Thought Leadership Discussion

A Primer on the Fundamental Elements of Economic Damages Analysis

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This discussion summarizes some of the fundamental elements that go into an economic damages measurement analysis. This discussion considers that the laws related to breach of contract claims and tort claims are complex. This discussion recognizes that many of the participants to a judicial action are not attorneys. Economic damages analysts ("analysts") are among these participants. Understanding some of the elements to a judicial action provides background information and context to the legal aspects that touch on many economic damages analyses. This in turn aids analysts in performing damages analyses and selecting the most appropriate damages measurement methods. Because measuring economic damages is sometimes related to quantifying business value, business valuation analysts are often qualified to perform economic damages analyses.

Introduction

Economic damages awards in judicial actions are meant to achieve two goals.

The first goal is to compensate the damaged party by putting that party in the same economic position it would have been in but for the wrongful act.

The second goal is to deter future wrongful acts from being performed by the defendant. This goal is accomplished by putting the defendant in the same economic position it would have been in (i.e., by disgorging its ill-gotten gain) but for the wrongful act. Of course, the law also provides for other remedies to encourage deterrence, such as punitive damages awards.

This discussion presents an overview of the elements of a judicial action that are relevant to the analysis and measurement of economic damages. The judicial action is based on a wrongful act committed by a "bad actor" that results in damages to another party. The damaged party seeks relief through the courts from this wrongful act by filing a lawsuit.

The wide and expansive nature of the law is complex, and the terminology used by participants in a lawsuit is often used loosely. This fact can leave participants to a lawsuit (other than the attorneys) unclear about the legal process and uninformed about many elements to a lawsuit. This lack of clarity even extends to the professional practitioners who may be involved in providing testifying expert services.

Conceptually understanding the elements to a judicial action can assist the forensic analyst ("analyst") in identifying the measurement methods to apply in the economic damages analysis.

The scope of the economic damages measurement analysis should not extend beyond the expertise of the analyst. While an understanding of the elements of a court action is important, the analyst's work should be performed under the direction of the client's legal counsel.

The following discussions relate to various legal areas surrounding a judicial action. Of course, these discussions do not represent legal opinions or legal guidance.

The Elements of a Judicial Action That Are Relevant to Economic Damages

The elements of a judicial action that are relevant to the analysis and measurement of economic damages include (1) legal standards, (2) types of courts, (3) types of claims, and (4) types of remedies. Each of these elements is addressed in the following sections.

Legal Standards Related to a Judicial Action

An economic damages measurement analysis is informed by a number of important legal standards that should be met to support the economic damages claim. These legal standards are important as they affect determinations in a claim with respect to culpability and veracity.

The legal standards are usually addressed in a later stage of the lawsuit. However, if the facts and circumstances of the lawsuit do not satisfy these legal standards, while the lawsuit may be valid in terms of the defendant's performance of a wrongful act, the plaintiff may not be eligible to receive any pecuniary relief.

Prior to filing the judicial action, the plaintiff's counsel will evaluate the lawsuit based on the merits of addressing these legal standards (as well as other considerations). The legal standards discussed below are (1) causation, (2) reasonable certainty, (3) economic loss doctrine, (4) proximate cause, (5) foreseeability, and (6) duty to mitigate.

Legal Standard of Causation

The legal standard of causation relates to the connection between the defendant's wrongful acts and the damages suffered by the plaintiff. It is noteworthy that causation is not established by mere correlation, even if the correlation is logical, strong, and direct. Causation is more than correlation.

Causation is established only when the wrongful acts of the defendant are the primary reason for the plaintiff's damages and there are no other factors that could have caused or contributed to the plaintiff's damages. This latter consideration may be subtle, but it is important. Some courts have challenged the analyst's credibility and even admissibility of the expert's testimony because the analyst did not convincingly establish the link between (1) the defendant's wrongful act and (2) the plaintiff's economic damages.

It is in the best interest of the plaintiff's legal counsel team (including all retained experts) (1) to address other factors that could have caused the plaintiff's damages and (2) to proffer some explanation as to why these factors are not relevant in the subject case.

Because the legal standard of causation may differ by jurisdiction, and given the nature of the legal claim (wrongful act), causation may be established by specifically addressing the following criteria.

First, causation may be established by simply linking the defendant's wrongful act directly to the plaintiff's damages in a way that demonstrates a relationship of cause and effect—rather than just correlation.

Second, it is important for the analysis (1) to provide a discussion of the rationale that clearly links the defendant's wrongful act to the plaintiff's damages and (2) to establish a reasonable expectation that the plaintiff's damages are the result of the defendant's wrongful act.

Third, establishing causation involves (1) addressing any and all other factors that could also have harmed the defendant and (2) discussing why these factors are not relevant.

Finally, it is important to understand that a plaintiff's economic damages may not be caused entirely by the defendant's wrongful act. For example, consider a shareholder action against a corporation where wrongful conduct resulted in a reduction of stock price. If the wrongful conduct occurred in times where the whole market experienced declining returns, then part of the plaintiff's economic decline may be related to the overall market decline.

