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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.

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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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 lots 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)

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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