

What's the Damage?

A Primer on Economic Damages in Business Litigation



HAROLD G. MARTIN JR.,
CPA/ABV/CFF, ASA, CFE

Keiter
Richmond, VA
HMartin@Keitercpa.com

In business litigations, CPAs are often engaged by an attorney to assist as consultants or expert witnesses in quantifying or rebutting economic damages suffered by the plaintiff as a result of an alleged harm committed by the defendant. This article presents an overview of the legal principles and professional standards—as well as the key concepts with which a CPA should be familiar—when expressing an expert opinion on damages in business litigation. The discussion of damages focuses on lost profits for illustrative purposes; other measures of damages may also be applicable depending on the particular facts and circumstances. Both federal and state statutes and case law are cited. With respect to state law, Virginia is used as a representative example.

TYPES OF DAMAGES

The overall objective of a civil litigation is to make the harmed party whole and punish the defendant for committing a wrongful act. To accomplish this, assuming that a defendant is found to be liable, the court may award damages to the plaintiff. *Black's Law Dictionary* defines “damages” as: “money claimed by, or ordered to be paid to, a person as compensation for a loss or injury.”¹ As discussed in “AICPA Practice Aid 06-04 — Calculating Lost Profits,” there are three types of damages awarded:²

- *Actual or compensatory*: As compensation for an actual harm
- *Nominal*: As a result of a harm, but the amount is immaterial
- *Punitive*: In addition to actual damages in the event the defendant acted with deceit, malice or recklessness (not recoverable in a breach of contract)

Damages such as lost profits are an example of actual or compensatory damages. Claims for these types of damages usually arise from either a breach of contract or a tort (e.g., fraud, negligence, personal injury, property damage, unfair competition, unlawful misappropriation).

LEGAL PRINCIPLES

To be awarded actual damages in a civil litigation, a plaintiff must prove two critical points to the trier of fact (i.e., the judge in a bench trial or the jury in a jury trial): The defendant was liable (i.e., caused harm to the plaintiff) and the plaintiff suffered economic harm as a result of the defendant's actions.³

Typically, the CPA expert's scope of work will not include the determination of liability (causation of the harm), but will instead focus on the quantification of the resulting damages. However, in order to quantify damages, it is important to understand the principle of causation as it may have implications for the damages calculation.

Causation

Damages are recoverable by the plaintiff only if the act committed by the defendant was the proximate cause of the damages. The plaintiff must prove that the wrongful act committed by the defendant directly resulted in the harm suffered by the plaintiff.⁴ Virginia courts define “proximate cause” consistently, stating it “is that act or omission which, in natural and continuous sequence, unbroken by an efficient intervening cause, produces the event, and without which that event would not have occurred.”⁵

If the attorney instructs the expert to assume causation and limit

the scope of work to the quantification of damages, the expert should still consider whether all of the claimed damages incurred by the plaintiff resulted from the wrongful act of the defendant or there were other contributing factors. For example, if a portion of the plaintiff's losses are attributable to economic conditions, then this portion of the losses would not be recoverable from the defendant.

Reasonable Certainty

The plaintiff must prove damages to a reasonable degree of certainty, i.e., damages are recoverable only if the plaintiff can prove that the damages are reasonable and have been calculated without speculation. Applicable federal or state laws define the required degree of certainty.⁶ The

Continued on next page

expert TIP

Ultimately, the selection of the appropriate approach for measuring damages is a legal matter, and the expert should seek guidance from the attorney regarding applicable statutes or case law.

courts draw a distinction between “certainty in fact” and “certainty in amount,” as stated in *Palmer v. Conn. Railway & Lighting Co.*:

However, it is important to recognize that the calculation of net lost profits pursuant to the standard of ‘reasonable certainty’ does not require exact precision. In an early case, the U.S. Supreme Court separated the certainty regarding the fact of damages from the reasonable certainty as to their amount. ‘Certainty in the fact of damages is essential,’ it ruled: ‘[c]ertainty as to the amount goes no further than to require a basis for a reasoned conclusion.’⁷

The Supreme Court of Virginia has made similar rulings in the following cases: *Lockheed Information Management Systems Company, Inc. et al. v. Maximus, Inc.*; *Maximus, Inc. v. Lockheed Information Systems Company, Inc. et al.*; and *Leroy D. Wood v. Pender-Doxey Grocery Company*.

