Lost Profits Damages:  
From Expert Testimony Through Jury Instructions

By Richard L. Seabolt

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Business disputes that proceed to litigation frequently are resolved on — or just short of — the courthouse steps because there is insufficient early attention given to damages issues.

Damages analysis tends to be deferred until late in the litigation for a number of reasons. Financial or economic issues associated with damages often take a back seat to liability issues because lawyers by training tend to prefer focusing on the legal principles and on discovery procedures that probe the factual setting and motivations that gave rise to the dispute. The tendency to defer damages analysis is reinforced by litigation procedure that typically does not require designation of testifying experts until late in the case. But early involvement by experts with financial

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qualifications are often the key to an effective lost profits damages analysis.

Decision tree analysis or hindsight review of litigation results often show that damages issues are far more significant in determining the ultimate outcome than other issues that may have seemed more important during the heat of discovery battles.

If we want to advance our clients' desires to resolve business disputes as early and as inexpensively as possible, we need to reorder our priorities so there is greater focus as early as possible on the issues associated with damages claims. In business litigation cases, that means an early focus on lost profits claims, because it is those claims, not the hard out-of-pocket claims, that tend to drive whether the case is tried or is settled — and the amount recovered/paid as the result of trial or settlement.

This article is intended to provide an overview for California litigators who are faced with bringing potential lost profits claims or defending against such claims. The focus is on identification of the key issues associated with lost profits claims so issues can be spotted and appropriate tactical decisions can be made before and during the course of litigation. Wherever possible, key cases and important secondary authorities are provided so more in-depth coverage of particular issues can be easily accessed and reviewed by a litigator faced with these issues.

— Selection of Financial Expert —

One of the earliest decisions to consider in a lost profits case is the retention of a forensic financial expert. There often is a natural tendency to defer retention of an expert. Experts are expensive and can be particularly expensive if the lawyer retaining the expert has not adequately identified the issues to be addressed by an expert. But there are compelling reasons to consider the retention of a forensic financial expert at the earliest opportunity.

Theoretically lost profits cases can be tried without expert testimony. Business owners are permitted to testify about their business plans and their opinions regarding the profits they lost as a result of defendant's conduct.

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But the risks are great that such testimony will be considered insufficient to satisfy the special requirements for lost profits claims. See, *Resort Video, Ltd. v. Laser Video, Inc.*, 35 Cal. App. 4th 1679, 1699 (1995) (testimony by founder of corporate plaintiff on what profits "would have" been generated was excluded).

From the plaintiff's perspective, it is particularly important to retain forensic financial experts early. Such experts can assist plaintiffs' lawyers about whether to undertake a case and how to plead a case. Plaintiffs have
a head start and should try to keep the lead. Litigation can resemble the story of the camper who put on his running shoes after encountering a bear, and answered his camping companion's skepticism that he could outrun the bear with "I don't have to outrun the bear, I only need to outrun you." In litigation, the ability to focus quickly on the key issues is important, but the truly important ability is to focus more quickly than your adversary.

If the potential amount in dispute is large and/or the particular area of specialty is narrow, a plaintiff may choose to take advantage of the plaintiff's inherent headstart and retain the leading experts in the field before the defendant has become familiar with the issues. Once retained, the expert consultant is precluded from providing advice to the opposing party. See, Shadow Traffic Network v. Superior Court, 24 Cal. App. 4th 1067, 1081-82 (1994).

From the defense perspective, it is less clear that the early retention of an expert is quite as important. Defendants typically want to focus on liability issues and underplay damages issues. Until the plaintiff has committed to a damages theory and approach, there is a risk that a defense consulting expert may anticipate and investigate theories that the plaintiff has not developed — and perhaps not even considered. Sometimes such anticipatory investigation combined with the intellectual curiosity of defense experts can increase, rather than decrease, the litigation risks to the defense. If the amount in dispute can justify the increased expense, this risk can be reduced or eliminated by the retention of a forensic financial expert whose sole role is to provide litigation-related consulting advice with the express understanding that the expert will never be designated as a testifying expert in the case. Such an approach reduces the risk that documents disclosed to the expert or work product becomes some of the most damaging evidence at trial. Although there is some California authority that an expert can serve as both a consulting expert and a testifying expert and maintain work product protection over the work done as a consultant (National Steel Prods. Co. v. Superior Court, 164 Cal. App. 3d 476 (1985)), California courts often require disclosure of all work product by an expert designated as a testifying expert at the time of his or her deposition. Brekopp v. Ford Motor Co., 71 Cal. App. 3d 841 (1977).