The overall market decline would not be included as economic damages, and the additional portion of the plaintiff's economic decline would be related to the defendant's wrongful act. That is, the non-market-based decline would be related to, or caused by, the defendant's wrongful act. In this scenario, any market economic decline should be (1) addressed and separated from the plaintiff's total economic decline and (2) excluded from the concluded economic damages.

In commercial litigation, while causation should be demonstrated in a lawsuit, causation does not necessarily need to be established by the plaintiff's damages analyst. Depending on the nature of the business and the nature of the legal claims, causation may be established by other constituents to the lawsuit, such as an industry expert, a fact witness, the defendant's legal counsel, and so forth.

Legal Standard of Reasonable Certainty

The legal standard of reasonable certainty is guided by Section 352 of the *Restatement (Second) of Contracts* (1981) that reads, "Damages are not

recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."[1] In other words, the damages should be provable, and not speculative.

There remains no consensus on the measure of reasonable certainty as individual state courts and federal courts have advanced their own opinions as to the nature of reasonable certainty. The courts should strike the right balance in evaluating whether reasonable certainty is established or not. If the bar is set too high, this would encourage potential unscrupulous actions of the defendant. If the bar is set too low, this would encourage the plaintiffs to undertake judicial actions, because the burden of proof is easier to establish.

Legal Standard of Economic Loss Doctrine

The recoverability of damages—and the nature of damages—differ between a tort case and a breach of contract case. The legal standard of economic loss doctrine sets out the extent of loss a plaintiff can recover in a tort case.

Under a contract, the parties to the contract determine the respective rights and duties. If one party believes the other has breached a duty under the contract, a suit can be raised against the breaching party. In addition to the contract, the Uniform Commercial Code also provides guidelines for the rights and responsibilities of the parties to a contract.[2]

On the contrary, a tort involves a breach of a civil duty (not a contractual duty). Torts are sometimes thought of as personal injury cases, but the wrongful act extends beyond this. Torts include such wrongful acts as assault, battery, false imprisonment, defamation of character, interference with business, unfair competition, tortious interference with contract, trespass, negligence, and infringement of protected intellectual property rights.

Under tort law, an injured party can bring a civil lawsuit to seek compensation for a wrong done to the party or to the party's property.[3] In other words, the plaintiff can only recover the losses related to personal injury or property loss based on the economic loss doctrine in a tort case. Thus, recovery of actual monetary losses is precluded under tort law based on the economic loss doctrine.

Under a breach of contract claim, the economic loss extends to monetary losses. This definition of the economic loss doctrine is by no means invariable. While this narrow definition of the economic loss doctrine—that plaintiff's recovery is limited to losses related to personal injury loss or property loss—is the majority view held by most states and federal jurisdictions, a minority of states and federal jurisdictions extend the damages available to plaintiffs to include monetary losses.

In cases under tort law, the damages expert may seek specific guidance from counsel regarding the scope of eligible damages prescribed under the economic loss doctrine.

Legal Standard of Proximate Cause

The legal standard of proximate cause limits the plaintiff's economic damages to the point at which the defendant's actions cease to "proximately cause" harm to the plaintiff. In other words, damages suffered by the plaintiff do not continue indefinitely.

The determination of proximate cause can be understood in the context of the two components of causation: (1) actual (but-for) cause and (2) legal (proximate) cause.

Actual cause has been defined by some courts in terms of a but-for test, "The defendant's conduct is a cause of the event if the event would not have occurred but for that conduct; conversely, the defendant's conduct is not a cause of the event if the event would have occurred without it."[4]

Said another way:

- There is causation if the following statement is true: if there was no defendant, there would be no damages to the plaintiff.
- There is no causation if the following statement is true: if there was no defendant, there still would be damages to the plaintiff.

While actual cause can cast the universe of factors that caused the plaintiff's damage wholly on the defendant, legal cause acts in a manner that "tempers the expansive view of causation."[5] In other words, legal cause puts a limit on the defendant's liability to a demarcation point beyond which "the law arbitrarily declines to trace a series of events."[6]

Another court explained legal cause as follows:

> The law does not undertake to charge a person with all the possible consequences of a wrongful act, but only with its probable and natural result; otherwise, the punishment would often be entirely disproportioned to the wrong, thereby impeding commerce and the ordinary business of life, and rendering the rule [of causation] impracticable.[7]

Legal Standard of Foreseeability

In general, the legal standard of foreseeability limits the plaintiff's ability to recover damages from the defendant to the extent that the results or

consequences of the defendant's wrongful acts are reasonably foreseeable.

The legal standard of foreseeability is related to the legal standard of proximate cause. Foreseeability is one of the fundamental tests that can be applied to aid in determining proximate cause. In other words, proximate cause can be tested by reasonable foreseeability.

Legal Standard of Duty to Mitigate

The legal standard of the duty to mitigate is another condition placed on the plaintiff in order to be awarded damages. This condition means that the plaintiff is required to take reasonable steps to reduce or altogether eliminate the loss that was caused by the defendant's wrongful act. Failure to take reasonable steps to minimize damages may result in the damages award being reduced.

