damages

By Zachary G. Newman and Anthony Ellis – October 22, 2012

Lost-profits-damage claims can arise in any manner of cases, including contract disputes, business torts, antitrust, and even insurance cases. As lost-profits claims often have the potential to significantly exceed conventional damage claims, litigants are well served to understand the unique evidentiary and theoretical challenges that are associated therewith. Although establishing lost profits may be as simple as calculating the anticipated profit on goods sold, other scenarios may present far more difficult calculations, even involving complex and potentially costly expert testimony and analysis.

Burden of Proof

The requirements and standards of proof for claiming lost-profits damages vary depending on the context in which such damages arise. While an exact calculation of lost profits is not necessary for the recovery of damages (*see Rusty's Weigh Scales & Serv., Inc. v. N. Tex. Scales, Inc.*, 314 S.W.3d 105, 110 (Tex. Ct. App. 2010) (*citing Texas Instruments, Inc. v. Teletron Energy Mgmt., Inc.*, 877 S.W.2d 276, 279 (Tex. 1994))), plaintiffs should provide enough definite proof of the amount to "afford a sufficient basis for estimating" the amount of lost profits being claimed. *See Muir v. Navy Fed. Credit Union*, 744 F. Supp. 2d 145, 148 (D.C. Cir. 2010) (*citing Boggs v. Duncan*, 202 Va. 877, 882, 121 S.E.2d 359, 363 (1961)). Many courts require that the proof be sufficient to allow fact finders to reach a "reasonably certain determination of the amount of gains prevented." *See Glynn v. Impact Sci. & Tech., Inc.*, 807 F. Supp. 2d 391 (D. Md. 2011) (applying New Hampshire law). If such claims are contingent or uncertain, some jurisdictions will preclude recovery of lost-profits damages. *See, e.g., Muir*, 744 F. Supp. 2d at 149.

Many courts have recognized that the standard of "reasonable certainty" is not subject to a uniform or concrete definition. Thus, in certain jurisdictions, such as Minnesota, the plaintiff is required to prove future damages to a "fair preponderance of evidence." *Pietrzak v. Eggen*, 295 N.W. 2d 504, 507 (Minn. 1980). Other states, such as Ohio, consider evidence to be reasonably certain if "it is probable or more likely than not." *Bobb Forest Prods. v. Morbark Indus.*, 151 Ohio App. 3d 63, 88, 783 N.E.2d 560, 579 (Ohio Ct. App. 2002). Truthfully, this may be a linguistic difference, and there may not be much substantive difference in what a plaintiff would need to demonstrate to satisfy either standard. Some courts apply the reasonable-certainty standard only to the question of causation but not to the amount of such damages. *See* Joseph Wylie & Christopher Fahy, *Proving and Defending Lost-Profits Claims*, Business Torts Journal, Fall 2007, at 7. In such cases, courts may not always require that the amount of damages be established with the "same degree of certainty" as the evidence used to calculate such an amount. As the Supreme Court of Missouri noted:

> In some cases, the evidence weighed in common experience demonstrates that a substantial pecuniary loss has occurred, but at the same time it is apparent that the loss is of a character which defies exact proof. In that situation, it is reasonable to require a lesser degree of certainty as to the amount of loss, leaving a greater

> degree of discretion to the court or jury. This principle is applicable in the case of proof of lost profits.

Ameristar Jet Charter, Inc. v. Dodson Int'l Parts, Inc., 155 S.W.3d 50, 55 (Mo. 2005) (quoting *Ranch Hand Foods, Inc. v. Polar Pak Foods, Inc.*, 690 S.W.2d 437, 444–45 (Mo. Ct. App. 1985)).

The "New Business" Exception to Recovery

Arguably the greatest variation of the "reasonable certainty" standard exists in the context of analyzing potential lost-profits damages of new businesses. Because new businesses lack past experience from which profits may be estimated, it is difficult to make a reasonably certain claim for the loss of expected profits. As such, a few states, such as Virginia, have adopted or applied a "new business rule" that bars recovery of lost-profits damages for newly established business enterprises. *See, e.g., Vienna Metro LLC v. Pulte Home Corp.*, 786 F. Supp. 2d 1076, 1086 (E.D. Va. 2011); *Sunrise Continuing Care, LLC v. Wright*, 277 Va. 148, 154, 671 S.E.2d 132, 135 (2009); *Clark v. Scott*, 258 Va. 296, 520 S.E.2d 366 (1999) (determining that a dental practice that operated for eight months was still considered a new business under the "new business rule").

