



Attaining Reasonable Certainty

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in Economic Damages Calculations (Part II of III)

The purpose of this article—the second of three on this topic—is to provide the reader with an understanding of Chapter 2 (Costs) of the 2018 Practice Aid as well as certain other publications containing a body of knowledge on the best practices for developing “avoided or saved costs,” sometimes referred to by the courts as incremental costs. A prior article dealt with Chapter 1 (Revenue and Growth Rates) and part three will cover Chapter 3 (What Constitutes Best Evidence) of the 2018 Practice Aid and related topics.



In 2015, the American Institute of CPAs (AICPA) Forensic and Valuation Services (FVS) issued a practice aid entitled, “Attaining Reasonable Certainty in [Economic Damages](#) Calculations”. That publication added to the body of knowledge available to experts calculating [lost profits](#) and other forms of economic damages.

In November 2018, the AICPA FVS updated the practice aid, also entitled, “Attaining Reasonable Certainty in Economic Damages Calculations” (hereafter, the 2018 Practice Aid) further adding to the body of knowledge. The 2018 Practice Aid was updated after the AICPA decided that case law research may yield additional topics worth presenting.

The purpose of this article—the second of three on this topic—is to provide the reader with an understanding of Chapter 2 (Costs) of the 2018 Practice Aid as well as certain other publications containing a body of knowledge on the best practices for developing “avoided or saved costs,” sometimes referred to by the courts as incremental costs^[1]. A prior article dealt with Chapter 1 (Revenue and Growth Rates) and part three will cover Chapter 3 (What Constitutes Best Evidence) of the 2018 Practice Aid and related topics.

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The 2018 Practice Aid noted that “[as] with any lost profits calculation, the cases dealing with costs ... often turn on specific facts and analyses, as well as the particular action and law under which the case was brought.”^[2] The 2018 Practice Aid referred to principles articulated by the *Court of Appeals of Texas in Holmes v. Jetall Cos.* where the Court wrote the following: “The common thread running through each of the cases we have summarized is that a party seeking to prove lost profits must provide a model showing how the amount of lost profits can be determined, support that model with facts and assumptions, and demonstrate how the assumptions in the model are reasonable.”^[3]

Determining lost profits involves analyzing a counterfactual world, a world that will never exist allegedly as a result of the defendant's action to be proved at trial (along with liability and causation). For the lost profits calculation to restore the plaintiff back to the position that it would have been in but for the alleged damaging events, the counterfactual world recreates, through (hopefully) reasonable assumptions, the difference between what plaintiff would have made in profits versus what plaintiff made in profits (if any).

The 2018 Practice Aid noted that “Courts have enunciated that such an analysis seeks to measure lost net profits rather than lost gross profits, as the “measure of damages is just compensation for the loss or damage actually sustained.”^[4] Simply put, as a general proposition (and there may be exceptions), economic damages experts calculate and testify as to lost net profits, not lost sales or lost gross profits.

Chapter 2 of the 2018 Practice Aid discussed courts' treatment of the identification of the appropriate avoided costs to include in a lost profits analysis and concluded there was no one checklist that can address the unique facts and circumstances of each case.^[5] “What these cases demonstrate is that courts are focused on the extent to which the practitioner has analyzed and calculated the avoided costs necessary to estimate the lost net profits of the injured party. Courts have been receptive to a practitioner's identification of avoided costs when the record indicates that the practitioner has investigated the nature of such costs and engaged in a reasoned analysis for deducting, or failing to deduct, these from a lost profits calculation.”^[6]

Chapter 2 of the 2018 Practice Aid analyzes approximately a dozen instances when courts have addressed the issue of properly identifying costs that should be deducted to calculate lost net profits in the but-for world. “These cases demonstrate the need for the practitioner to analyze the nature of the lost revenue and the particular costs associated with that particular revenue stream, a theme present in each of the sections in [Chapter 2 of the 2018 Practice Aid].”^[7] The balance of this article attempts to extract the most salient “takeaways” from each of these cases.^[8]

In *Kellmann v. Workstation*,^[9] the Court explained that net profits were the appropriate measure for lost profits, specifically that lost profits were damages for the loss of net income, reflecting income from lost business activity, less expenses that would have been attributable to that activity. A complete calculation of lost profits must be based on net profits, not gross revenue or gross profits.