Historically, owners of new businesses were subject to state statutes that established standards that made it difficult to prove damages. These so-called “new business rules” precluded a new business from collecting damages under the theory that projected future losses were inherently speculative. However, many states have since repealed such rules in order to address the obvious inequity to the new business owner. For example, in 2002, the Code of Virginia, Unestablished business damages; lost profits, § 8.01-221.1, was amended to read: “A party shall not be deemed to have failed to prove lost profits because the new or unestablished business has no history of profits.”⁸

Foreseeability

A third legal principle, foreseeability, is applicable to contract claims.⁹ Under this principle, damages are recoverable only if they are reasonably foreseeable by the breaching party at the time a contract was executed.¹⁰

DAUBERT CHALLENGES¹¹

PricewaterhouseCoopers, LLC, conducted a survey of the reasons financial experts were excluded and published a summary of its findings in “*Daubert Challenges to Financial Experts*”:

- ✓ In 2014, *financial experts were most commonly excluded because their testimony was not considered reliable...*
- ✓ When excluding testimony due to a lack of reliability, *courts most frequently cited a lack of sufficient data or the use of methods that are not generally accepted as reasons for exclusion.*

ADMISSIBILITY OF EXPERT OPINIONS

The Federal Rules of Evidence (FRE) govern the admissibility of evidence at civil and criminal trials in federal courts. FRE Rule 702, Testimony by Experts, sets forth the criteria the court considers to determine admissibility of an expert opinion:

If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an *expert by knowledge, skill, experience, training, or education*, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case [emphasis added].¹²

The majority of states have adopted evidence rules patterned after the FRE for use in their courts.

The U.S. Supreme Court has established additional guidelines for the courts to consider in determining the admissibility of expert opinions. In *Daubert v. Merrell Dow Pharmaceuticals*, the Supreme Court ruled that trial judges must make a pre-trial determination of whether expert testimony should be admitted. The Court outlined a two-prong structure to evaluate

the admissibility of expert testimony:

1. Does the expert qualify in the stated field in accordance with the FRE?
2. Is the proposed testimony scientific knowledge that will assist the trier of fact?¹³

The court also established four factors to consider:

1. Whether the theory can be (and has been) tested
2. Whether the theory or technique has been subjected to peer review or publication
3. The theory’s potential rate of error
4. The theory’s general acceptance¹⁴

While the *Daubert* decision focused on scientific experts, in *Kumho Tire Co., Ltd. v. Carmichael*, the Court ruled that the *Daubert* requirements apply to all expert witnesses.¹⁵ See **Sidebar** above for more information on *Daubert* challenges to financial experts.

PROFESSIONAL STANDARDS

In addition to any relevant legal requirements affecting a testifying expert, a CPA who is a member of the American Institute of Certified Public Accountants (AICPA) must also comply with the AICPA Code of Professional Conduct in any role, including when serving as a consultant or expert witness in business litigation. Further, the AICPA’s *Statement on Standards for Consulting Services, No. 1 (CS 100)*
Continued on next page

applies to all AICPA members who provide consulting services, including consulting or expert witness services in business litigation.

If the scope of work includes valuation services, AICPA members must also comply with the AICPA's *Statements on Standards for Valuation Services* (SSVS Section 100). State boards of accountancy may also impose compliance with AICPA standards on their licensees even if they are not AICPA members. Moreover, as discussed in the AICPA's *Essentials of Forensic Accounting*, triers of fact in legal disputes may essentially extend the Code of Professional Conduct to any CPA in a particular matter as a *de facto* standard for the expected conduct of CPAs regardless of memberships or licensing.¹⁶

ALTERNATIVE MEASURES OF DAMAGES

Determining the appropriate measure of damages in business litigation depends upon the facts and circumstances (as well as applicable statutes). The following three alternative harm scenarios are discussed: temporary, permanent, and temporary followed by permanent.¹⁷

Temporary harm is depicted in **Table 1** at right. In this example, the business had been profitable historically and was projected to be profitable in the future. However, after being harmed, the business experienced a temporary decline in profitability (from the date of harm to the ending date of the damages period), before resuming its normal level of expected profitability. An appropriate measure of damages might be lost profits, which is calculated as the difference between the projected profits "but for" the harm and the actual profits during the damages period.