An illustration of the bias against these claims found in some jurisdictions can be found in Virginia, where courts have barred recovery of lost profits for new businesses despite the fact that the Virginia legislature enacted a statute that expressly permits new or unestablished businesses to sue and obtain damages for lost profits. *See* Va. Code Ann. § 8.01-221.1 (2012) (allowing the recovery of lost-profits damages for a new or unestablished business that presents proper proof). Courts in such jurisdictions have reasoned that a new commercial business that lacks a track record of actual profits generally cannot qualify for recovery because such profits are too uncertain to meet the legal standard of reasonable certainty. *See, e.g., Re/Max of Ga. v. Real Estate Group on Peachtree*, 201 Ga. App. 787, 789, 412 S.E.2d 543, 546 (Ga. Ct. App. 1991) (holding that lost profits of a new business are generally too speculative for recovery).

New York courts also have recognized that it is more difficult for new businesses to prove lost profits with reasonable certainty and to ultimately recover damages. *See Ashland Mgmt., Inc. v. Janien*, 82 N.Y.2d 395 (1990) (holding that calculations of anticipated profits based on advanced financial data and strategies met the burden of reasonable certainty, but recognizing the difficulty in establishing such damages). Nevertheless, it is not impossible to meet the burden. In *Ashland*, the court noted that the claim rested on "the parties' carefully studied professional judgments of what they believed were realistic estimates of future assets." *Id.* at 406. The court also noted that although the parties were launching a new investment strategy, "they were not entering a new or unfamiliar business." *Id.* Key factors included the fact that the new strategy was an enhancement to an existing successful business, there was a "ready reservoir of customers," and there was extensive testing to provide a predictable damage analysis. *Id.*

Because the "new business rule" can emasculate any "reasonable certainty" and result in harsh consequences, many jurisdictions have rejected it and opted, instead, for less rigid versions or alternative pleading hurdles. Illinois courts, for example, have created exceptions to the rule permitting lost-profits damages to be proven when the new business venture was selling products similar to other products with a known market (*see Milex Prods., Inc. v. Alra Lab.*, 237 Ill. App. 3d 177, 603 N.E.2d 1226 (Ill. App. Ct. 1992) (awarding lost profits that were determined by evidence based upon actual products in the marketplace and authoritative sources for data)), or when a new business was prevented from acquiring operations of an existing business, *see Malatesta v. Leichter*, 186 Ill. App. 3d 602, 542 N.E.2d 768 (Ill. App. Ct. 1989). Wisconsin and Texas have also recognized lost-profits claims for new businesses, but note that they impose a heightened standard for new businesses making a lost-profits claim. *See*, *e.g.*, *Helena Co. v. Wilkins*, 47 S.W.3d 486, 505 (Tex. 2001) (noting that a new business that lacks a profit history is not precluded from recovering lost-profits damages); *Mrozek v. Intra Financial Corp.*, 281 Wis. 2d 448, 477, 699 N.W.2d 54, 68 (2005) (recognizing that a party seeking lost profits for a business with no previous profit history may obtain damages but must provide additional guidance and evidence to allow a "fact finder to reasonably ascertain future lost profits").

Presenting Evidence of Lost Profits in Admissible Form

Because the uncertain nature of lost profits makes it difficult to calculate with mathematical precision, sufficient allegations need to be made and evidence presented to enable the fact finder to make a fair and reasonable finding that damages were actually suffered. *See Price-Orem Invest. Co. v Rollins, Brown & Gunnell, Inc.*, 784 P.2d 475, 478 (Utah Ct. App. 1989). Practitioners should bear in mind that lost profits refers to lost *net* profits and have been defined as "what remains in the conduct of a business after deducting from its total receipts all of the expenses incurred in carrying on the business." *See G & W Marine, Inc. v. Morris*, 471 S.W.2d 644, 647 (Tex. Civ. App. 1939). Thus, the defending party should take sufficient discovery to determine whether the claimant is seeking its own operating costs or its gross profits. Generally, the claimant will be unable to recoup direct costs it would have incurred in earning the profits. However, it is less certain whether fixed costs, such as overhead expenses and tax benefits, should also be deducted from the gross-profit calculations. *See* Andrea Renne St. Julian, "Lost Profits Resulting from Tortious Injury to Business," American Jurisprudence Proof of Facts 3d (April 2012), at § 12; *see also Waggoner Motors, Inc. v. Waverly Church of Christ*, 159 S.W.3d 42, 59 (Tenn. Ct. App. 2004).