Types of Courts

The U.S. court system, historically originating from the English court system, is made up of civil courts and criminal courts. Civil courts render compensatory and equitable remedies. Criminal courts primarily render the remedy of incarceration. Disputes, where analysts are brought in to perform a damages analysis, are tried as civil disputes in the U.S. civil court system.

Within the U.S. civil court system, two discrete types of civil courts have historically existed: (1) courts of law and (2) courts of equity. Courts of law, awarding remedies (relief) based on pecuniary damages, adjudicate disputes in accordance with federal and state law. Courts of equity adjudicate disputes in accordance with a set of principles based on fairness, equality, moral rights, and natural law, rather than a strict interpretation of the law. Courts of equity award remedies in the form of an action, rather than a monetary payment.[8]

Most states have merged their courts of law and courts of equity. Consequently, courts now administer both pecuniary remedies and equitable remedies. Depending on the nature of the dispute, courts may also administer a combination of pecuniary remedies and equitable remedies.

However, there still remain some state courts that have not merged their courts and have retained their courts as either courts of law or courts of equity. Perhaps the most notable state court that has retained its court of equity is the Delaware Court of Chancery. Its website states, "Delaware's Court of Chancery is the nation's preeminent business court. As a court of equity, the Court of Chancery has jurisdiction to hear and determine cases involving equitable rights (such as trusts and fiduciary duties) and equitable remedies (such as injunctions and specific performance)."[9]

Types of Claims

There are three types of claims that can arise in a judicial action:

1. A contract claim
2. A tort claim
3. A statutory claim

A Contract Claim

A contract claim arises when the dispute relates to a contract entered into by two or more parties. These parties to a contract—parties in privity or parties with privity—and third parties identified in the contract are the only parties who can raise contract claims. Thus, parties not in privity cannot seek remedies in a contract claim. However, the parties may seek remedies in a tort case or a statutory case depending on the nature of the circumstances.

Elements that should exist in a judicial action of a contract claim, in addition to the applicable legal standards discussed previously, include the following:

- The existence of a bona fide contract
- The party claiming the breach must perform the contract or demonstrate intent to perform the contract
- A material breach of the contract by the defendant to the contract claim
- Damages that are caused by the breach

In a contract claim, the purpose of the damages award is to place the injured party in substantially the same position as the party would have been in had the contract been performed and not breached.

A list of types of typical contract claims include, but are not limited to, the following:

- Breach of contract
- Fraud in the inducement
- Misrepresentation
- Breach of express or implied warranty
- Breach of covenant of good faith and fair dealing

A Tort Claim

A tort claim is a civil wrongful act that arises when a dispute is not related to a contract. The party committing the tort is the tortfeasor. While a contract

claim relates to a breach of contract, a tort claim typically relates to a breach of a fiduciary duty. Generally, in a tort claim, the purpose of the damages award is to place the injured party in substantially the same position as that which was occupied prior to the tortious activity. This purpose of the damages award in a tort claim is essentially the same purpose as that in a contract claim.

The three common elements that should be present in every tort claim are as follows:

- The existence of a legal duty to the plaintiff
- The breach of that legal duty by the defendant
- The plaintiff experienced harm or damages as a result of the breach of duty

A list of types of typical tort claims include, but are not limited to, the following:

- Defamation
- Tortious interference with contract
- Theft of trade secrets
- Breach of fiduciary duty
- Negligence
- Conversion
- Infringement
- Expropriation
- Condemnation
- Misappropriation
- Wrongful termination

A Statutory Claim

A statutory claim arises when the wrongful act is performed in violation of a federal or state statute. Therefore, the guidelines vary by state or local jurisdiction.

Cases that commonly result in statutory damages include the following:

- Breaches of intellectual property or copyright law
- Public policy violations
- Tax evasion

Common judicial actions that arise based on statutory claims relate to the following:

- Copyrights – governed by 17 U.S.C. section 504. According to section 504(b), "The copyright owner is entitled to recover the actual damages suffered by him or her as a result of the infringement, and any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages."
- Trademarks – covered under the Lanham Act, trademarks are generally governed by 15 U.S.C. section 1117. Trademarks are also governed by state trademark registration acts. Similar to copyrights, infringement damages is measured as the sum of the actual damages of the trademark holder and the infringer's profits.
- Patents – governed by 35 U.S.C. section 284. This statute awards the patent holder adequate compensation for the patent infringement. Damages can range from a reasonable royalty payment on the infringed patent to the lost profits the patent holder would have earned but-for the patent infringement by the defendant.
- Trade secrets – solely governed by state statutes. In court actions related to trade secrets, counsel should advise the analyst of the relevant trade secret statutes and any relevant judicial precedent. In most states, some version of the Uniform Trade Secrets Act has been adopted.

Types of Remedies

There are three types of remedies that can be awarded in a judicial action. These remedies generally relate to the types of courts in which the judicial actions are filed. These three types of remedies are (1) compensatory remedies, (2) punitive remedies, and (3) equitable remedies.

Historically, compensatory remedies and punitive remedies have been awarded in courts of law, while equitable remedies, as its name suggests, have been awarded in courts of equity. Since these two courts have been merged in most states, all three types of remedies may be awarded in civil court actions. Also, all three types of remedies may be awarded in both contract cases and tort cases.