Permanent harm is presented in **Table 2** at right. In this example, the business also had been profitable historically and was projected to be profitable in the future. However, after being harmed, it had permanent decline in profitability from the date of

TABLE 1 - TEMPORARY HARM



TABLE 2 - PERMANENT HARM



harm into perpetuity. An appropriate measure of damages might be the loss in value calculated as the difference between the value of the business before the harm and the value of the business after the harm.

The appropriate measure of damages in which the business is initially temporarily harmed, but then ceases operations, would be measured using both lost profits and lost value.

Lost profits would be used to measure damages for the period in which the business is temporarily harmed, and lost value would be used to measure the permanent harm at the time operations cease.

DAMAGES PERIOD

The period of time over which damages are calculated typically begins on *Continued on next page*

the date of harm and ends on the date the plaintiff would have been returned to the position it otherwise would have attained but for that harm. For example, in a breach of contract claim, damages are generally projected to a point at which the operations return to normal or over the remaining contract term, if the contract term can be established with reasonable certainty. Alternatively, if the loss in value is permanent, the damages may be determined based upon a projection of the lost economic income into perpetuity.

MEASUREMENT DATE, INFORMATION CONSIDERED, AND DISCOUNT PERIOD

The measurement date for purposes of calculating damages is typically the date of harm or the date of trial.¹⁸ Once the measurement date is determined, it is then necessary to select the information to be considered for purposes of analysis and also to determine how past and future damages will be valued (i.e., consideration of the time value of money). As discussed in *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, there are two primary approaches that are used in practice: *ex ante* and *ex post*.¹⁹ The differences between the *ex ante* and *ex post* approaches consist of three key elements:

- 1) Effective measurement date
- 2) The information to be considered
- 3) The discount period

In applying an *ex ante* approach, the date of initial harm is selected as the measurement date. The damages period begins on the date of harm and ends on the date the harm ceases. Only the information that is known or reasonably knowable as of the date of harm is considered for purposes of the analysis and subsequent events are irrelevant. All lost profits (both past and future) are discounted back to the date of harm. Prejudgment interest for the period between the date of harm and date of trial is then added to the present value of the damages. **Table 3** illustrates the application of the *ex ante* approach.