In *Englewood v. United States*^[10] the Court found that the defendant had breached the contract, awarding \$3.2 million in “lost profits” to plaintiff based on taking “the Potential Revenue less the Actual Revenue received.” The Court found that such a calculation was simply a “gross revenue” calculation that failed to “deduct costs and expenses Englewood saved, that is, did not pay, as a result of the breach.”^[11] As a result of calculating only lost gross revenue, plaintiff had been incorrectly placed in a better position than it would have been in had there been no breach—i.e., had received a “windfall”. The Appellate Court directed the Trial Court to reduce the award by operational expenses plaintiff did not pay but would have had to pay had defendant not breached the contract.

In *Jackson v. Morales*^[12] the Court noted that damages must be proved to a reasonable certainty, not place the injured party in a better position than they otherwise would have been and future lost profits “should reflect net profits as opposed to gross profits.”^[13] At trial, plaintiff testified (he had not hired a damages expert) as to damages by relying on a physician-compensation survey. While the survey contained regional based compensation information, plaintiff could not recall the compensation information for the specific region at issue. The survey did not indicate whether the figures contained therein were gross or net income and plaintiff could not provide additional information. Testimony from others noted the figures in the survey represented gross income from which plaintiff would pay overhead, salaries, supplies, rent and “everything he needed to run his practice.”^[14] The Court made clear that a failure to consider the nature of the information relied upon, as well as appropriately considering and deducting avoided expenses, can be fatal to damages testimony and analyses relied upon by a plaintiff in meeting plaintiff's burden to establish the amount of lost net profits.^[15]

In *Bettius v. National*,^[16] after post-judgment filings by defendant, the Court ruled that “[p]roof of net profits is material evidence in an action to recover damages for lost profits.”^[17] The Court noted that (under Virginia law), professional corporations are different entities existing for separate purposes. By way of summary of the Court's explanations, the professional corporation may distribute its earnings to its shareholders to avoid double taxation on the shareholders who also are the professional employees. That results in the professional corporation's net income for tax purposes being at or near zero, but does not suggest the professional corporation is not earning a profit resulting in professional corporations ending up with little or no recovery. ^[18]

In *Springs v. Blind Maker*,^[19] the Court found defendant's operating costs remained basically the same when plaintiff refused to sell it more material and held that under these circumstances, gross profits were an appropriate measure of lost-profit damages. There are other circumstances where courts have accepted gross profits as the measure of lost net profits. The 2018 Practice Aid^[20] noted that in such instances, the courts have looked at the nature of the business activity and found that costs were not, in fact, avoided.

In *Waggoner v. Waverly*,^[21] wind caused paint used by defendant's painter to blow into plaintiff's car dealership, damaging vehicles. Plaintiff eventually sold all damaged vehicles and continued to pay sales staff even though there were less vehicles to sell. Plaintiff sought damages for the cost of cleaning the vehicles plus lost profits related to Chrysler's decision to cut back its financing for plaintiff's vehicles, asserting that Chrysler's financing cutback was caused by the incident and that the financing reduction impaired plaintiff's ability to acquire and sell vehicles. Plaintiff's expert presented a lost profits calculation comparing pre-incident and post-incident profits. Defendant's expert found that the dealership had experienced a steady decline in pre-incident sales and concluded there were no losses traceable to the incident.