Compensatory Remedies

Compensatory remedies are pecuniary and involve measurements of economic damages. There are a number of types of compensatory remedies. The main types of compensatory remedies are (1) expectation remedies, (2) reliance remedies, (3) restitution or disgorgement remedies, (4) anticipatory breach remedies, (5) ex ante remedies and ex post remedies, (6) consequential remedies, and (7) statutory remedies.

Expectation Remedies

Expectation remedies are measured from the plaintiff's perspective and are related to the plaintiff's loss. Expectation remedies typically apply in contract claims in which the harming party breaches a contract with the harmed party. Expectation remedies seek to make the plaintiff whole as if the defendant had fulfilled the promise or bargain of the contract in full.[10]

Courts sometimes refer to expectation remedies as the "benefit of the bargain" because it seeks to compensate the plaintiff for the benefit of the bargain that was lost as a result of the wrongful act.

Reliance Remedies

Reliance remedies are also measured from the plaintiff's perspective and are also related to the plaintiff's loss. Reliance remedies typically apply in tort claims and in some contract claims as well. Reliance remedies unwind a transaction and restore the harmed party to the same position had the transaction not existed in the first place. In the case of torts, compensation for nonpecuniary losses such as pain and suffering would also be included. Reliance remedies often may include out of pocket costs, and, when appropriate, may even include compensation for lost opportunities.

Reliance remedies that strictly involve the unwinding of a transaction as if it did not exist may result in an economic damages estimate that is less than that of expectation remedies. However, in cases where lost opportunities are included in the damages measurement, reliance remedies may approach expectation remedies.

Restitution or Disgorgement Remedies

Restitution or disgorgement remedies are measured from the defendant's perspective, instead of from the plaintiff's perspective. These remedies are related to the defendant's gain, instead of the plaintiff's loss. Also known as unjust enrichment or ill-gotten gains remedies, collectively, these remedies are referred to here as "restitution" remedies.

Restitution remedies act in the same way as reliance remedies, except from the perspective of the defendant. Restitution remedies unwind a transaction and restore the breaching party to the same position had the transaction not existed in the first place.

The compensatory remedy of restitution is analogous to the equitable remedies of specific performance and injunctive relief (discussed in subsequent sections).[11]

Courts can award multiple remedies—such as restitution, expectation, and others—so long as the restitution does not overlap any of the other remedy measures. Accordingly, counsel may seek a combination of expectations remedies and restitution remedies and direct the analyst to quantify both of these damages.

Anticipatory Breach Remedies

As the name implies, an anticipatory breach occurs when either party to a contract notifies the other that it will not perform its duties under the contract. An anticipatory breach also occurs when the nonbreaching party assumes there will be a breach because of the actions of the breaching party. In this case, the nonbreaching party may sue when the anticipatory breach occurs and does not need to wait until the actual breach.[12]

Ex Ante Remedies and Ex Post Remedies

Ex ante remedies and ex post remedies primarily have to do with considerations of available information and the measurement date. In an ex ante analysis, the measurement date is the date of the wrongful act and the available information is the information that is known or knowable at the date of the wrongful act. Information about subsequent events are not considered in an ex ante analysis.

In an ex post analysis, the measurement date is the date of the analysis (a current date) and the available information is all the information that is known or knowable as of the current date. Thus, events subsequent to the date of the wrongful act are considered in an ex post analysis.

The simplest example to illustrate the implications of an ex ante analysis versus an ex post analysis is the lottery ticket example. The harmed party purchases a lottery ticket for one dollar, which is stolen by the harming party. One week later, this ticket is the winning lottery ticket and the harming party receives $100 million.

Based on an ex ante analysis, the harmed party is awarded one dollar to be made whole, given what was known or knowable at the date at which the ticket was stolen. Based on an ex post analysis, the harmed party is awarded $100 million to be made whole, given at the time of the lawsuit, it was known that the stolen ticket was worth $100 million.

Note that either of these analyses is not a complete damages analysis method on its own. Instead, each method includes certain considerations, namely information and damages date, that are included in a damages analysis method. For example, in a lost profits method, the selected damages date and the information known on the damages date determines

whether the lost profits damages measurement is ex ante or ex post.

Generally, the analyst will perform either an ex ante analysis or an ex post analysis based on (1) the information available, (2) what makes economic sense given the facts and circumstances of the case, (3) what makes economic sense based on analysis of the data, (4) instruction from counsel, and (5) what the courts have accepted in the particular jurisdiction in which the case is being litigated.

Consequential Remedies

Consequential remedies, as the name implies, are additional damages that arise as a consequence of the damages directly related to the wrongful act. Consequential damages arising from a breach of contract claim can be reasonably foreseen at the time the parties entered into the contract.[13]

A classic example of a breach of contract consequential damages is a construction contract where the builder completes the construction of a hotel. However, the building has plumbing issues such that (1) the owner incurs costs to fix the plumbing issues (direct damages) and (2) the owner losses profits because the plumbing issues delayed the opening of the hotel (consequential damages).

Statutory Remedies

Statutory claims are discussed above in the section related to types of claims. Statutory remedies refer to standard payments that compensate for injuries, losses, or civil violations. Statutory remedies accelerate judicial actions because there is no requirement for a measurement of actual economic damages and the support for the calculations.