TABLE 3 - QUANTIFYING DAMAGES— LOST PROFITS *EX ANTE* METHOD

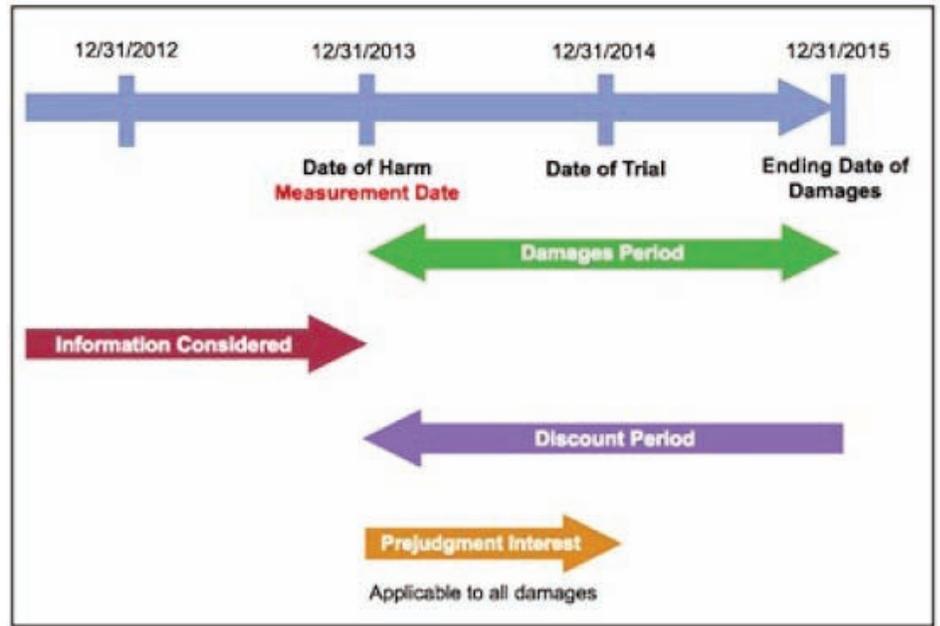
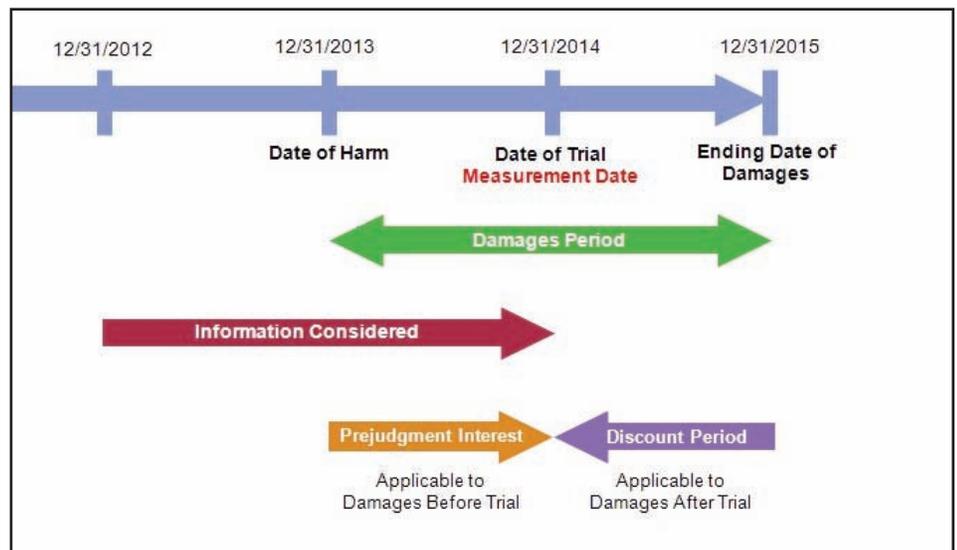


TABLE 4 - QUANTIFYING DAMAGES— LOST PROFITS *EX POST* METHOD



In applying the *ex post* approach, the date of trial is selected as the measurement date. The damages period begins on the date of harm and ends on the date the harm ceases. All information that is known or reasonably knowable as of the date of trial is considered for purposes of the analysis (subsequent events after the date of harm are considered). Damages between the date of harm and date of trial (past damages) are not discounted. Prejudgment interest for the period between

the date of harm and date of trial are added to these past damages. Any future damages after the date of trial are discounted back to a present value as of the date of trial. **Table 4** illustrates the application of the *ex post* approach.

Proponents of the *ex ante* approach note that it properly considers risk in that it measures damages at the date of the harm based on the information known or knowable at that point in time, and this value reflects

Continued on next page

the expected risk of achieving future income. This approach results in making the plaintiff whole based on the circumstances that existed as of the date of harm. Alternatively, the *ex post* approach assumes a certain outcome as it considers information subsequent to the date of harm. This approach results in making the plaintiff whole based on the circumstances that existed as of the date of trial.²⁰

The differences in outcomes that may be obtained using the *ex ante* and *ex post* approaches are illustrated in a 1990 article, "Janis Joplin's Yearbook and the Theory of Damages."²¹ The article presents a hypothetical case involving the theft of a high school yearbook that cost \$5. The yearbook was signed on graduation day by Janis Joplin, who later became a famous rock star. Sometime after this date, but before Joplin became famous, a thief stole the yearbook. After Joplin became famous, her signature was worth \$1,000 to collectors. The theft was discovered and the original owner of the yearbook sued the thief for damages. At issue is whether the damages should be based on the value of the yearbook at: 1) the date of theft (*ex ante*) — \$5, or 2) the date of the trial (*ex post*) — \$1,000. The article proposes that making a plaintiff whole means making it whole as of the date of harm, which ignores hindsight and takes into account uncertainty, and adding to this amount the time value of money.