In this litigated dispute, the defendant asserted the plaintiff was not entitled to damages because it had not been profitable at the time of the incident. In essence, rephrasing the 2018 Practice Aid and the Court's decision in the context of a damages claim, lost profits must be

based on net profits, with net profits equaling the expected revenue from the sale of the goods minus the cost of the goods sold minus all of the seller's expenses fairly attributable to the sale of the goods but excluding fixed overhead expenses which would have been incurred notwithstanding the wrongful act.^[22] The Court found the expert failed to include all of plaintiff's variable expenses properly attributable to the sale of vehicles and that the expert's calculation of an average gross profit per vehicle multiplied by the number of vehicles was inconsistent with the requirement that lost profits be based on net profits.

In re: *Mahurkar Patent Litigation*, in deciding that the appropriate compensatory damages to award was lost profits, the Court explained that there were two components to the calculation: sales diverted and the reduction in the price realized for products sold. In analyzing the question of costs necessary for the lost profits analysis, one expert concluded variable costs of manufacturing and selling the products were approximately 28% of selling price, excluding variable overhead costs, such as the expenses of the sales force (on the ground that the same salesperson could handle higher volumes of sales). That expert reasoned the salesperson's salaries and related costs, while incremental costs of production, would not be incremental costs of an expansion in output. Another expert allocated more costs to the variable category (and computed its costs separately for product components) including marketing and sales, storage, packaging and administrative expenses in the analysis of costs (which was at odds with the other expert's conclusion that these types of expenses did not increase with output.)

In this case, the Court found the second expert's analysis of costs superior, stating the following: "Although costs of sales, general overhead, and the like, are not variable for small changes in out-put over the short run, they are most assuredly variable for larger changes over the long run."^[23] The 2018 Practice Aid noted that: "The Court's opinion, in this case, is a reminder to experts to consider all the evidence regarding the nature of costs to be included in any lost profits analysis. Here, the Court focused on the substantial increase in sales that would have occurred in the but-for world of no infringement, finding that although costs may not vary for small changes in the short run, larger changes in sales would result in costs changing over the long run."

In *ERI v. Swinnea*,^[24] the Court noted, "it is not necessarily the case that a company will incur increased expense or overhead, especially where—as evidence here suggests—a corporation was already profitable at the time damages began, and evidence supports an inference that it could have performed profitable services using only its existing resources. Continuing, the Court explained that "[t]his is not a manufacturing scenario, where production costs necessarily exist. Rather, [plaintiff] was a consulting company, which wrote plans and specifications, solicited bids for projects, and completed surveys. Evidence suggests that [plaintiff] would have been able to perform all this service work using its existing employees."^[25] "The Court considered the nature of the business in assessing whether overhead costs and other expenses are an appropriate deduction as an avoided cost. Under the facts of this case, the Court concluded that such costs and expenses would not increase with the relevant lost sales and should not be included in a lost profits calculation. This suggests to the practitioner that the nature of the lost sales and business in question should be a consideration in identifying the relevant costs to include in a lost profits calculation."^[26]

In *RKR v. Associated*, both experts agreed expenses should be deducted from any lost profits calculation but disagreed on the appropriate expenses to include in such a calculation. The Court found defendant's expert's methodology appropriate as "it only took into account the extra overhead that [defendant] incurred in order to service [plaintiff's] contracts over and above what it would have expended without servicing [plaintiff's] contracts."^[27] The Court explained that plaintiff was in the business of renting uniforms, regardless of obtaining the defendant's account. As such, the costs that were expended for overhead would have been expended regardless. The Court explained that since overhead was already ongoing, the only extra overhead to incur to service the defendant's account was contained within the amount that plaintiff needed to expend over and above what plaintiff was already expending to service defendant's account.^[28]

In *eCommerce v. MWA*,^[29] after addressing the appropriate lost revenue to consider in the but-for world, the Court addressed the parties' experts' analysis of the profit margin to use for calculating lost profits through deducting the appropriate costs. To determine incremental costs, Plaintiff's expert had used a regression analysis, while defendant's expert had used an account analysis methodology—"an understanding of the nature of each individual expense line item and how it would be expected to change with changes in revenue, as well as an analysis of how each expense ha[d] historically changed with revenue."^[30] The Court approved the defendant's expert's account analysis methodology, finding "that individualized account analysis can give an expert insight into a company's incremental costs beyond what a pure regression analysis can provide. On the other hand, [the Court] also credit[ed] [plaintiff's] expert criticism that account analysis methodology leaves room for subjectivity and bias, two elements that are absent from a pure regression analysis."^[31]