The following are examples of common statutes and their statutory damages:[14]

- Copyrights – statutory damages for copyright violations range from $750 to $30,000
- Trademarks – statutory damages for trademark violations, including unfair competition, infringement, and willful dilution, range from $1,000 to $250,000

Damages analysts may or may not be involved in the calculation of statutory damages.

Punitive Remedies

As mentioned above, one of the main goals of an economic damages award is to deter future wrongful acts from being performed by the harming party. A damages analysis will seek to quantify the ill-gotten gains achieved by the harming party and counsel will pursue the compensatory remedy of restitution to disgorge the harming party of its ill-gotten gains.

The restitution remedy, then, will result in placing the harming party in the same economic position it would have been in but for the wrongful act it performed. This remedy may or may not successfully deter the wrongful acts of harming parties.

Punitive remedies are special damages awarded in addition to actual damages. As such, punitive remedies are specifically designed to punish wrongful acts as a further deterrent. Punitive remedies are not tied directly to the plaintiff's losses or the defendant's gains.

Courts often award punitive remedies when the harming party exhibits deceitful, malicious, reprehensible, or reckless conduct. Courts do not award punitive damages in breach of contract court actions.[15]

This is because the policy of contract law is not to compel adherence to contracts, but only to require each party either to perform under the contract or compensate the other party for any resulting injuries.[16]

Courts may also award punitive remedies in addition to compensatory remedies in connection with a tort claim.[17]

Equitable Remedies

Historically, equitable remedies were the remedies that were awarded in courts of equity and could not be awarded in a court of law where damages awards were pecuniary. Even though courts of law and courts of equity are merged in most U.S. states, these merged courts continue to render equitable remedies.

Equitable remedies include the following:[18]

- Rescission – undoing or reversing actions taken under a contract
- Reformation or rectification – restructuring the terms of a contract to prevent an inequitable outcome
- Specific performance – compelling performance of the contract according to its terms
- Injunction – compelling a party from refraining from certain acts
- Subrogation – providing that one party can assume the rights of another
- Account of profits – assessing profits improperly gained by a fiduciary that breached its duty (disgorgement or unjust enrichment)

- Declaratory relief – seeking a preemptive court ruling as a common mechanism of relief in divorce and certain contract matters

Although rescission is a nonpecuniary, equitable remedy, depending on the facts and circumstances of the case, a pecuniary restitution remedy may be applicable—in addition to the equitable remedy of rescission.[19]

A landmark Delaware Supreme Court decision concluded that in the context of a self-dealing transaction involving the duty of loyalty, the rescissory damages standard is based on requiring a disloyal fiduciary to disgorge any unjust enrichment derived from his wrongdoing. The court stated:

> [T]he absence of specific damage to a beneficiary is not the sole test for determining disloyalty by one occupying a fiduciary position. It is an act of disloyalty for a fiduciary to profit personally from the use of information secured in a confidential relationship, even if such profit or advantage is not gained at the expense of the fiduciary. The result is nonetheless one of unjust enrichment which will not be countenanced by a Court of Equity.[20]

With the exception of some rescissory damages cases, equitable remedies may not involve the analyst performing an economic damages analysis.

Economic Damages Analysis

Performing the economic damages analysis is the final element of this discussion. All of the elements previously discussed have a direct or indirect impact on the nature of the damages analysis and the types of damages methods the analyst will adopt. Analysts who are also business valuation specialists are often qualified to perform damages measurement analyses. This is the case for several reasons.

First, measuring economic damages is often related to quantifying the value of a business. This relationship can be seen by comparing (1) the methods of measuring economic damages and (2) the methods of valuing a business.

Second, business valuation analysts frequently enter the field of economic damages analyses.

Third, one of the damages measurement methods is the lost business value method. This measurement method can be very problematic for analysts who are not trained in business valuation. This is because, in the fluid and changing landscape of many litigation cases, the appropriate damages method may not be evident at the beginning of the case. If at an advanced stage in the case it becomes clear that the best damages measurement method is the lost business value method, this creates a potential problem for the analyst who does not have experience performing business valuations.

Fourth, because analysts who are not also business valuation specialists are less experienced in performing a lost business value method, they are less likely to select this damages measurement method—even if it may be the most appropriate method.

Considerations

The analyst should examine the following considerations when selecting the appropriate damages measurement methods:

1. The type of claim that is set forth in the judicial action
2. The requisite legal standards supporting the types of claims set forth in the judicial action
3. The type of asset or business that is subject to the damages analysis
4. If applicable, the existence of (a) case law, (b) judicial precedents, or (c) a particular judge's precedents with respect to preferred methods
5. Statutory measures
6. The input and instruction of counsel

As a condition for commencing a judicial action, counsel may either assume or determine that the types of claims being advanced in the lawsuit satisfy the required legal standards. However, this may not be true in every case. Also, such determinations may not be definitive until the case is underway and the documents become available through discovery. For this reason, counsel may ask the analyst to perform some initial analyses in order to ensure that the remaining legal standards can be satisfied before going further into the lawsuit. Conversely, the analyst may raise these issues with counsel early in the case. The analyst may perform some of these initial analyses before investing too much time and expense into the case, in order to ensure that any of the legal standards that relate to the damages analysis are satisfactory and supportable.