An alternative view was expressed by the Supreme Court in *Sinclair Ref. Co. v. Jenkins Petroleum Co.* In this case, the U.S. Supreme Court advocated an *ex post* approach with respect to the information to be considered, noting that all available evidence comprised a "Book of Wisdom" that should be evaluated in reaching a decision:

At times the only evidence available may be that supplied by testimony of experts as to the state of the art, the character of the improvement, and the probable increase of efficiency or savings of expense.... This will generally be the case if the trial follows quickly



Franklin M. Fisher and R. Craig Romaine, in their 1990 article "Janis Joplin's Yearbook and the Theory of Damages," examine a hypothetical case that questions whether damages should be based on the value of a yearbook at:

1) the date of theft (*ex ante*) — \$5, or 2) the date of the trial (*ex post*) — \$1,000.

after the issue of the patent. But a different situation is presented if years have gone by before the evidence is offered. Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within.²²

Some experts have adopted a hybrid approach that blends aspects of both the *ex ante* and *ex post* approaches. The hybrid approach is similar to an *ex ante* approach with respect to the measurement date, the damages period, discounting, and calculation of prejudgment interest. However, it is similar to the *ex post* approach with respect to the information considered. Ultimately, the selection of the appropriate approach for measuring damages is a legal matter, and the expert should seek guidance from the attorney regarding applicable statutes or case law.

CALCULATING LOST PROFITS

The approach for calculating lost profits damages involves three steps:

1. Forecast the revenues the plaintiff would have earned but for the harm
2. Estimate the incremental (avoided) costs related to the estimated revenues

3. Calculate the difference between the estimated profits and actual profits

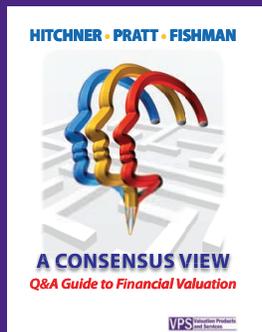
The costs that should be deducted from lost revenues to derive lost profits are incremental or avoided costs. These costs represent those expenses that would have been incurred in connection with the generation of the lost revenues but, because of the harm, were not incurred (or avoided). Incremental costs include variable costs, and may also include certain fixed costs (e.g., those costs incurred to expand production capacity in order to attain projected revenues but for the harm).

DISCOUNT RATE

The discount rate is a factor used to calculate the present value of future damages such as lost profits as of the measurement date. "The Comprehensive Guide to Lost Profits and Other Commercial Damages" presents three alternative types of discount rates:

1. *Safe rate*: Rate of return on a safe investment, determined as a matter of law (e.g., a U.S. Treasury security)
2. *Investment rate*: Rate earned from investing the damages in some type of investment
3. *Risk-based rate*: Rate equivalent to the risk the plaintiff would have incurred had it actually received the damages²³

Continued on next page



“If one could consult a thought leader in the profession, surely the names of Jim Hitchner, Shannon Pratt, and Jay Fishman would be on everyone’s short list. Moreover, to have agreement on the answer would be even better!”

**— HAROLD G. MARTIN, JR.,
CPA/ABV/CFF, ASA, CFE
Partner-in-Charge of Valuation
and Forensic Services, Keiter
Richmond, VA**

“I highly recommend this book for individuals who want a better or more in-depth understanding of the valuation process and methodology.”

**— SCOTT R. SALTZMAN,
CPA, CVA, ASA, MAFF
Managing Member, Saltzman, LLC
President, NACVA
Denver, CO**

“This new work by three of the profession’s top thought leaders will provide insight and clarity in many areas to anyone within our profession. Based on my technical review, I found it a great addition to my BV bookshelf.”

**— RONALD L. SEIGNEUR,
CPA/ABV/CFF, ASA, CVA, CGMA
Managing Partner,
Seigneur Gustafson LLP
Denver, CO**

**To order,
CLICK HERE**

LITIGATION SERVICES - Economic Damages, continued

TAXES AND DAMAGES

Lost profits are generally taxable as ordinary income to the party to whom damages are paid. This is true for either a legal judgment or settlement. Consequently, lost profits should be prepared on a pre-tax basis.