In *Polaroid v. Eastman Kodak*,^[32] once the Court had determined lost sales, it addressed the need to reduce such sales to lost profits through the incremental income approach. The Court noted: "The incremental income approach recognizes that typically, the cost of producing additional units of the patented product is not as great as the cost of producing the first. This approach separates the costs the patent owner historically incurred into fixed and variable components. Generally, the patent owner would incur the variable costs in producing additional volume but, unless new investment is required, would not incur those costs which are fixed and already paid. Incremental costs are subtracted from incremental revenue to determine lost profits. The incremental income method for determining the cost of making the infringer's sales has been widely used in determining patent infringement damages."

In this case, the plaintiff's expert analyzed fixed and variable portions of expenses using an account analysis method based on general ledger data (examining accounts at the general ledger level and determining whether that cost was fixed or variable). Defendant's expert analyzed variability of expenses by performing a regression analysis to estimate the cost/volume relationship. The Court concluded that "account analysis [was not] the best method for cost accounting in these circumstances."^[33] In contrast, the Court found defendant's expert's use of regression techniques to estimate costs to be "more objective and accurate."^[34]

In *Glattly v. Air Starter*, the Court (quoting from other opinions)^[35] noted that recovery of lost profits must be based on one complete calculation which may often require certain credits and expenses. The Court considered defendant's expert's use of profit margin

information to measure deductible costs. Defendant's expert had relied on profit margin information provided by defendant's president and owner, "not... tied to a particular product or a particular customer" ... "an average profit margin for all of [defendant's] sales" ... "[n]o other evidence... presented to support the profit margin" relied upon by defendant's expert. The Court ruled the evidence presented by defendant's expert was "insufficient to show any amount of reasonably certain lost profits" and that there was a lack of independent investigation into the appropriateness of the profit margin assumptions and defendant's expert did no independent work to verify the reasonableness or reliability of the profit margin assumptions provided and no other evidence was offered in support of those assumptions.

In *HHT v. Nationwide*, defendant's president testified as to the industry norm for net profit and defendant's net profit for the prior year (also explaining what that net profit represented). The Court pointed out that there was evidence of what the net profit margins represented and found that there was legally sufficient evidence to support findings on damages. Although defendant did not use an expert when calculating its lost profits, its president provided information regarding the expenses deducted from sales to arrive at the profit margin used in the lost profits calculation and the Court found the testimony sufficient to ensure that expenses were properly deducted in the lost profits calculation." When confronted with testimony regarding margin information, the cases highlighted in this section show the Court's concern with ensuring that the margin used in a lost profits calculation appropriately includes avoided expenses."^[36]

Readers who are interested in learning more about estimating avoided costs with reasonable certainty in economic damages calculations could also look to the Fannon Text^[37] clarifying that the incremental costs that should be deducted from lost revenues to determine lost profits are generally referred to as "avoided costs"—those costs plaintiff would have incurred in connection with the generation of its projected lost revenues. The Fannon Text cautions that if "analyses of avoided costs fail to address the reasonableness of the expenditures necessary to generate the estimated lost revenues, then the overall lost profits analyses may prove to be unreliable."^[38]

Readers who are interested in delving further into the issue of overhead costs in business interruption claims,^[39] in nonpatent intellectual property damages,^[40] in copyright infringement damages,^[41] in patent infringement damages,^[42] in reasonable royalty calculations^[43] and in contracts for the construction or design of a real estate project^[44] may find valuable, detailed guidance in The Weil Text. That text also discusses^[45] the use of the "incremental approach" (the expert subtracts incremental costs from revenue in determining lost profits) versus the "full absorption approach" (where all types of manufacturing costs: direct material, direct labor, and fixed overhead are included in determining lost profits).^[46]

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^[1]AICPA FVS Practice Aid: Attaining Reasonable Certainty in Economic Damages Calculations: pg. 30.