It is important to note the inherent scope and objectives that should be part of the analyst's work. First, the analyst provides an independent and impartial analysis and is not an advocate for the client. Second, the analysis performed by the

analyst is theoretically intended for the court's benefit, even though the analyst is retained, and paid, by the client. Therefore, the analyst should be judicious about what assumptions he or she is willing to accept and the scope of his or her opinions.

A less than cautious approach by the analyst may (1) put the damages analysis at risk in the subject lawsuit, (2) expose the analyst to a *Daubert* challenge, and (3) compromise the credibility of the analyst. The damages analysis prepared by the analyst is not necessarily required to address all, or maybe any, of the legal standards related to the claims of the lawsuit so long as these legal standards are addressed by other constituents to the case. For example, counsel, another expert, a fact witness, or some other constituent may address the required legal standards.

General judicial precedent and a specific judge's precedent may both play a role in the selection of the appropriate damages measurement method. Examples of generally accepted methods used in certain types of cases include royalty rate and lost profits calculations in patent cases, trendline analysis in business interruption insurance cases, event studies in securities cases, and market share analyses in antitrust cases.

In other types of cases, there may be multiple appropriate damages measurement methods and each of these methods may yield different results. For example, in patent cases, if there are not enough data to apply the lost profits method, an alternative method may be a royalty rate method.

Thoughtful consideration should be exercised in selecting the appropriate damages measurement method to apply. If the analyst selects a damages measurement method that will simply generate a higher economic damages calculation than alternative methods, but the analysis includes assumptions that may be questionable, this may result in the damages analysis being rejected by the court. The analyst should rely on a set of assumptions and supporting data that are clear, understandable, logical, and supportable both (1) in written form in the expert report and (2) orally in deposition and trial testimony.

A final consideration regarding the selection of a damages measurement method is that of making a concerted effort to determine the true harm to the plaintiff—and not just performing a calculation. For example, let's say a start-up company enters into a contract with a party to sell its products at both specified contractual prices and specified contractual volumes over the term of the contract. If, as a result of the defendant's breach, the plaintiff becomes financially distressed and is forced to file for bankruptcy, the plaintiff may file a lawsuit for breach of contract.

In this case, the analyst may consider two damages measurement methods: (1) the lost profits method and (2) the lost business value method. Let's say the damages measurement using the lost profits method results in $30 million. On the other hand, the damages measurement using the lost business value method results in $5 million. This damages measurement is so much lower than the lost profits measurement because the company was still in the start-up stage. Even though both calculations were performed correctly and relied on appropriate damages measurement methods, based on the facts and circumstances of the case, the true measurement of the damages suffered by the plaintiff may favor the lost profits method result of $30 million.

Damages Measurement Methods

The selected damages measurement methods should comport with the types of claims and the types of remedies in the subject lawsuit. Determining the objectives of the judicial action may guide the selection of damages measurement methods.

There are a number of damages measurement methods available to the analyst. Depending on the type of claim, there are generally accepted damages measurement methods. There are primary damages measurement methods and there are supporting damages measurement methods.

Primary Damages Measurement Methods

This discussion addresses three primary damages measurement methods: (1) the lost profits method, (2) the lost business value method, and (3) the reasonable royalty method. These three damages measurement methods do not represent the universe of all damages measurement methods.[21]

The Lost Profits Method

Perhaps the most common damages measurement method is the lost profits method. The lost profits method quantifies the additional profits (above actual profits) that the plaintiff would have achieved but for the wrongful act of the defendant. In performing a damages measurement analysis by applying the lost profits method, other supporting damages methods and calculations may be involved. These analyses may include the before-and-after method, the projections (but-for) method, the yardstick method, the market share method, the ex post method, and the ex ante method.

Instead of lost profits on lost sales, the claim could be that the plaintiff's loss relates to lower product pricing. In this case, the lost profits method would still be applied in measuring damages.

However, instead of the "loss" being the difference between but for sales and actual sales, the loss would be the difference between the but for price of product sales and the actual price of product sales.

If counsel is seeking restitution remedies in the judicial action, then an unjust enrichment damages measurement may be involved in the economic damages analysis. Measuring damages for unjust enrichment is similar in manner to estimating lost profits. However, instead of applying the lost profits method in analyzing the plaintiff's business, the lost profits method is applied in analyzing the defendant's business.

If counsel is seeking convoyed sales based on the entire market rule, these lost sales that the plaintiff suffered will also be estimated by applying the lost profits method.

The Lost Business Value Method

This damages measurement method is often applied when the defendant's wrongful act results in the destruction of the plaintiff's entire business. In this instance, the analyst will perform a business valuation of the plaintiff's whole business as of a date prior to the commission of the wrongful act.[22]

In an instance where the defendant's wrongful act did not result in the destruction of the plaintiff's entire business, it may also be appropriate to apply the lost business value method. In this case, the damages analysis involves measuring the loss to the plaintiff's business value from the defendant's wrongful act by performing a business valuation as of a date prior to the wrongful act and another business valuation as of a date immediately after the wrongful act. The difference between these two business value indications represents a measurement of damages.

