

Forensic Analysis and Lost Profits Damages Measurements

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Damages analysts (“analysts”) are often asked to measure lost profits damages in either breach of contract claims or tort claims. Typically, a plaintiff will establish three principles in order to be awarded damages related to a lost profits claim: proximate cause, foreseeability, and reasonable certainty. While it is the primary responsibility of plaintiff’s legal counsel to prove a lost profits claim, the analyst can assist counsel with the task. That is, the analyst can develop a lost profits measurement that is credible and supported by the facts of the case and by relevant market data. In the Horizon Health Corporation v. Acadia Healthcare Company, Inc., decision, the plaintiff could not recover lost profits. This is because the court concluded that (1) the plaintiff’s testifying expert presented an analysis that was speculative and (2) the evidence was insufficient to support the plaintiff’s lost profits claim.

INTRODUCTION

In tort claims and in breach of contract claims, damages are sometimes measured as the loss in monetary value that one party experiences as a result of another party’s alleged wrongful actions.

That wrongful act may be a breach of contract, an act causing injury (e.g., tort, infringement, or fraud), or a violation of a duty that resulted in a loss of revenue, profits, or possibly long-term value (i.e., lost profits).

In a lost profits claim, the plaintiff should prove that the injury and the damages were caused by the defendant. The plaintiff typically retains an analyst to assist counsel in proving that “but for” the alleged wrongful actions of the defendant, the affected business would have realized a certain amount of income (e.g., profits or cash flow) during the damages measurement period.

The objective of the lost profits analysis is to restore the plaintiff to an equivalent economic position “but for” the alleged wrongful act—and not to make the plaintiff better off than it otherwise would have been.

Typically, the plaintiff’s counsel will establish three elements in order for the plaintiff to receive an award of lost profits damages:

1. Proximate cause
2. Foreseeability
3. Reasonable certainty

The plaintiff’s claim is subject to legal standards, and the measurement of damages will be scrutinized by the finder of fact and challenged by the defendant(s).

To assist counsel with the proof of damages, the plaintiff may engage an analyst to measure the lost profits damages. The lost profits damages measurement should be supportable and credible—and should be prepared in accordance with applicable professional standards.

When the plaintiff’s analyst provides a damages measurement that is credible and supported by the facts and circumstances, and by company and market data, meeting the legal standards for damages is more probable. The failure to do so may result in a reduction of the damages award or even a denial of damages.

This discussion summarizes (1) the three elements that a plaintiff should establish to prove a lost profits claim, (2) the importance of selecting an analyst who can credibly measure lost profits damages, and (3) the consequences of failing to provide support for the lost profits damages claim.

The *Horizon Health Corporation v. Acadia Healthcare Company, Inc.*, judicial decision provides an example of how failing to provide support for a damages claim can result in an undesirable outcome.¹

DEFINING DAMAGES

Damages are generally defined as “the sum of money which a person wronged is entitled to receive from the wrongdoer as compensation for the wrong.”²

From a legal perspective, there are three primary types of damages:

1. Actual or compensatory damages are awarded to a plaintiff in order to repay the actual losses incurred.
2. Nominal damages represent a small sum awarded to a plaintiff who has experienced some invasion of rights but did not suffer substantial loss or injury.
3. Punitive damages are awarded not to compensate a plaintiff but rather to penalize the defendant for acting with recklessness, malice, or deceit.

LOST PROFITS DAMAGES

In commercial litigation, the award of lost profits is the remedy that a plaintiff can seek for the damages caused by the wrongful act of a defendant. However, the plaintiff can only seek “net” lost profits as damages.

“Net” lost profit damages are generally defined as “gross revenue that would have been earned but for the wrongful act reduced by avoided costs. Avoided costs are defined as those incremental costs that were not incurred because of the loss of revenue.”³

As presented below, a general method to measure lost profits is provided by the following formula.

$$\begin{aligned} \text{Lost Revenue} - \text{Avoided Costs} + \text{New Costs} \\ = \text{Lost Profits} \end{aligned}$$

Lost profits damages are typically available for claims that involve breach of contract, torts, and infringement of intellectual property. Examples of torts that can cause business lost profits include

fraud, misrepresentation, and unfair competition. Lost profits damages claims related to intellectual property include patents, copyright, and trademark infringement.

ELEMENTS OF LOST PROFITS DAMAGES

Typically, the plaintiff’s counsel should establish three elements in order for the plaintiff to be awarded lost profits damages. The plaintiff should show that:

1. the conduct upon which the claim is based caused the lost profits damages,
2. the parties contemplated the possibility of lost profits damages or that the lost profits damages were a foreseeable consequence of the conduct, and
3. the lost profits damages are capable of proof with reasonable certainty.