^[2] *Ibid*, pg. 30.

^[3] *Ibid*, pg. 31, referring to *Holmes v. Jetall Cos., Inc.*, 2016 Tex. App. LEXIS 7213 (Tex. App. July 7, 2016).

^[4] *Ibid*, pg. 31, referring to *South Plains Switching, Ltd. v. BNSF Railway Co.*, 255 S.W.3d 690, 705 (Tex. App. 2008).

^[5] 2018 Practice Aid, pg. 58.

^[6] *Ibid*.

^[7] *Ibid*, pg. 31.

^[8] The reader should recognize that the brief summaries in this article are not a substitute for reading the entirety of Chapter 2 of the 2018 Practice Aid or the important portions of the court rulings themselves.

[9] *Ibid*, pg. 31, referring to *Kellmann v. Workstation Integrations, Inc.*, 332 S.W.3d 679 (Tex. App. 2010).

[10] *Ibid*, pg. 33, referring to *Englewood Terrace Ltd. P'ship v. United States*, 113 Fed. Cl. 718 (Fed. Cl. 2013).

[11] *Ibid*.

[12] *Ibid*, pg. 36, referring to *Jackson HMA, LLC v. Morales*, 130 So.3d 493 (Miss. 2013).

[13] *Ibid*, pg. 37.

[14] *Ibid*, pg. 37.

[15] *Ibid*, pg. 38.

[16] *Ibid*, pg. 38, referring to *Bettius & Sanderson, P.C. v. National Union Fire Ins. Co.*, 839 F.2d 1009 (4th Cir. 1988).

[17] *Ibid*.

[18] In practice, the author has seen this issue sometimes resolved by including the shareholders of a professional corporation as plaintiffs in the litigation. Separately, the author has been involved in a lost profits case where the sole shareholder of a for-profit company was a not-for-profit that received all its income. At trial, defendant argued that the for-profit company never had profits that could be lost as the annual charitable contribution always equaled profits before that amount. At trial, in a triumph for plaintiff, the Court ruled that the jury could not be told that all "profits" were "paid" to a not-for profit shareholder.

[19] *Ibid*, pg. 39, referring to *Springs Window Fashions Div., Inc. v. Blind Maker, Inc.*, 184 S.W.3d 840 (Tex. App. 2006).

[20] *Ibid*, pg. 39–40.

[21] *Ibid*, pg. 40, referring to *Waggoner Motors, Inc. v. Waverly Church of Christ*, 159 S.W.3d 42 (Tenn. Ct. App. 2004).

[22] *Ibid*, pg. 40–41.

[23] *Ibid*, pg. 43.

[24] *Ibid*, pg. 44, referring to *ERI Consulting Eng'rs, Inc. v. Swinnea*, 318 S.W.3d 867 (Tex. 2010).

[25] *Ibid*, pg. 45.

[26] *Ibid*, pg. 46.

[27] *Ibid*.

[28] *Ibid*.

[29] *Ibid*, pg. 48, referring to *eCommerce Indus., Inc. v. MWA Intelligence, Inc.*, 2013 WL 5621678 (Del. Ch. Sep. 30, 2013) (un-published).

[30] *Ibid*, pg. 50

[31] *Ibid*, pg. 50.

[32] *Ibid*, pg. 50, referring to *Polaroid Corp. v. Eastman Kodak Co.*, 16 U.S.P.Q.2d 1481, 1990 WL 324105 (D. Mass. October 12, 1990).

[33] *Ibid*, pg. 52.

[34] *Ibid*, pg. 53.

[35] *Ibid*, pg. 54, referring to *Glattly v. Air Starter Components, Inc.*, 332 S.W.3d 620 (Tex. App. 2010).

[36] *Ibid*, pg. 56.

[37] On and after Chapter 10, Section 3.2 of The Fannon Text.

[38] *Ibid* pg. 234.