Facts and circumstances will dictate whether it is more appropriate to measure damages by applying the lost profits method or the lost business value method. Most analysts may tend to favor the lost profits method over the lost business value method due to the complexities of performing a business valuation.

There is a body of professional literature that discusses the generally accepted business valuation approaches and methods. These business valuation approaches and methods are summarized below.

The Reasonable Royalty Method

This method is usually applied in intellectual property ("IP") cases where the measurement of damages considers licensing the IP for royalty income. In cases where the lost profits method cannot be applied because of a lack of financial information, the reasonable royalty method may be applied instead due to the simplicity of the analysis (which involves a revenue assumption and a royalty rate assumption). There are a number of methods that may be applied to estimate the royalty rate. These royalty rate measurement methods are discussed below.

Supporting Damages Measurement Methods

Supporting damages measurement methods are used as inputs into one or more of the primary damages measurement methods. We categorize these supporting damages measurement methods by what they typically measure.

Estimating Revenue

There are four methods that may be employed to project the damaged entity revenue. These methods can be applied to all of the damages measurement methods discussed above. They are as follows:

1. The before-and-after method – This method involves comparing the revenue performance of the business before and after the alleged wrongful act.
2. The projections (but-for) method – This method involves comparing the actual revenue to revenue projections that were expected to take place but for the wrongful act.
3. The yardstick method – This method involves comparing actual revenue as a result of the wrongful act with the revenue of comparable businesses that were not affected by the wrongful act.
4. The market share method – This method involves comparing the plaintiff's market share prior to the wrongful act with its actual market share after the wrongful act.

Timing

Timing refers to the ex post method and the ex ante method. This factor was discussed above. Both of these methods can be applied to all damages measurement methods.

Business Valuation Approaches and Methods

There are three generally accepted business valuation approaches. These generally accepted approaches are the (1) income approach, (2) market approach, and (3) asset-based approach.

The income approach methods include (1) the discounted cash flow ("DCF") method and (2) the direct capitalization method. Both of these income approach methods are based on the principle that

the value of the business is equal to the present value of the future income to be derived by the owners of the business. Both of these methods require the following analyses: revenue analysis, expense analysis, investment analysis, capital structure analysis, residual value analysis, and discount rate analysis.

The DCF method involves a projection of the subject company results of operations for a discrete, multiyear period. The discrete cash flow projection is then converted to a present value. The DCF method also involves a terminal value analysis at the end of the projection period. The direct capitalization method involves dividing a market-derived direct capitalization rate into a normalized estimate of future income.

The market approach methods include (1) the guideline publicly traded company method and (2) the guideline merged and acquired company method. Both of these market approach methods are based on the principle that the value of a business interest may be estimated based on what astute and rational capital market investors would pay to own an equity interest in a company similar to the subject company. Particular attention is paid to the appropriate discounts and premiums for controlling ownership interest, noncontrolling ownership interest, lack of marketability, cost of an initial public offering, and so forth.

In applying the guideline publicly traded company method, capital market pricing multiples of publicly traded guideline companies are used to estimate the value of the subject company. In applying the guideline merged and acquired company method, the value of the subject company is estimated by analyzing the prices paid for controlling ownership interests in guideline merged and acquired company transactions that have occurred over a reasonably recent time period.

The asset-based approach considers the values of the subject company assets (both tangible and intangible) and the values of the subject company liabilities (both contingent and recorded). The asset-based approach encompasses a valuation (either discrete or collective) of the subject company (1) current assets, (2) tangible real property, (3) tangible personal property, and (4) intangible assets. This valuation approach also encompasses a valuation (either discrete or collective) of the subject company (1) current liabilities, (2) notes payable, and (3) contingent liabilities.

Estimating Royalty Rates

There are four generally accepted methods to estimate royalty rates. Any one of these four methods can be used in the reasonable royalty method. These estimation methods are listed below:

1. The incremental profit method – This method involves applying the weighted average cost of capital of comparable companies that do not operate the IP to all the assets of the plaintiff.

   This process results in an estimate of the profits the company would expect to earn if it did not use the IP. These profits are subtracted from the profits earned by the plaintiff to arrive at incremental profit from the IP. This measure of incremental profit is divided by the defendant's wrongful sales to arrive at a reasonable royalty rate.

2. The differential income method – This method involves applying two DCF methods, one with the effects of the wrongful act and one without the effects of the wrongful act.

   Subtracting the lower projected cash flow from the higher (but-for) cash flow and dividing these each year by sales will result in an estimate of a reasonable royalty rate.

3. The comparable uncontrolled transaction ("CUT") method – This method involves comparing the subject IP to third party IP found in arm's-length license agreements of CUTs. The royalty rates of the third-party CUTs provide an estimate of a reasonable royalty rate.

4. Comparable profit margin method – This method involves subtracting the expected profit margin of the subject company from the normal profit margin of comparable companies that do not use the subject IP.

   The difference between these two profit margins provides an estimate of a reasonable royalty rate.