In some cases, establishing lost profits is fairly straightforward and involves merely showing the profit the non-breaching party would have made on the transaction after deducting the claimant's costs if it had been consummated, which can be established based on the transaction documents already executed. Where the calculation is not so simple, courts have recognized a variety of ways that parties can establish their lost profits. The two predominant methods are the "before-and-after theory" and the "yardstick test." Under the "before-and-after theory," the claimant must demonstrate prior earnings as evidence of lost profits. The "yardstick test" involves external data comparing the profits of a business that is closely related to that of the claimant's business.

Regardless of the applicable theory, counsel must take care in assembling and presenting the evidence for lost profits in admissible form. Given that many lost-profit claims are challenged at the pleading stage in a motion to dismiss, a claimant should assemble and verify the supporting information prior to pleading. The most persuasive types of evidence include verifiable data, corroborated profit history, and comparative profit performance.

In the case of new business models or evidence that requires some degree of speculation or opinion, litigants may want to use expert as well as lay-witness testimony, consistent with the requirements set forth in the Federal Rules of Evidence (FRE). *See* Wylie and Fahy, at 10. Under FRE 701, courts may consider the testimony of business owners with special knowledge of the business and its operations to testify as to the facts of the business that relate to the lost-profits calculations. Some courts have even admitted lay-witness testimony where the witness has direct knowledge regarding the profit calculation. *See, e.g., In re Merritt Logan, Inc.*, 901 F.2d 349, 359 (3d Cir. 1990) (allowing the plaintiff's accountant bookkeeper and principal shareholder to testify concerning the company's lost profits). To ensure the admissibility of expert and lay-witness testimony, claimants should make sure that experts strike a balance between a "reasonable estimation of damages and speculating about what could have been." *See* Neil Steinkamp, Gavin J. Fleming, and Jacob Reed, "Presenting Evidence when Businesses Have Limited Financial Information."

Breach-of-Contract Claims

In contract cases, in addition to the standard requirements of proving damages to a "reasonable certainty," most jurisdictions require the claimant to prove that the lost profits were within the contemplation of the parties at the time of contract. *See*, *e.g.*, *Mead v. Johnson Group, Inc.*, 615 S.W.2d 685, 687 (Tex. 1981). For example, Massachusetts courts apply the "contemplation of the parties" test by requiring that

> the loss be the natural, primary and probable consequence of the breach, . . . the profits arising from the performance of the contract or the loss [resulting] from its nonperformance were within the contemplation of the parties, and . . . the profits are not so uncertain or contingent as to be incapable of reasonable proof.

Knightsbridge Marketing Services, Inc. v. Promociones Y Proyectos, S.A., 728 F.2d 572, 575 (1st Cir. 1984). Establishing that future profits were foreseeable and contemplated by the parties at the time of contract requires specific evidence, and the claimant must take care in developing this evidence through the contract itself or admissions by the breaching party. *See Mid-America Tablewares, Inc. v. Mogi Trading Co., Ltd.,* 100 F.3d 1353, 1362 (7th Cir. 1996) (stating that determining whether future profits were within the contemplation of the parties at the time of contracting "turns on the specific facts established at trial"); *see also Fid. Interior Constr., Inc. v. Southeastern Carpenters Reg'l Counsel*, 675 F.3d 1250 (11th Cir. 2012).