These three elements are usually referred to as proximate cause, foreseeability, and reasonable certainty.⁴

Proving proximate cause, foreseeability, and reasonable certainty is the responsibility of counsel. However, the analyst should be aware of the three elements and how they relate to the damages analysis work product.

Proximate Cause

Lost profits damages are recoverable only if the plaintiff can demonstrate that the defendant’s wrongful act was the proximate cause of the loss. This requirement is based on the principle that “but for” the wrongful act, the plaintiff would have not suffered economic losses.

According to the *Calculating Lost Profits Practice Aid*, “there must be a link between the wrongful act and the resulting damages.” Damages cannot be calculated or measured until proximate cause is proven.

There are many variables that can cause lost profits for a business; it is important for the analyst to consider all possible causes of the loss. Although it may not be possible to eliminate the effect of all other possible causes, it is important for the analyst to show that the defendant’s actions were the primary cause of the economic loss.

To support the plaintiff’s claim of—or the defendant’s denial of—proximate cause, it is important for the analyst to understand the following:

1. The subject company's industry and its position within the industry
2. The actual and projected impact of external factors on the performance of industry participants

The damages analysis should be performed over the alleged damages period. Lost profits can only be claimed over the "loss period," which is a finite length of time. The loss period typically begins no earlier than the date of the wrongful act. However, the end of the loss period can vary depending on the underlying cause of the action and the facts of the case.

Statutory authority and/or judicial precedent can have an impact on the reasonableness of the length of the damages period.

Foreseeability

Foreseeability relates to the principle that a breach of contract, tort, or wrongful conduct was likely to cause damage, not that it was foreseeable. The principle of foreseeability is relevant only in contract law.

In breach of contract claims, the parties should determine if lost profits damages were contemplated by the contract parties when they entered into the contract. To do so, the courts will examine the terms of the contract, such as the circumstances known to both parties and what liabilities were assumed by the signing parties.

In breach of contract claims, foreseeability requires the legal determination of whether the plaintiff seeks (1) an award of general damages or (2) an award of special or consequential damages.

General damages are the natural results of the breach of contract. Typically, general damages are easier to claim because they are the profits the non-breaching party would have earned if the contract had been performed.

Special, or consequential, damages are the result of the impact of a contract breach on matters such as the nonbreaching party's ability to fulfill other agreements or inability to operate its business. The plaintiff should prove that the damages were caused by special or peculiar circumstances that the defendant had known and did not communicate at the time of contracting.

The foreseeability rule was first established in an English court over 150 years ago in *Hadley v. Baxendale*⁶—and was later adopted by the U.S. courts. In *Hadley*, the court found that damages are recoverable only if:

1. the damages were reasonably foreseeable by both parties at the time of the contract and
2. the damages arose naturally from the breach.⁷

The foreseeability rule establishes that lost profits damages are available only if the plaintiff can prove that the breaching party knew of the special circumstances that could lead to the economic loss.

Reasonable Certainty

The courts have recognized that lost profits cannot be measured with absolute certainty. Rather, lost profits should be measured based on reliable evidence. The concluded damages measurement should be rational and not speculative. This is the basis of the principle of reasonable certainty.

Nearly every court in the United States has adopted the rule that lost profits must be proven with reasonable certainty. However, the courts have not provided any concrete definition of "reasonable certainty." There are no accepted criteria or standards to determine how reasonable certainty can be met.

Courts have applied the reasonable certainty standard to claims for lost profits by considering a multitude of factors. In most cases, courts deciding on whether lost profits have been proven with reasonable certainty consider the following factors:

1. The court's confidence that the measurement is accurate
2. Whether the court is certain that the injured party has suffered at least some damages
3. The degree of blameworthiness or moral fault on the part of the defendant
4. The extent to which the plaintiff has produced the best available evidence of lost profits
5. The amount at stake
6. Whether there is an alternative method of compensating the injured party⁸

Of the aforementioned factors, the court's confidence in the accuracy of the lost profits measurement is considered to be the most important factor. The court's confidence in the analyst's loss measurement is affected by the basis (i.e., the support) for the measurement.

Courts generally award the injured party lost profits because the analyst-provided loss

measurement was based on verifiable data. The courts generally prefer the before-and-after method for measuring lost profits damages. This damages measurement method generally applies verifiable data from the plaintiff's business in the measurement of the economic loss.

In the before-and-after method, the historical, or actual, profits of the subject business before the damaging event are compared to the profits of the business after the effects of the damages event. The rationale for this method is, "but for" the damaging event, the plaintiff's profits during the two periods would have been similar.

One typical error in the application of the before-and-after method is the failure of the analyst to consider other factors that may have caused the profit loss. These other factors may include changing market conditions or company inefficiencies.

