# <u>Proving Lost Profits In a Subrogation Case: It's No Easy Matter</u>

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As subrogation professionals, it is sometimes easy to overly focus on the liability issues in each case, leaving a thorough damages analysis for another day. However, it is a better practice to perform a complete evaluation of the legally recoverable damages early during the subrogation investigation, so that the true value of the claim can be ascertained and relayed to the subrogating insurer. This is especially so in cases where the business interruption portion of the loss is significant, since an error in proper quantification of the recoverable portion of the business interruption loss could dramatically change the overall valuation of a case -- both for settlement and trial purposes.

Satisfaction of the prerequisites for a business interruption payment per an insurance policy does not automatically mean the losses are legally recoverable in a subrogation lawsuit against a third party. Failing to recognize the potential gap between amounts paid for business interruption and amounts legally recoverable as lost profits may consequently result in unrealistic recovery expectations and unwarranted litigation expenses. Also, a mere cursory review of a claim for lost profits may prove ineffective if a joint prosecution agreement -- based on pro rata shares -- has to be adjusted at a later date to account for damages that are subsequently deemed legally unrecoverable. Prudent subrogation professionals, therefore, should make every effort to evaluate the true value of a claim for lost profits as early as possible.

### ***Identify the Applicable Standards***

An evaluation of a claim for lost profits, like any other claim for damages, starts by identifying the applicable evidentiary standards in your particular jurisdiction. There are two standards to identify: (1) the standard for proving that the lost profits were *caused* by the wrongful act, and (2) the standard for proving the actual *amount* of profits that were lost. Due to the inherently speculative nature of a claim for lost profits, both standards will generally require a more in-depth showing of proof in comparison to the typical claim for damages.

Most jurisdictions require that the causation element of a lost profits claim be satisfied to a degree of "reasonable certainty."[1] Reasonable certainty means "the quality of evidence must be of a higher caliber than is needed to establish most other factual issues in a lawsuit."[2] Many jurisdictions also apply the "reasonable certainty" standard to the proof required to establish the amount of damages.[3] However, in some jurisdictions, once causation is established to a reasonable certainty, the courts arguably apply a more lenient standard to the calculation of the amount of damages. Specifically, some jurisdictions approve lost profits calculations so long as there is a mere "rational basis" for the amount sought.[4] Thus, identifying which standards apply in your jurisdiction will help focus your investigation of the true value of the lost profits claim, and also make it more likely you will recover lost profits as damages via a settlement or at a trial.

***Decide If You Need An Expert***

Once the applicable evidentiary standards have been identified, it is necessary to determine whether an expert is needed to satisfy these standards. Hiring someone, usually a CPA, to act as your damages expert may be a reflex when you receive a case involving lost profits; but the expense of expert testimony is not always warranted. A business owner with personal knowledge regarding the loss of profits is often permitted to testify as to those damages, so long as the damages are straightforward and require only commonsense calculations.[5] For example, damages incurred as a result of unfulfilled orders can most likely be established without an expert. It is only when the calculations are not straightforward that an expert is needed to explain any inferences that must be made from the documents and underlying data.

If expert testimony is necessary, do not assume that the individual who evaluated the first party insurance claim is qualified to testify in the subrogation recovery action. Although utilizing the same person who assisted with the claim adjustment would undoubtedly save on expenses, the attempt to save expenses may prove more costly if the testimony is later excluded under *Daubert*, *Frye*, or some other applicable standard governing the admissibility of expert testimony. Therefore, always confirm the expert's qualifications at the outset by asking for a Curriculum Vitae. It may also be prudent to explore the individual's knowledge of major publications in the field of accounting and the governing Code of Professional Conduct, as these are topics opposing counsel will likely reference when questioning your expert witness. If the damages expert also has "real life" experience in the business she is evaluating, this is most beneficial.

***Understand the Methodology and Crunch the Numbers***

Insufficient expertise can disqualify an expert, but the more common basis for disqualification is the use of an unreliable methodology. In general, there are two methods by which to calculate lost profits: (1) the before and after method, and (2) the yardstick test.

The before and after method is based on a review of the insured's prior earnings and expenses. By reviewing the history of the insured's financials, an expert is able to perform a regression analysis and identify financial trends. These trends are then used to extrapolate the amount of profit the insured would have made had the wrongful act not occurred. The use of a regression analysis to compute lost profits is noted as a reliable methodology in the Reference Manual on Scientific Evidence published by the Federal Judicial Center.[6] In fact, some courts have gone so far as to say a regression analysis should be performed whenever possible.[7] Accordingly, if your expert's methodology consists of something other than the before and after method, you should be on high alert and continue to question the reliability of your expert's opinion on lost profits.