Lost Profits in Tortious Injury to Business Claims

The types of intentional torts claims that allow for the recovery of lost profits include, but are not

limited to: tortious interference with the performance of a contract or prospective economic advantage, fraud, breach of fiduciary duty, defamation, and even malicious prosecution. *See* Andrea Renee St. Julian, "Lost Profits Resulting from Tortious Injury to Business," 26 Am. Jur. Proof of Facts 3d, 119–204 (2012). Within the context of these tortious causes of action, the claimant has the burden of proving the foreseeability of the harmful conduct, and the causality between the tortious conduct and the resulting loss of profits. *See, e.g.*, *J'Aire Corp. v. Gregory*, 24 Cal. 3d 799 (1979). In proving lost profits, there is typically a good deal of focus on the comparison of profits before and after the occurrence of the tortious conduct. *See Roane-Barker v. Southeastern Hosp. Supply Corp.*, 99 N.C. App. 30, 40, 392 S.E.2d 663, 669 (Ct. App. 1990) (explaining that the plaintiff was entitled to show evidence of its lost profits by comparing its past history of profits with gross sales of his former salesmen). A before-and-after profits comparison is less effective in establishing lost profits for new businesses that lack a profit history or businesses whose profits after the tortious conduct are not significantly less than previous years. These businesses could instead establish the profits they were expected to make before the tortious occurrence, present evidence of the profits of similar competitors, or evaluate gains made by the tortfeasor. *See Sandare Chemical Co. v. WAKO Int'l, Inc.*, 820 S.W.2d 21 (Tex. Ct. App. 1991) (outlining methods and holding that a plaintiff who had no profit history could prove lost profits through the profits gained by the defendant).

To establish the foreseeability requirement, the claimant will need to demonstrate in many jurisdictions that it was foreseeable he would be harmed by the defendant's conduct. The California Supreme Court awarded plaintiff restaurant owner lost profits damages when construction delays prevented the restaurant from operating. *See J'Aire Corp. v. Gregory*, 24 Cal. 3d 799, 598 P.2d 60 (1979).

To satisfy causation, the claimant cannot simply present proof that the business operated at a loss following the alleged tortious actions. *See Turner v. PV International Corp.*, 765 S.W.2d 455 (Tex. Ct. App.1988). To meet the reasonable-certainty standard, the plaintiff must also have had the ability as a business to perform the work that would have produced the lost profits, and had the opportunity to acquire the work that would have produced the profits. *See Cal. E. Airways v. Alaska Airlines*, 229 P.2d 540 (Wash. 1951).

Lost Profits in Antitrust Claims

Under the Sherman Antitrust Act and the Clayton Act, which prohibit contracts, combinations, and conspiracies that reduce competition in the marketplace, lost profits can be alleged and awarded. *See* Sherman Antitrust Act, 15 U.S.C. § 1; Clayton Antitrust Act, 15 U.S.C. §§ 12–27, 29 U.S.C. §§ 52–53. In an antitrust claim, the plaintiff must have suffered an "injury of the type the antitrust laws were intended to prevent," such as a business's loss of profits as a result of supra-competitive pricing or a reduced ability to compete. *See Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489 (1977). As in breach-of-contract and tortious-injury cases, the amount of the lost profits claim should be "a just and reasonable estimate based on relevant data." *See Zenith Radio Corp. v. Hazeltine Research, Inc.*, 395 U.S. 100, 123 (1969).

The appropriate types of damages in the antitrust context are dependent on the nature of the alleged restraint on the marketplace. *See* Patrick L. Anderson, Theodore R. Bolema and Ilhan K. Geckil, "Damages in Antitrust Cases," Anderson Economic Group, Feb. 26, 2007, at 4. When antitrust violators cause prices to increase through monopolization, a price-fixing conspiracy, or exclusionary conduct, for example, the harm they cause may be alleged as (1) overcharges paid for goods actually purchased, and (2) lost profits resulting from the lost opportunity to buy and resell a greater volume of goods. *See* Jeffrey L. Harrison, "The Lost Profits Measure of Damages in Price Enhancement Cases," 64 Minn. L. Rev. 751, 753, 770–72 (1980). Cases involving price-fixing and monopolization often result in an overcharge injury, which could entitle the claimants to compensation for the consequences of the wrongful action. *See Berkey Photo, Inc. v. Eastman Kodak Co.,* 603 F.2d 263, 297–98 (2d Cir. 1979), *cert. denied*, 444 U.S. 1093 (1980).

Conclusion

Lost-profit claims are sure to fall under rigorous factual review at trial and sustain challenges during a motion to dismiss and a motion for summary judgment. To present a persuasive case for recovery of lost profits, a claimant's counsel should be attentive to the various tests and standards of proving lost-profits damages within the context of a breach of contract, tortious injury to a business, or antitrust claims. Careful attention to providing sufficient evidence and abiding by evidentiary rules could make the difference between recovering damages and having the claim barred.

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