Another analysis error in applying the before-and-after method is the arbitrary selection of the time period in which to calculate the profits for comparison, potentially producing the highest differential in profits and inappropriately favoring the plaintiff.

Another damages measurement method applied by analysts is the yardstick (or comparable) method. The yardstick method also relies on data related to the plaintiff's business.

Applying the yardstick method, the analyst identifies companies or industries that are sufficiently comparable to the subject business. The financial performance of the comparable company is used to project likely revenue and profits the subject company would have realized "but for" the defendant's wrongful actions.

One challenge in applying the yardstick method is identifying a company or industry that is reasonably representative of the subject company. If the yardstick company or industry is not sufficiently comparable to the subject company, then the damages measurement will not meet the reasonable certainty standard.

In a recent judicial decision, the court determined that the plaintiff's analyst did not provide sufficient evidence to support the award of lost profits. This judicial decision is *Horizon Health Corporation v. Acadia Healthcare Company, Inc.*

HORIZON HEALTH CORPORATION V. ACADIA HEALTHCARE COMPANY, INC.

The Texas Supreme Court supported the court of appeals reversal of the trial court award of lost prof-

its damages. The Supreme Court concluded that the Horizon Health Corporation ("Horizon") analyst's damages measurement was speculative and did not meet the reasonable certainty standard.

The Facts of the Case

Founded in 1981, Horizon provides contract management services to hospitals and health care providers to manage their psychiatric and behavioral health programs. In 2007, Psychiatric Solutions, Inc. ("PSI"), acquired Horizon.

In 2010, members of the Horizon upper management team attempted, but failed, to acquire Horizon from PSI. PSI was ultimately acquired by Universal Health Services, a public company.

Subsequently, the PSI CEO left PSI and became CEO of Acadia Healthcare Company ("Acadia"). In May 2011, the Horizon president, Michael Saul ("Saul") proposed a plan to Acadia to form a subsidiary for Acadia to manage mental-health programs for hospitals and other mental-health providers.

Acadia agreed and certain members of the Horizon management team resigned from Horizon in August and September 2011 and created Psychiatric Resource Partners ("PRP").

The new members of PRP recruited John Piechocki ("Piechocki"), a top performing sales person at Horizon, to join PRP and began competing with Horizon, soliciting business from the Horizon prospective and existing customer base.

In October 2011, Horizon filed a lawsuit against certain members of the PRP management (i.e., Saul, Peter Ulasewicz, Barbara Bayma, Tim Palus, and Piechocki—the individual defendants)—for:

1. breach of fiduciary duty;
2. misappropriation of trade secrets, conversion and liability; and
3. tortious interference with existing contracts and prospective business relationships and conspiracy.

In a forensic investigation, Horizon discovered that the defendants had copied company policies and procedures, financial models, and lists of sales leads before resigning from Horizon. Horizon also sued four members of the PRP management for breach of their covenants-not-to-compete and the wrongful solicitation of Piechocki.

The Outcome of the Trial

At trial, the jury delivered a unanimous verdict in favor of Horizon. The jury awarded Horizon:

1. \$898,000 in future lost profits from the Westlake Regional Hospital (“Westlake”) customer contract that the PRP management team had “stolen” from Horizon in violation of the covenants-not-to compete,
2. \$3,300,000 in future lost profits based on the violation of the covenants-not-to solicit committed by certain members of the PRP management team in its recruitment of Piechocki,
3. \$50,000 for the fair market value of the stolen property or trade secrets (i.e., copies of the Horizon computer systems, customer contracts, policies, and procedures),
4. \$5,049.24 for fraudulent travel expenses for trips taken in June 2011 by certain members of the PRP management team when they were employees of Horizon,
5. \$1,750,000 in exemplary damages to deter and retribute the defendants, and
6. \$900,000 in attorney’s fees.



In total, the jury awarded Horizon over \$6.9 million for damages. The trial court accepted the full amount of damages awarded by the jury and allowed a sanction against Saul for \$41,740. However, the trial court did reduce the attorney’s fees award to \$769,432.

The Appeal

Acadia appealed and Horizon cross-appealed on the reduction in attorney’s fees.

Upon review, the court of appeals rendered a take-nothing judgment for Horizon on all its contractual and tort claims, except for theft of property and trade secrets and fraudulent expense reports. The court of appeals determined that the Horizon analyst testimony was speculative and legally insufficient.

Further, the court of appeals ruled that the jury’s award of \$1,750,000 in exemplary damages was unconstitutionally excessive and ordered a new trial on Horizon’s attorney’s fees.

Again, both the plaintiff and defendants filed petitions for review.