Another early issue relates to the critical decision on the selection of the particular forensic financial expert. Different disputes suggest different areas of specialization. Forensic accountants, forensic economist and business valuation experts have different areas of focus and different skill sets appropriate to different subject matter. Qualifications in the particular area of expertise obviously are important. But often even more
critical is the recommendations of other lawyers who have used the expert at deposition or trial and can address the expert’s ability to teach and explain and the expert’s ability to withstand cross-examination on the factual assumptions underlying his or her projections.

**Method By Which**

**Lost Profits Are Proven**

The California Supreme Court in *Grupe v. Glick*, 26 Cal.2d 680, 692 (1945) set out some of the fundamental principles associated with recovery of damages for the loss of prospective profits. The Supreme Court identified factors that bear on lost profits claims as including: past volume of business, projected growth and expense experience. These factors, in particular the assumed growth rate and applicable discount rates, can dramatically affect the results of a lost profits analysis.

*The Loss Must Be of Profits, not Revenue* — Lost profits claims, of course, must focus on lost profits, not lost revenue. To recover lost profits, the analysis must take into account the costs associated with generating those profits. It is necessary to account for and deduct the value of all labor, materials, rents and other expenses, such as the interest on the capital necessary to generate the profits. Mere proof of loss of gross revenue is insufficient to prove a lost profits claim. See, *Gerwin v. Southeastern Cal. Assn. of Seventh Day Adventists*, 14 Cal. App. 3d 209, 223 (1971).

*Lost Profits Must Be Reasonably Foreseeable* — Lost profits damages are limited to those damages which were reasonably foreseeable at the time of contracting. The common law rule of *Hadley v. Baxendale* is embodied in California Civil Code section 3300, which provides that the aggrieved party in a breach of contract action be compensated “for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.” See also, *T.L. Martin v. U-Haul Co. of Fresno*, 204 Cal. App. 3d 396, 409 (“the promisor is not required to compensate the injured party for injuries that he had no reason to foresee as the probable result of his breach when he made the contract”). Although the limitation should be considered, it arises and is litigated relatively infrequently. In *T.L. Martin, supra*, the limitation was used as a rationale to limit recovery of contract damages to the 30 day period provided

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“*The law requires only that some reasonable basis of computation of damages be used…*”

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by contract for termination. Occasionally, the reasonable foreseeability requirement is imposed to limit liability when there is a claimed loss that resulted from an unusual causal chain or special circumstance. See, *Sabrow v. Kaplan*, 211 Cal. App. 2d 224, 228 (1962).

*Lost Profits Must Be Reasonably Certain* — The most significant practical limitation to
recovery of lost future profits is the requirement that they be proven with reasonable certainty. Late California Supreme Court Justice Stanley Mosk was fond of a Yogi Berra quote that captures the difficulty in proving future lost profits with reasonable certainty: Yogi, according to Justice Mosk, once opined that: “The problem with predictions is that they are hard to make, particularly if they touch on the future.” Lost future profits claims necessarily touch on the future and courts appropriately treat optimistic plaintiff projections of what the plaintiff would have earned with some skepticism. That skepticism has produced jury instructions that embody the “reasonable certainty” hurdle.

Both plaintiffs and defendants should be aware that the hurdle is not as high as it might appear from the currently used and proposed standard California jury instructions. The currently used BAJI instruction requires that both the fact that profits were lost and the amount of the lost profits damages must be proven to a “reasonable certainty.” The current Judicial Council Task Force draft jury instructions scheduled for release and publication by Matthew Bender – Lexis/Nexis in the Fall 2003 repeat those requirements. But case law makes clear that the “reasonable certainty” required to prove that there were lost profits is a different standard from what is required to prove the amount of lost profits. GHK Associates v. MAYER Group, Inc., 224 Cal. App. 3d 856, 873 (1990) (“[w]here the fact of damages is certain, the amount of damages need not be calculated with absolute reasonable certainty. The law requires only that some reasonable basis of computation of damages be used, and the damages may be computed even if the result reached is an approximation.”). The Litigation Section comments on the proposed instructions suggest that the instructions provided to the jury should not use the same phrase “reasonable certainty” when the appellate courts have made clear that the standards for the two elements of proof differ. See, State Bar Litigation Section website (http://www.calbar.org/litigation/committees/jury/jury-instructions_third-release_september-2002.pdf at SBC page 72); Paul M. Zieff, Future Lost Profit Damages in Business Litigation, ABTL Report Northern California, Vol. 11, no. 2 (March 2002).

