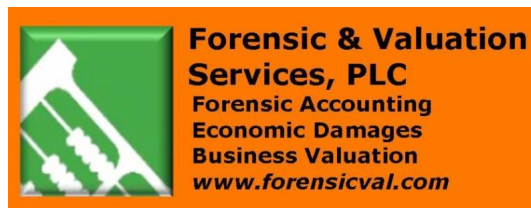


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## Lost Profits and Economic Damages Newsletter

### **Number 1 - General Concepts**

The Lost Profits newsletter series focuses on the concepts and methods used to calculate economic damages from Lost Profits. In this edition, we explain the general and legal concepts associated with Lost Profits damages. The issues that follow describe the customary methods used to calculate the loss of revenues and avoided costs to arrive at lost profits:

#2 - The "Before and After" Method

#3 - The "Yardstick" (or "Benchmark") Method, Terms of the Contract Method and Use of the Defendant's Profits Method

#4 - Avoided Costs

#5 - Intellectual Property Damages in Non-Patent Cases

***If you would like to see the entire five-part series, [Click Here](#).***

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### **Definition of Lost Profits**

Lost Profits are typically claimed as an element of economic damages in a lawsuit involving a business. An entity suffers lost profits when one of the following occurs as a result of the alleged acts of the defendant:

- \* Revenues are lower than they would have been;
- \* Costs are higher than they would have been; or
- \* Some combination of the two.(1)

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Financial experts typically do not determine whether the defendant actually committed the acts in question, we estimate the net profits lost from the acts over the loss period with consideration for causation within a reasonable degree of accounting and economic certainty.

## Generally, Only Lost "Net Profits" Are Allowed

Lost "net profits" are generally calculated by estimating the gross revenue that would have been earned but for the wrongful act, minus the expenses that are saved or avoided as a result of not producing the revenue. After the net lost profits are determined, any actual profits earned during the loss period are deducted as mitigation to compute the total net damages.(2)

## Loss Period

The loss period normally begins at the date of the alleged wrongful act, event or infringement. The beginning date may be after the event date if the losses do not occur until a later period. In a contract breach, the loss will be computed through the earlier of the return of the business to normal, pre-damage levels or the end of the term of the contract. A contract dispute loss period may include assumed renewal periods if renewals are customary in the industry or had been previously experienced or expected by the plaintiff. Renewals are fact-specific and depend on the specific contract environment and may be subject to other contract provisions and rights of the parties involved. In situations such as tort claims, the loss period may extend to time of the return-to-normal, pre-damage levels or the end of a "foreseeable" period.(2)

## Causation

Damages for lost profits are recoverable only if the breach or wrongful act by the alleged wrongdoer defendant was the proximate cause of the loss. The causal relationship is often referred to as the "but for" rule meaning that "but for" the actions of the defendant, the plaintiff would have suffered no loss. There must be a link between the wrongful act and the resulting damages and it must be provable. While causation may seem obvious, proving it is often difficult. The expert must verify that the plaintiff's operations before and after the alleged wrongful event were comparable and the causation can be positively correlated. Relevant differences must be considered when estimating the amount of lost revenues that relate directly to the alleged breach or tort.(2) The expert usually considers other possible causes of the loss. Examples include an airport-based business that had a lease dispute with the airport that delayed their opening for eight months in 2002 causing alleged loss of revenue, but airport traffic was down 50% after 9/11; an unusual and/or non-recurring event such as major road construction on the businesses' street that lasted six months; and a stark downturn in the economy, such as the recent great recession.

## Certainty

The plaintiff must prove that the damages related to lost profits are reasonable based upon reliable factors, but absolute precision is not required. Estimates are allowable; however, the calculations cannot be based upon speculation.(2) Experts will usually include language in a report similar to: "within a reasonable

degree of accounting and economic certainty."

- 1) *PPC's Guide to Litigation Support Services*, Vol. 1, 12th Ed., 2007, Thomson.
- 2) Excerpts from the AICPA Practice Aid 06-4, "Calculating Lost Profits".

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## Lost Profits and Economic Damages Newsletter

### **Number 2 - Calculating Lost Revenues with the Before and After Method**

The Lost Profits newsletter series focuses on the concepts and methods used to calculate economic damages from lost profits. In this edition, we explain the "Before and After" Method used to calculate the loss of revenues. Our next edition will explain the "Yardstick" (or "Benchmark") Method, Terms of the Contract Method and Use of the Defendant's Profits Method.