Summary and Conclusion

This discussion addressed four elements to a judicial action and provided background information and context to some of the legal aspects that affect every damages analysis.

Understanding these elements should better inform the analyst about a judicial action and the nature of the claims and remedies in the court action. In turn, this knowledge should aid the analyst in performing the damages measurement analysis and selecting the appropriate damages measurement methods.

It is important that the legal standards in the litigation be addressed by one or more participants to the lawsuit. Failure to satisfy these legal standards

may result in the rejection of the damages analysis or even a cancelation of the judicial action.

It is important for the analyst to rely on a set of assumptions and supporting data that are clear, understandable, logical, and supportable both (1) in written form in the expert report and (2) orally in the deposition and trial testimony.

Although retained by one party to the judicial action, the goal of the analyst's report and testimony is to aid the court in measuring the amount of damages suffered by the plaintiff because of the wrongful act of the defendant.

Notes:

1. *Restatement of the Law Second, Contracts 2d, Pamphlet No. 3* (Philadelphia, PA: American Law Institute, Student Edition, 1981), Sections 316-end.
2. Henry R. Cheeseman, *Business Law*, 5th ed. (Upper Saddle River, NJ: Pearson Education, 2004), 192–93.
3. Ibid., 74–81.
4. See, e.g., Dick v. Lewis, 506 F. Supp. 799, 805 (D.N.D. 1980) (applying North Dakota law) (citing W. Page Keeton, et al., Prosser and Keeton on Torts § 41 (4th ed. 1971)); Gercey v. United States, 409 F. Supp. 946, 954 (D. R.I. 1976) (Suits in Admiralty Act case) (citing W. Page Keeton et al., Prosser and Keeton on Torts § 41 (4th ed. 1971)); Culver v. Bennett, 588 A.2d 1094, 1097 (Del. 1991) (same); Anderson v. St. Francis–St. George Hosp., Inc., 671 N.E.2d 225, 227 (Ohio 1996) (same).
5. Paige v. Saint Andrew's Roman Catholic Church Corp., 734 A.2d 85, 91 (Conn. 1999) (alterations in original) (internal quotations and citation omitted).
6. Palsgraf v. Long Island R.R. Co., 162 N.E. 99, 103 (N.Y. 1928) (Andrews, J., dissenting).
7. Smith v. W. Union Tel. Co., 83 Ky. 104 (Ct. App. 1885) (emphasis in original); see also Doe v. Linder Constr. Co., 845 S.W.2d 173, 181 (Tenn. 1992) ("The consequences of an act go forward to eternity, and the causes of an event go back to the dawn of human events, and beyond. Any attempt to impose responsibility upon such a basis would result in infinite liability.") (alteration in original) (internal quotations and citations omitted); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729-55 (1975).
8. Cheeseman, *Business Law*, 200.
9. https://corplaw.delaware.gov/delaware-court-chancery-supreme-court/, dated May 6, 2018.
10. See John R. Trentacosta, *Damages in Breach of Contract Cases*, 76 Mich. Bus. J. 1068 (1997) (describing expectation damages as damages that place the injured party in the same position as if the breaching party completely performed the contract); Bausch & Lomb, Inc. v. Bressler, 977 F.2d 720, 728-29 (2d Cir. 1992) (defining expectation damages as damages that put the injured party in the same economic position that party would have enjoyed if the contract had been performed). Also, see Restatement (Second) of Contracts §344 cmt. a (1981). Expectation has been called "a queer kind of 'compensation,'" because it gives the promise something it never had, i.e., the benefit of its bargain. L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 Yale L.J. 52, 53 (1936). The policy underlying expectation damages is that they promote and facilitate reliance on business agreements. Id. at 61–62.
11. Caprice L. Roberts, "Restitutionary Disgorgement for Opportunistic Breach of Contract and Mitigation of Damages," *Loyola of Los Angeles Law Review* 42 (2008): 131–44.
12. Uniform Commercial Code, Section 2-610; Restatement (Second) of Contracts, Section 253.
13. Cheeseman, *Business Law*, 306.
14. https://www.upcounsel.com/statutory-damages, dated May 9, 2018.
15. Cheeseman, *Business Law*, 94–95.
16. Richard R. Posner, *Economic Analysis of Law*, supra note 6, at 131. For an argument in favor of punitive damages in contracts, see William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 Duke L. J. 629 (1999).
17. Mark A. Allen, et al., *Reference Guide on Estimation of Economic Damages, in Reference Manual on Scientific Evidence* (Federal Judicial Center, ed. 3d ed. 2011), 437.
18. Cheeseman, *Business Law*, 311–13.
19. Roman L. Weil, et al., *Litigation Services Handbook – The Role of the Financial Expert*, 6th ed. (Hoboken, NJ: John Wiley & Sons, Inc., 2017), chapter 4.4, p. 19.
20. Thorpe by Castleman v. CERBCO, Inc., 676 A.2d 436, 445 (Del. 1996).
21. Previously, we indicated that certain types of court cases have established precedents for very specific types of economic analyses such as market share analyses in antitrust cases and event studies in securities cases.
22. Previously, we explained an example where the lost business value method understated the true damages because the plaintiff's business was a start-up company at the time of the wrongful act.

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