Although the before and after method is the preferred method for calculating lost profits, in some cases there is not sufficient financial history for an expert to review. In those cases, an expert is likely to employ the yardstick test. The yardstick test consists of a study of other businesses comparable to the insured's business. The estimate as to the lost profits incurred is based on what the lost profits of other similar businesses may have been in a similar situation. This method is generally less reliable and not as widely accepted by the courts, because it adds more factors that may not be *exactly* like the insured's business. This in turn creates more opportunities for effective impeachment of the damages expert during cross-examination.

Regardless of the method utilized, it is important to have an understanding of the data upon which the calculations are based. Always ask your expert how many years of financial history she reviewed: The more history reviewed, the more reliable the calculations. Additionally, discuss the types of expenses considered by your expert. Lost profits by definition are lost revenue, minus the expenses that would have been incurred in generating that revenue. Therefore, a lost profits calculation necessarily includes an identification of those expenses that were incurred despite the wrongful act, and those expenses that were avoided in light of the wrongful act. A discussion of these issues will help you assess the reliability of your financial expert's calculations.

***Become Familiar with the Business in Question***

Of course, the expert's calculations can only be as good as the data itself. For that reason, a thorough analysis of a claim for lost profits goes beyond discussions with the expert and includes additional fact findings. For example, if the insured is a small business, its records may not be as precise as with a larger, more established business. As such, you may need to question the insured regarding additional documents that may need to be consulted by your expert to ensure all the appropriate data is factored into the lost profits calculation. Also, closely held companies often pay a salary to owners instead of notating a profit for the company. Although perfectly acceptable for purposes of tax calculations, some courts do not consider owner compensation as an expense with regard to claims for lost profits.[8] If you are in such a jurisdiction, your expert will need to adjust the financial data to recharacterize the owner's salary expenses as profit.

The age of the business in question could also significantly weaken a claim for lost profits. As stated previously, opinions concerning lost profits are inherently speculative. When a business is new, there is much less financial history upon which to base an estimation, making it difficult to establish the claim for damages to the requisite level of certainty by using the before and after method. In *Kenford Co., Inc. v. Erie County*,[9] the New York Court of Appeals acknowledged the problematic nature of lost profits claim by new businesses and stated: “If it is a new business seeking to recover for loss of future profits, a stricter standard is imposed for the obvious reason that there does not exist a reasonable basis of experience upon which to estimate lost profits with the requisite degree of reasonable certainty.”

Results under the yardstick test may also be scrutinized when dealing with new businesses. For example, the claimant’s experience in business ownership, the location of the business, and the saturation of the specific market may make it difficult to predict, per the yardstick test, how the insured would have fared had the wrongful act not occurred. The difficulties in establishing a lost profits claim for new businesses has resulted in some courts barring such claims as *per se* speculative.[10] Although, notably, more and more jurisdictions are moving away from the *per se* bar against lost profits claims for new businesses. In fact, more courts are becoming more liberal in their view by allowing the jury to consider the age of the business when weighing the evidence to determine whether the relevant evidentiary standard has been met.[11] Becoming familiar with the insured’s business is the only way to identify these potential proof problems and their impact on the recoverability of lost profits.

***Conclusion***

The inherently speculative nature of a claim for lost profits requires more attention be given to assessing the recoverability of these types of damages. Identifying the applicable standards and discussing potential problems with your expert and your client early during the subrogation investigation, will help you hone in on the subrogation claim’s true value. Moreover, an early awareness of the nuances of a lost profits claim allows for a more effective and efficient path toward a more robust subrogation recovery.

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[1] *See e.g.*, *Vickers v. Wichita State Univ., Wichita*, 518 P.2d 512, 515 (Kan. 1974).
[2] J. CALLAMARI & J. PERILLO, CONTRACTS § 14-8, at 600 (1987).
[3] *See e.g.*, *Gilmore v. Cohen*, 386 P.2d 81, 82 (Ariz. 1963).
[4] *See e.g.,Waggoner Motors, Inc. v. Waverly Church of Christ*, 159 S.W.3d 42, 59 (Tenn. Ct. App. 2004).
[5] *See Bowen v. Robinson*, 227 S.W.3d 86, 97 (Tex. App. 2006).
[6] National Academy of Sciences and the Federal Judicial Center, *Reference Manual on Scientific Evidence* (3d ed. 2011), *available at* http://www.fjc.gov.
[7] *See Zenith Elecs. Corp. v. WH-TV Broadcasting Corp*., 395 F.3d 416, 419 (7th Cir. 2005).

[8] *See e.g.*, *Springs Window Fashions Div., Inc. v. Blind Maker, Inc.*, 184 S.W.3d 840, 877 (Tex. App. 2006).

[9] 493 N.E.2d 234, 235 (N.Y. 1986).

[10] *See e.g*., *RSB Lab. Servs., Inc. v. BSI, Corp*., 847 A.2d 599, 609 (N.J. Super. Ct. App. Div. 2004).

[11] *See Drews Co., Inc. v. Ledwith-Wolfe Assocs., Inc.*, 371 S.E.2d 532, 534 (S.C. 1988) (commenting on the nationwide trend rejecting a complete bar for new businesses).