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### **The "Before and After" Method**

The most straightforward approach to estimating revenues lost as a result of the alleged wrongful event, act or infringement is to conduct a "Before and After" analysis. Under this method, the plaintiff's revenues before the alleged breach or tort are compared to the revenues after the event and any reduction is presumed to be caused by the defendant's actions. The underlying theory is that "but for" the defendant's actions, the revenues would have been earned. The expert must verify that the plaintiff's operations before and after the alleged wrongful event were comparable and the causation can be positively linked. Important differences such as an owner who worked 40 hours per week in the business before the event and only works 25 hours per week after the event, or any other unusual and/or non-recurring event should be considered in estimating the amount of lost revenues that relate directly to the alleged breach or tort.(1)

For example, assume the manager of The Cajun Restaurant breaches his employment contract with the LLC and establishes a competing restaurant that opens 1/1/2014. The manager's contract required him to provide services to the LLC through 12/31/2015 and contained a two-year noncompete clause. Under the terms of the contract, the manager was restricted from competing with the LLC through 12/31/2017 and is liable for any damages from the breach. Assume the LLC's gross revenues were \$1.5 million in 2013 (the year before the competition) and dropped to \$1.0 million in 2014. Further assume that a new manager was hired on 1/1/2015 and revenues returned to \$1.5 million in 2015.

It appears that the manager's actions caused the LLC to lose \$500,000 of revenues in 2014. Damages in subsequent years were mitigated by the fact that the LLC hired a replacement in 2015, resulting in revenues returning to \$1.5 million in 2015. The before and after method offers a quick and understandable estimation of the amount of revenues lost by the LLC as a result of the manager's breach of contract. The expert should research whether any other reason may be the cause of the loss of revenues. For example, suppose the city road department started a major road and intersection rebuilding project right in front of the restaurant in March of 2014 that lasted for six months. The expert must consider and analyze whether or not the road project caused the loss versus the manager's breach.

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## Previous issues:

### #1 - The general and legal concepts associated with Lost Profits.

1) *PPC's Guide to Litigation Support Services*, Vol. 1, 12th Ed., 2007, Thomson.

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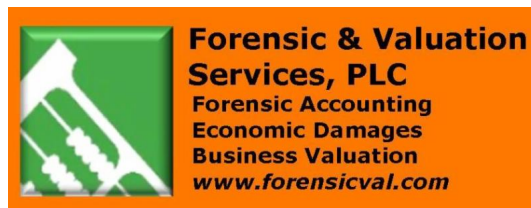
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## Lost Profits and Economic Damages Newsletter

### **Number 3 - Calculating Lost Revenues with the Yardstick, Contract and Defendant's Profits Methods**

The Lost Profits newsletter series focuses on the concepts and methods used to calculate economic damages from lost profits. In this edition, we explain the "Yardstick" (or "Benchmark") Method, Terms of the Contract Method and Use of the Defendant's Profits Method used to calculate the loss of revenues. Our next edition will explain the various methods to calculate the avoided costs associated with generating the loss of revenue.

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### **The "Yardstick" (or "Benchmark") Method**

A common approach to estimating revenues lost because of a harmful act, event or infringement is the "Yardstick" method which compares the plaintiff's revenues against those of a similar business, product, or comparable measure (i.e., a Benchmark). The best "yardstick" for a closely-held business is a business of similar size and nature in the same geographic area as the plaintiff. Examples of possible yardsticks that might be employed in the calculation include:

- \* The performance of the plaintiff at a different location, or a "sister-store";
- \* The plaintiff's actual experience versus past budgeted results; the most useful types of budgets are those that were produced in the normal course of

business prior to the litigation;

\* The actual experience of a similar business unaffected by the defendant's actions;

\* The plaintiff's competitors; (excellent sources of comparative information, but difficult to obtain);

\* Comparable experience and projections by non-parties;

\* Industry averages and statistics; and

\* Pre-litigation projections; similar to budgets, the most useful types of projections are those that were produced in the normal course of business prior to the litigation and not produced specifically for the litigation.(1)