Time for Measuring Lost Profits — Wrongful Act or Trial — Ex Post Data — Particularly when there has been an extended period of time between the wrongful act and the time of trial, parties need to consider whether their lost profits analysis is based on a measurement as of the time of the wrongful act with a pre-judgment interest adjustment or a measurement as of the time of trial. Both approaches are supported by case law. See, George P. Roach, Correcting Uncertain Prophecies: An
Analysis of Business Consequential Damages, 22 Rev. Litig. 1, 68 (Winter 2003). A related issue is whether actual events subsequent to the time of the wrongful act can or should be considered in the lost profits analysis. Again, there is support for both approaches. Perhaps the strongest argument for the use of “ex post data,” or evidence of events subsequent to the date of the wrongful act, is that it has more credibility with the jury since any challenge would necessarily be based on an argument contrary to what actually occurred. Id. at 3.

Causation Issues in Lost Profits Claims

The plaintiff in a breach of contract action “must prove a breach by the defendant and the amount of damages caused by the breach.” Golden Eagle Refinery Co. v. Assoc. Int’l Ins. Co., 85 Cal. App. 4th 1300, 1314 (2001) (citing Reichert v. General Ins. Co., 68 Cal. 2d 822, 830 (1968)). Failure to prove causation can have devastating consequences to a contract damages claim. See, Huber; Hunt & Nichols, Inc., 67 Cal. App. 3d 278, 293 (1977) (computer printout that was “the single piece of evidence” supporting contractor’s claimed damages excluded); Golden Eagle Refinery Co., 85 Cal. App. 4th at 1316 (summary judgment affirmed because plaintiff’s expert was unable to establish the necessary causal connection between events and claimed damages).

Traditionally recovery of lost profits for a new business was considered improper because the measurement of any lost profits was viewed as too speculative in the absence of income and expense experience. But more recent cases qualify the traditional view. See, Gerwin, 14 Cal. App. 3d at 221 (“the rule is not a hard and fast one”). They state that lost profits “may nevertheless be recovered if the evidence shows with reasonable certainty both their occurrence and the extent there-of.” See, Resort Video, supra, 35 Cal. App. 4th at 1698 (quoting Gerwin, but ultimately affirming a new trial order following a plaintiff’s verdict, on the ground that the verdict had been based on “speculative evidence of

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(1983). To the extent lost profits could have been avoided, they are not recoverable. See also, Grupe v. Glick, 26 Cal. 2d 680, 694 (1945) (an award of lost profits required trial court findings regarding “the absence of a reasonable substitute in the market.”).

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Early disclosure of the plaintiff’s damages analysis, with an accompanying deposition of the plaintiff’s expert, can often focus the court and the parties on critical issues earlier in the litigation.

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The Inter-Relationship Between Lost Profits Claims and Business Value Claims — Plaintiffs sometimes attempt to claim both the value of their business at the time it was destroyed and their lost future profits that would have been obtained if their business had not been destroyed. The value of a business, however, is the net present value of expected future cash flow from the business. Commentators and court decisions generally recognize such claims as an attempt at double recovery. See, Kenneth M. Kolaski and Mark Kuga, Measuring Commercial Damages via Lost Profits or Loss of Business Value: Are These Measures Redundant or Distinguishable, 18 J.L. & Com. 1, 13-15 (Fall 1998).

Similarly, lost profits claims can be duplicative of claims involving damage to business reputation or goodwill. See, supra, at 17 citing Checker Bag Co. v. Washington, 27 S.W.3d 625, 641 (Tex. App. — Waco 2000) (“Business reputation or ‘goodwill’ is usually considered to be a part of the value of the business. The ability of the business to make a profit is reflected in its value. Thus, the recovery of both lost profits and damage to business reputation could easily be duplicative.”)

California courts have recognized that a lost profits claims and business value claims can be duplicative. In fact, the Court of Appeal in Rosenthal v. Gould, 273 Cal. App. 2d 239 (1969) recognized that the value of a business or business interest operates as a cap on any lost profits claim. In Rosenthal, the plaintiff claimed damages in an optometry partnership dispute. The Court of Appeal affirmed the trial court finding of breach of fiduciary duty, but reversed the damages award as excessive. The Court held that the plaintiff had acknowledged that based on a “rule of thumb” the value of this service-based practice was the equivalent of a multiple of one times “the business’ annual gross volume.” Id. at 245-246. Although the plaintiff had also claimed lost profits for the remaining period of the optometry partnership’s lease, the Court of Appeal held that the plaintiff “would not be entitled to recover more than” the unpaid portion of the value of the plaintiff’s business interest. Id. at 246.