PREJUDGMENT INTEREST

Many jurisdictions provide that a plaintiff should be compensated with interest on lost profits from the date of harm to the date of trial. This type of interest is referred to as “prejudgment interest.” The applicable rate and type (e.g., simple versus compound) is typically defined by statute.

SUMMARY

The ultimate objective of the CPA expert is to assist the trier of fact in understanding the evidence. In business litigation, the opinion expressed by the expert who demonstrates an understanding of, and conducts his work in accordance with, the legal principles, professional standards, and concepts applicable to economic damages will be perceived by the court as more credible. Consequently, his or her testimony may be given more weight by the court in reaching a final decision. *EO*

Reprinted with permission from the Virginia Society of Certified Public Accountants (VSCPA).

I wish to thank the following professional colleagues for reviewing this article and providing their insights: R. James Alerding of Alerding Consulting, LLC, Neil J. Beaton of Alvarez & Marsal Valuation Services, Kristopher J. Boushie of NERA Economic Consulting, Dr. Michael A. Crain of The Financial Consulting Group, and James R. Hitchner of Financial Valuation Advisors.

- ¹ Bryan A. Garner, editor, *Black’s Law Dictionary*, 10th ed. (St. Paul, Minn.: Thomson West, 2014), p. 471.
- ² AICPA Business Valuation and Forensic & Litigation Services Section Practice Aid 06-4, *Calculating Lost Profits* (New York: American Institute of Certified Public Accountants, 2006), p. 17.
- ³ James R. Hitchner, editor and coauthor, *Financial Valuation Applications and Models*, third edition (Hoboken, NJ: John Wiley & Sons, Inc., 2013), p. 990.
- ⁴ AICPA Practice Aid 06-04, p. 19.
- ⁵ *Cohn v. Knowledge Connections, Inc.*, <http://caselaw.findlaw.com/va-supreme-court/1256023.html>.
- ⁶ AICPA Practice Aid 06-04, p. 20.
- ⁷ *Palmer v. Connecticut Railway & Lighting Co.*, 311 U.S. 544, 561 (1941), <http://caselaw.findlaw.com/us-supreme-court/311/544.html>.
- ⁸ LIS Virginia Law, <http://law.lis.virginia.gov/vacode/title8.01/chapter3/section8.01-221.1/>
- ⁹ *Financial Valuation Applications and Models*, p. 992.
- ¹⁰ AICPA Practice Aid 06-04, p. 20.
- ¹¹ “Daubert Challenges to Financial Experts,” Pricewaterhouse Coopers, LLC, <http://www.pwc.com/us/en/forensic-services/publications/daubert-study-2014.html>.
- ¹² Federal Evidence Review, <http://federalevidence.com/rules-of-evidence>.
- ¹³ *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).
- ¹⁴ *Ibid.*
- ¹⁵ *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999).
- ¹⁶ Michael A. Crain, et al., *Essentials of Forensic Accounting*, (New York: American Institute of Certified Public Accountants, 2015), p. 42.
- ¹⁷ *Financial Valuation Applications and Models*, pp. 993-995.
- ¹⁸ Michael A. Crain, “Discounting Lost Profits in Damage Measurements,” *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: BV Resources, LLC, 2014), p. 351.
- ¹⁹ Nancy J. Fannon and Jonathan Dunitz, editors, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* (Portland, OR: BV Resources LLC, 2015), pp. 347-350.
- ²⁰ Roman L. Weil, et al., *Litigation Services Handbook — The Role of the Financial Expert*, 4th edition (New York: John Wiley & Sons, Inc., 2007).
- ²¹ Franklin M. Fisher and R. Craig Romaine, “Janis Joplin’s Yearbook and the Theory of Damages,” *Journal of Accounting, Auditing, and Finance*, vol. 5, no. 1 and 2 (Westport, CN: Greenwood Publishing Group, 1990), <http://web.mit.edu/ffisher/www/janis.pdf>.
- ²² Legal Information Institute (LLI), <https://www.law.cornell.edu/supremecourt/text/289/689>.
- ²³ *The Comprehensive Guide to Lost Profits and Other Commercial Damages*, pp. 347-350.