## Terms of the Contract

In some instances, the lost profits calculation is made in relation to a specific contract in which many of the elements of the calculation may be set forth. A damage model can be developed that calculates the revenues and in some cases expenses anticipated under the terms of the contract. Examples of usable variables include the number of units to be sold, unit prices, term or time period, specific machinery plaintiff is to purchase and maintain, inventory or pre-order levels plaintiff is to maintain, methods of delivery, etc.(1)

## Use of the Defendant's Profits

In certain situations, such as cases involving unfair competition or the misappropriation of trade secrets, an accounting of the profits realized by the defendant may be used as the measure of the plaintiff's lost profits. In obtaining an accounting of the defendant's profits, the plaintiff is generally only entitled to receive value of the unjust enrichment of the defendant through disgorgement, i.e., the defendant is required to surrender profits attributable to the misappropriation or bad act to the plaintiff. To the extent that profits are attributable to other factors, the defendant would not have to disgorge those amounts.(1)

In some jurisdictions (and for some causes of action), the plaintiff only has the burden to identify the revenues associated with the misappropriation, whereas the defendant has the burden to prove both the costs incurred in generating the revenues as well as apportioning the profits between the misappropriation and other profit generators. In some trade secret actions, the defendant does not even have to make a profit from actual use of the purloined information, only project profits internally that the plaintiff may use as a basis for a lost profits claim.(1)

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### Previous issues:

**#1 - The general and legal concepts associated with Lost Profits.**

**#2 - The "Before and After" Method of calculating lost revenues.**

1) Excerpts from the AICPA Practice Aid 06-4, "Calculating Lost Profits".



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## Lost Profits and Economic Damages Newsletter

### **Number 4 - Avoided Costs**

The Lost Profits newsletter series focuses on the concepts and methods used to calculate economic damages from lost profits. In this edition, we explain the concepts behind the avoided costs associated with the loss of revenue. The next and final edition of this Lost Profits Newsletter explains Intellectual Property Damages in Non-Patent Cases.

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### **What Are "Avoided Costs"?**

Avoided Costs are those expenses that would have been incurred to produce the revenue that is lost due to the alleged act of the wrongdoer, but were not actually incurred. The avoided costs must be deducted from the calculated lost revenue to arrive at the net lost profits. Experts will usually analyze the plaintiff's cost structure in order to determine the relationship between individual cost elements and categories in relation to the related lost revenue.  
(1)

### **Variable Costs and Fixed Costs**

Variable costs fluctuate and are directly related to the amount of sales or revenues lost such as cost of goods sold or labor to produce a product or service. Fixed costs are those that will be incurred whether or not the revenues are lost, such as rent; although, some rent may be variable depending on the

length of the period of loss.(1) Some costs could be both, such as utilities. For example, electricity cost to run the lights in a facility will be incurred regardless of how much manufacturing is occurring, but would most likely increase greatly if all of the widget making machines were running, but half are idle due to the wrongful act.

## Fixed Costs in Tennessee

According to attorney Ross Pepper in his article published in the *Tennessee Bar Journal*: "No Deduction for Fixed Overhead. The only published case in Tennessee that offers anything more than a cursory explanation of what expenses must be deducted from gross profits to arrive at net profits is *Waggoner Motors Inc. v. Waverly Church of Christ* [159 S.W.3d 59 (Tenn. App. 2004)]. The plaintiff in the *Waggoner Motors* case was an automobile dealer, so the case involved lost profits from the sale of goods, not from services. In *Waggoner Motors*, the court defined net profits as "the expected revenue from the sale of the goods minus the cost of the goods sold minus all the seller's expenses fairly attributable to the sale of the goods." Citing an unpublished Tennessee opinion, the *Waggoner Motors* court further stated that net profit means gross profit less "administrative costs including selling expenses, which are overhead." Finally, in *Waggoner Motors*, in a footnote, the court stated that "fixed overhead expenses" do not have to be deducted from gross revenue to arrive at net profits. Therefore, under *Waggoner Motors*, a plaintiff must deduct all expenses "fairly attributable" to the sale of goods, but fixed overhead expenses are not considered to be expenses encompassed in that phrase."