The Rosenthal case not only provides sup-
port for a defense attack on a claim as an attempted double recovery, but also provides a method by which a defendant can attack a grossly inflated lost profits claim. Lost profits claims can be limited to the value of the plaintiff's business interest. An expert who can present a competent discounted cash flow valuation method typically can cap the claim at that value. Moreover, business valuation “rules of thumb” that use value-price to earnings multiples can be used to show that the extrapolated lost profits total exceeds the business value established by the marketplace.

Court Scrutiny of Forensic Expert Testimony

In 1999, in *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), the U.S. Supreme Court extended the reach of *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993) from scientific expert testimony to “all expert testimony.” The trial court's role as a gatekeeper to scrutinize the reliability and relevancy of expert testimony under *Daubert* requires a consideration of: (1) testing of the technique or methodology, (2) peer review and publication, (3) error rate, and (4) general acceptance of the methodology. *Daubert*, at 593-94. *Daubert* challenges to forensic financial experts who have been proffered to testify on lost profits issues have been the subject of considerable discussion in reported cases and secondary authorities. See, e.g., Kevin M. Kennedy, *The Use of Daubert and Its Progeny to Attack Lost-Profit Claims*, 20 Franchise L.J. 167 (Spring 2001); Sofia Adrogue and Alan Ratliff,

But California has not adopted the federal Daubert/Kumho Tire approach to expert testimony. Instead, California approaches expert testimony under the Kelly/Frye standard, which requires a showing of “general acceptance” of the method employed by the involved expert. People v. Kelly, 17 Cal. 3d 24 (1976). In People v. Leahy, 8 Cal. 4th 587 (1994), the Supreme Court of California specifically declined to follow the Daubert decision in favor of its own Kelly decision, despite a strong dissent by Justice Baxter that the stricter Kelly/Frye standard would cause the exclusion of relevant expert evidence “until a sufficient number of scientific experts in the field take enough interest in the subject to enable the party offering the evidence to satisfy a court that there is a consensus among experts in that field as to the reliability of the evidence.” Id. at 626.

Although the hurdle under the California Kelly standard is higher than the more flexible federal court Daubert standard, its scope is not as broad. Kelly is limited to scientific evidence and, thus, is not applicable to testimony by forensic accountants and economists. As a result, the ability to challenge financial experts in California courts is more limited. Such challenges can be based on relevance, foundation or Evidence Code section 352 (probative value outweighed by undue prejudice or risk of confusing or misleading the jury). In Westrec Marina Mgmt., Inc. v. Jardine Ins. Brokers Orange County, Inc., 85 Cal. App. 4th 1042, 1050-1051 (2000), the Court of Appeal affirmed the exclusion of a plaintiff’s expert testimony on the ground that the expert “was not qualified to present evidence regarding profits lost in [the program involved in the case].” The court reasoned that the expert did not conduct surveys of similar businesses to develop the factual foundation that would have supported his opinions.

There is a practical import to these differences between federal and California law. Federal courts are more likely to exclude financial expert testimony on lost profits damages as part of the court’s gatekeeping function under Daubert. Defendants, in particular, generally obtain a procedural advantage in making pre-trial challenges to experts by motion in limine, summary judgment, or other pre-trial hearing. The factual foundations of the expert’s methodology can be explored and challenged without unduly focusing the jury on damages issues, thereby undermining liability defenses. See, Kennedy, supra, at 173-174.

—Conclusion—

Although there are many tactical decisions for litigators to make in connection with lost profits claims, one procedural technique that could be suggested by litigators or adopted by the courts to promote earlier evaluation and settlement is to provide a procedure for early disclosure of experts so discovery can focus on what counts — the critical damages issues that often are the principal focus of settlement discussions. Such a procedural technique is often employed in construction defect litigation, but rarely adopted in traditional commercial litigation. Early disclosure of the plaintiff’s damages analysis, with an accompanying deposition of the plaintiff’s expert, can often focus the court and the parties on critical issues earlier in the litigation. That focus can facilitate the court and parties’ interests in obtaining a resolution as early and as cost effectively as possible.