In reviewing the trial jury’s findings, the court of appeals considered the law regarding legal-sufficiency of review in which the court is “limited to reviewing only the evidence tending to support the jury’s verdict and must disregard all evidence to the contrary, except contrary evidence that is conclusive.”⁹

The rule concerning the sufficiency of evidence in lost profits for damages is that the recovery of lost profits does not require an exact calculation of damages. However, opinions of lost profits should be proven with objective facts and data to establish reasonable certainty.

The Supreme Court Review

The Supreme Court of Texas agreed with the court of appeals that the evidence was legally insufficient to support with reasonable certainty that Horizon had suffered lost profits from (1) the loss of the Westlake contract and (2) the solicitation of Piechocki.

The Horizon argument for damages on the Westlake contract was based on the assumption that, but for the misconduct of the defendants, Horizon would have won the contract. The Supreme Court disagreed. The Supreme Court found no evidence that Westlake would have entered into a contract with Horizon had it not signed a contract with PRP.

Further, the Westlake contract with PRP contained a provision for an advance in construction costs, which was not found in any Horizon contracts, indicating that the Westlake contract was unique to Westlake and PRP.

At the trial court level, even the Horizon damages analyst had testified that he had no opinion as to whether Horizon would have been able to retain Westlake as a client.

The Supreme Court concluded that the loss of a contract does not establish lost profits with reasonable certainty, and that the evidence did not prove that Horizon would have won the Westlake contract. The evidence only showed that PRP would not have won the Westlake contract without the misconduct of the defendants.

The Supreme Court concluded that there was insufficient evidence to support the Horizon claim for lost profits relating to defendants' wrongful solicitation of Piechocki. The Horizon analyst based his lost profits analysis on:

1. the amount of time Piechocki would have continued working at Horizon but for the wrongful solicitation by defendants and
2. the number of contracts Piechocki would have sold if he had remained an employee at Horizon.

However, the Supreme Court concluded that this evidence was insufficient to establish lost profits with certainty. That was because the Horizon analyst relied on an average profit calculation using a typical Horizon contract—and not on the observable profit margin based on the contracts that Piechocki had sold at Horizon.

In other words, the Horizon analyst failed to tie lost profits of Piechocki competing with Horizon to the profitability of the contracts he had sold at Horizon. Due to the reliance on an under-supported analysis, the Supreme Court concluded that Horizon did not sustain lost profits from Piechocki's departure from Horizon.

Due to legally inefficient evidence presented by the Horizon analyst to support the award of damages, the plaintiff lost approximately \$4.2 million. This \$4.2 million amount had been originally awarded in the first trial.

SUMMARY AND CONCLUSION

In *Horizon Health Corporation v. Acadia Healthcare Company, Inc.*, while both the court of appeals and Texas Supreme Court concluded that legally sufficient evidence demonstrated that all of the individual defendants acted with malice and three of the individuals committed fraud, the courts still did not award lost profits damages to Horizon.

Insufficient evidence was presented to prove the lost profits claim, and lost profits could not be

estimated with reasonable certainty. In the instant case, the analyst was not able to provide a supportable work product and, therefore, damages were not awarded.

As demonstrated in the *Horizon* decision, retaining a qualified analyst to assist counsel by providing a supportable work product is an important component of the damages claim. While it is the responsibility of plaintiff's counsel to prove a lost profits claim, the analyst can support counsel by presenting a lost profits damages measurement that:

1. is calculated using appropriate damages measurements methods,
2. considers the relevant facts and circumstances of the case, and
3. is supported by sufficient evidence.

Notes:

1. *Horizon Health Corporation v. Acadia Healthcare Company, Inc.*, 520 S.W.3d 848 (Tex. 2017).
2. Frank Gahan, "The Law of Damages," 1 (1936), as cited in Bryan A. Garner, *Black's Law Dictionary*, 9th ed. (St. Paul, MN: West Publishing, 2009).
3. Richard A. Pollack, Scott M. Bouchner, Craig M. Enos, Colin A. Johns, and John D. Moyl, *Calculating Lost Profits, Practice Aid 06-4* (New York: American Institute of Certified Public Accountants, Inc., 2006), 19.
4. Jonathan M. Dunitz and Nancy J. Fannon, *The Comprehensive Guide to Economic Damages*, Vol. 1, 5th ed. (Portland, OR: Business Valuation Resources, 2018), 211.
5. Pollack, Bouchner, Enos, Johns, and Moyl, *Calculating Lost Profits, Practice Aid 06-4*, 19.
6. *Hadley v. Baxendale*, 156 Eng. Rep. 145, 151 (Ex. 1854).
7. Pollack, Bouchner, Enos, Johns, and Moyl, *Calculating Lost Profits, Practice Aid 06-4*, 20.
8. Dunitz and Fannon, *The Comprehensive Guide to Economic Damages*, 95.
9. *Bancorp, Inc. v. Culpepper*, 802 S.W.2d 226, 227 (Tex. 1990).



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