What Is Fixed Overhead? What expenses are considered "fixed overhead?" In *Waggoner Motors*, the court, again speaking in a footnote, defined fixed overhead expenses as "expenses that the injured party would have incurred notwithstanding the wrongful act." Thus, the plaintiff widget seller in our hypothetical would not have to deduct a portion of its rent or insurance expense for its facilities in order to arrive at its lost net profits under the reasoning of the *Waggoner Motors* case. The rule laid out in *Waggoner Motors*, that a plaintiff does not have to deduct fixed overhead expenses to arrive at an allowable sum for net profits, is consistent with the overwhelming weight of authority from other jurisdictions."(2)

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### Previous issues:

- #1 - The general and legal concepts associated with Lost Profits.**
- #2 - The "Before and After" Method of calculating lost revenues.**
- #3 - The "Yardstick" (or "Benchmark") Method, Terms of the Contract Method and Use of the Defendant's Profits Method of calculating lost revenues.**

1) Excerpts from the AICPA Practice Aid 06-4, "Calculating Lost Profits".

2) Pepper, Ross, "Recovering Lost Profits", *Tennessee Bar Journal*, August 2008 - Vol. 44, No. 8. [Click Here](#) to see the full article.

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## Lost Profits and Economic Damages Newsletter

### **Number 5 - Intellectual Property Damages in Non-Patent Cases**

The Lost Profits newsletter series focuses on the concepts and methods used to calculate economic damages from lost profits. In this final edition, we explain a few of the concepts behind damages associated with the infringement or misappropriation of certain types of intellectual property.

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### **Non-Patent Intellectual Property**

The three main types of non-patent intellectual property are copyrights, trademarks and trade secrets. Each property type carries unique ownership rights, but the damages available upon an infringement or misappropriation are similar with a few exceptions and can include damages based upon a reasonable royalty or lost profits. Generally, non-patent damages differ from patent damages as follows:

1. Damages can be claimed on the owner's losses;
2. Damages can be claimed on the wrongdoer's profits (unjust enrichment), but not both #1 and #2;
3. The owner only has to prove their loss of revenues and the wrongdoer must prove his costs when making a claim on the wrongdoer's profits;
4. The wrongdoer must prove that only a portion of his profits should be attributed to the wrongful act.

If the owner of non-patent intellectual property can prove that he would have both used the property and licensed it to others, several types of damages can be considered:

1. The owner's lost sales since the wrongdoer's costs were lowered which allowed the wrongdoer to lower prices;
2. The added competition lowered the prices in the market;
3. The owner was deprived of royalty payments he would have otherwise charged;
4. Lower royalty payments to the owner from legitimate third party licensees because those licensees may have also sold less product in the marketplace due to the infringement.(1)

### **Damages Issues Unique to Copyrights**

Owners can establish damages by:

1. Comparing the infringement to actual royalties established and charged prior to the act;
2. Following customary industry practices;
3. Calculating the cost to create the property;
4. Using Lost profits of the owner; this is often used when the owner and wrongdoer compete in the same market;
5. Calculating a reasonable royalty to the owner; this is often used when the owner and wrongdoer compete in different markets.(1)

### **Damages Issues Unique to Trademarks**

Owners can establish damages by:

1. Calculating lost sales based upon trends, projections and market share;
2. Measuring lower prices due to the act;
3. Estimating additional costs actually incurred or projected to incur to restore the value, such as corrective advertising.(1)

### **Damages Issues Unique to Trade Secrets**

Many of the damages issues are similar to copyrights and trademarks. The Tennessee Uniform Trade Secrets Act (2) contains this provision for damages:

47-25-1704. Damages.

(a) In addition to or in lieu of the relief provided by § 47-25-1703, a complainant is entitled to recover damages for misappropriation except to the extent that defendant can show a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation and such renders a monetary recovery inequitable. Damages can include both the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss. In lieu of damages measured by any other methods, the damages caused by misappropriation may be measured by imposition of liability for a reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret.

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### **Previous Issues:**

- #1 - The general and legal concepts associated with Lost Profits.**
- #2 - The "Before and After" Method of calculating lost revenues.**
- #3 - The "Yardstick" (or "Benchmark") Method, Terms of the Contract Method and Use of the Defendant's Profits Method of calculating lost revenues.**
- #4 - Avoided Costs.**

(1) Excerpts from Weil, Lentz & Hoffman, Litigation Services Handbook, Fifth Edition, John Wiley & Sons, Inc., 2012.

(2) Tenn. Code Ann. §§ 47-25-1701 through 47-25-1709.

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