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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.

Please remember that each engagement is unique and the concepts discussed in this newsletter may not always apply exactly as stated herein. Note that we are not a law firm and are not offering legal opinions, only our financial forensic interpretations.

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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)

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 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 done 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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