Lost Profits, Business Cycles, and the Reasonable Certainty Standard

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National Association of Certified Valuators and Analysts

Part 1: Find Industry and Location-Specific Data

Courts standards require that damages analysis results be within "reasonable certainty", and objective rather than speculative. And while the terms "reasonable certainty" and "speculative" are more terms of art than science, given these standards, it is of vital importance to analyze all relevant factors to the extent permitted by the best data available. And it is the responsibility of the damages expert to present an analysis that is both reasonably certain and objective by engaging in reasonable effort to request and/or research the best data available. The expert that is unable to isolate the wrongdoing from exogenous factors may be challenged on the basis that analysis is speculative.

While varied in their details across jurisdictions, courts standards require that damages analysis results be within "reasonable certainty",[i] and objective rather than speculative.[ii] And while the terms "reasonable certainty" and "speculative" are more terms of art than science, given these standards, it is of vital importance to analyze all relevant factors to the extent permitted by the best data available. And it is the responsibility of the damages expert to present an analysis that is both reasonably certain and objective by engaging in reasonable effort to request and/or research the best data available.

Many elements require analysis in lost profits quantification,[iii] and those to be analyzed from the perspective of the damages expert include the selection of the applicable method, the estimation of lost revenues and avoided costs, financial performance pre- and post-incident, the damages period, mitigation, as well as the economic and industry outlook and their effect on the economic damages claim.[iv] Moreover, damages are to be estimated as the best measure of the negative financial performance resulting from the harmful act, and not the portion of negative financial performance that may be attributable to other factors. In other words, the analysis has to "isolate" the effects of exogenous factors from the effects of the alleged wrongdoing,[v] and provide an estimate of damages that is reflective of the negative impact on financial performance resulting from the action(s) of defendant(s).[vi]

Because businesses operate within the context of the economy, their geographic characteristics, specific

industry, and so on, evidence of a negative change in profits is not sufficient basis to establish a 100 percent causal relationship between a decline in profits and the harmful act. Failure to isolate other sources of negative financial performance opens the door for potentially effective rebuttal through an opposing side's analysis that offers sufficient indications of the potential impact that business cycles, industry, and market conditions may have had on financial performance. This is particularly the case when the quantification of lost profits is conducted a few years removed from the disputed incident, and when significant historical data may be available regarding specific economic and market conditions.

Isolating the effects of external factors from that of the harmful act becomes an issue of both methodology and data. The analysis of lost profits is inter-temporal in nature, and hence requires data to cover periods of time potentially longer that the period of damages. Methodology can only be effectively applied if appropriate, reliable, and sufficient data (or proxy data) is available. This, clearly, is significantly more challenging for newer businesses or business segments for which historical financial data is limited or almost non-existent.[vii] [viii] [ix]

With regards to methodology, an analysis that includes the benchmarking of trends in the historical performance of the business vis-à-vis the historical trends in the economy, the industry, the local economy and market, and so on, is vital in isolating the effects of the wrongful act from the typical fluctuations of the business, particularly when such benchmarking analysis can be extended to a period of time preceding the period of damages. For example, the financial performance of the business in the presence of general or local economic downturns occurring a few years prior to the period of damages, and the timing of the business' recovery from prior, unrelated shocks, can tell a compelling story about the potential magnitude of the effects and duration of the wrongdoing. The actual methodology applied to analyze historical business performance relative to the relevant economy, industry, market, and locality depends on the data available. When data allows, regression models can be powerful tools. However, data quantity and quality limitations requirements may limit the validity of such models.[x] In the presence of data limitations, a simpler approach, such as, through descriptive statistics, may provide the necessary answers.

In regards to historical data on external factors, generally speaking, the closer the data is to the specific characteristics of the business, the better the analysis of the likelihood of the effect of exogenous factors. The more general the data is, the more careful the economic damages expert should be to qualify the limitations of the analysis.

The starting point may be the identification of general downturns in the economy and qualifying information that allows the economic damages expert to evaluate the business cycle and when the downturns, as well as the end of recession periods, may have first been felt. The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER)[xi] conducts in-depth analysis on the business cycles, and publishes extensive data and information on economic recessions and expansions. The process by which the NBER identifies the date of the beginning and end of recession requires that changes must be evident for at least two quarters in economic statistics such as the GDP, unemployment, interest rates, and inflation, and such changes are differentiated from other, smaller, normal economic fluctuations. Data and information available from the NBER can be an initial step into benchmarking the historical performance of the business relative to the economy. However, this data is more general and may not be reflective of the fact that certain industries and localities may experience downturns and expansions with timing differences relative to the rest of the economy and to differing degrees, or the fact that some industries are countercyclical.

Therefore, more specific data is necessary in order to enhance the value of the analysis, and which may be available through industry reports (from industry associations or independent research institutes and corporations), as well as through federal and local government agencies. Industry data specific to metropolitan areas and states is available in the marketplace. In some cases it may be available through a

specific county's publications of financial performance, such as sales tax revenues, and can provide insight into the historical strength of the local market at points in time. Other historical, location-specific data, such as rates of unemployment, income levels, and the value of homes, may also provide insight if applicable to the specific type of business and circumstances.

The objective is to identify and properly use data that can be demonstrated is relevant in isolating the effects of the wrongdoing from exogenous factors, and render the analysis of damages to be more likely qualified as reliable, not unnecessarily speculative, and within reasonable certainty.

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[i] *Celebrity Cruises, Inc. v. Essef Corp., 478 F.Supp. 2d 440, 447-55 (S.D.N.Y. 2007); Texaco, Inc. v. Penzoil Corp., 729 S.W.2d 768, 831, 866.*

[ii] *Russell v. Allianze Life Ins. Co. of N. Am., 2015 U.S. Dist. LEXIS 1946 (Jan. 8, 2015).*

[iii] Fannon, Nancy J.: *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, Third Edition, Volume 1, BVR, 2014.

[iv] Elements to be analyzed aside from the legal functions of counsel.

[v] Lazear, Victoria A. and Mark A. Allen, *Estimating Economic Damages: Identifying Sources of Disagreement Between Experts.* Cornerstone Research.

[vi] *National Market Share, Inc. Sterling National Bank, 392 F.3d 520, 525 (2d Cir. 2004).*

[vii] However, the absence of historical business data does not necessarily preclude a new business from recovering profits. Under certain circumstances, the absence of business specify data does not necessarily preclude the expert from conducting an analysis, if data can be obtained and analyzed based on the principles of the yardstick, for example. Court standards regarding the recovery of lost profits by new businesses with the adoption of the Modern New Business Rule.

[viii] Bollas, Bernadette J., The New Business Rule and the Denial of Lost Profits. Ohio State Law Journal, vol. 48, no. 3 (1987).

[ix] Anderson, Patrick L., *The Economics of Business Valuation, Towards and Value Functional Approach* . Stanford Economics and Finance, 2012.

[x] Gaughan, Patrick A., *Measuring Business Interruption Losses and Other Commercial Damages*. Second Edition. John Wiley & Sons, Inc., 2009.

[xi] http://www.nber.org/cycles/recessions.html