

## **Lost Profits in Commercial Litigation: Proving and Defending Damages**

Leveraging Calculation Methodologies, Documentation and Expert Evidence

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TUESDAY, MARCH 8, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# Proving Lost Profit Claims

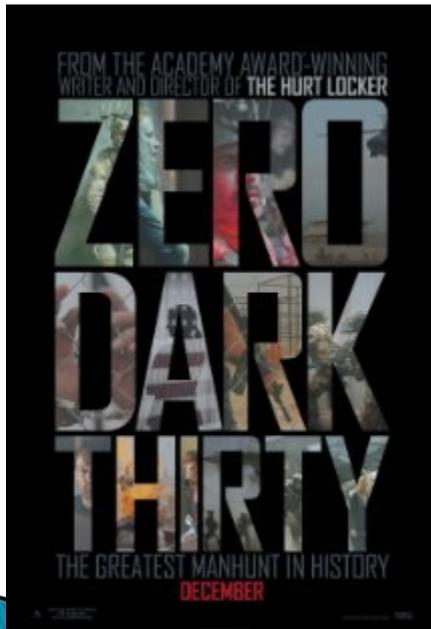
D. Mitchell McFarland

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# Certainty...

**California Code Section 3283** – “damages may be awarded ... for detriment ... certain to result in the future”



To quote **Maya** (Jessica Chastain) from ***Zero Dark Thirty***: "It's 100%. OK, I know certainty freaks you guys out, so 95%. But it's 100%!"

# Proving Lost Profits – Reasonable Certainty

- ▶ You must “prove” something that never happened
- ▶ To recover lost profits, you must demonstrate the profits that would have been obtained, “but for” ...[the breach, interference, etc.]
- ▶ And it must be proven to a “reasonable certainty”
- ▶ More than a scintilla of reasonable certainty

# What are “lost profits”?

Lost profits are damages for the loss of net income to a business.

The claim is for income from lost business activity, less expenses that would have been attributable to that activity.

# Permanent or Temporary

- ▶ Permanent Loss = Diminished Value Claim
  - Value at Event, less Value After the Event = Damages
- ▶ Temporary Loss = Lost Profit Damages
  - Damage period is the facts based period it will take the Plaintiff to be put back into the position prior to the wrongful event.
  - Contract period, historical relationships, historical retention rates, etc.
  - No case facts establishing a damage period, future losses become more speculative

- ▶ Restatement (Second) of Contracts §352 (1981)
  - “Damages are not recoverable for loss beyond an amount the evidence permits to be established with reasonable certainty.”
  
- ▶ The standard has been adopted by every jurisdiction
  - Robert L. Dunn, *Recovery of Damages for Lost Profits*, cites authorities from 36 states
  - ALR – *Recovery of Anticipated Lost Profits ...*55 A.L.R. 4<sup>th</sup> 507 (1987) cites 41 jurisdictions
  - *TAS Distrib. Co. v. Cummins Engine Co.*, 491 F.3d 625, 632 (7<sup>th</sup> Cir. 2007)(all jurisdictions enforce reasonable certainty).

# The Fact of Damages v. The Calculation of Damages

**New York** – “It must be demonstrated with certainty that such damages have been caused by the breach ...” *Kenford Co., Inc. v. County of Erie*, 67 N.Y.2d 57, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986)

**Texas** – “Uncertainty as to the fact of legal damages is fatal to recovery, but uncertainty as to the amount will not defeat recovery.”  
*Southwest Battery Corp. v. Owen*, 131 Tex. 423, 115 S.W.2d 1097, 1099 (1938)

**California** – “Lost profits ... Not only must such damages be pled with particularity ..., but they must be proven to be certain both as to their occurrence and their extent, albeit not with ‘mathematical precision.’” *Greenwich S.F., LLC v. Wong*, 190 Cal.App.4<sup>th</sup> 739, 754, 118 Cal.Rptr.3d 531 (2010)

But case law also references “reasonable certainty.”

And **BAJI 3903N** – “The amount of lost profits need not be calculated with mathematical precision, but there must be a reasonable basis for computing the loss.”

# Reasonable Certainty

- ▶ There are almost no law review articles that discuss it other than student notes
- ▶ For an exhaustive analysis – Robert M. Lloyd, Professor at Univ. of Tennessee –
  - *The Reasonable Certainty Requirement in Lost Profits Litigation: What it Really Means*. 12 Tenn. J. Bus. L. 10 (2010)

# Reasonable Certainty

- ▶ “The amount of the loss must be shown by competent evidence with reasonable certainty”
  - ***Southwest Battery Corp. v. Owen***, 115 S.W.2d 1097, 1098-99 (Tex. 1938)
  - Industry was well established -- Sale of car batteries not uncertain or speculative
  - A short history of profits combined with an established industry was sufficient
  - However, the court referred to the “new business” rule

## Reasonable Certainty - *Texas Instruments v. Teletron*

- ▶ Reasonable certainty is the standard
- ▶ Flexible standard but ...
  - “Profits which are largely speculative, as from an activity dependent on uncertain or changing market conditions, or on chancy business opportunities, or on promotion of untested products or entry into unknown or unviable markets, or on the success of a new and unproven enterprise, cannot be recovered.”
    - *Texas Instruments*, 877 S.W.2d at 279

# Reasonable Certainty

“New business” rule clarified –

The fact that business is new is a factor but not necessarily decisive

The enterprise is the “activity” not the entity.

“The focus is on the experience of the persons involved in the enterprise and the nature of the business activity, and the relevant market.”

*Texas Instruments, Inc. v. Teletron Energy Management, Inc.*, 877 S.W.2d 276, 279-280 (Tex. 1994)

# Examples

## *Texas Instruments v. Teletron*

- The T-2000 – a voice-prompted programmable thermostat
- Never been built, never been sold
- Not even a working model existed
- “Teletron’s expectations were at best hopeful, in reality, they were little more than wishful.”

# It's the Facts

- ▶ “Reasonable certainty” is a fact intensive determination
- ▶ Take a hard look at the business, the market, the people, the business plan, capital and all other factors
- ▶ *Holt Atherton Industries, Inc. v. Heine* – 835 S.W.2d 80 (Tex. 1992)
  - “[It] ... is a fact intensive determination.”
  - “...[E]stimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits can be ascertained.”
  - Evidence that is without any factual foundation is purely speculative and conclusory

# Examples

## *VingCard A.S. v. Merrimac Hospitality*

59 S.W.3d 847 (Tex. App. – Fort Worth 2001, pet. denied)

- Merrimac had exclusive rights to build computer work station for VingCard’s hotel door keycards and credit cards;
- Also to create another version for restaurant industry
- Through its president, Merrimac put on evidence of
  - experience in the industry,
  - established customer base,
  - production and sales of the product,
  - marketing and distribution capability of VingCard and Ibertech
- The court held these were “objective facts, figures and data that provided a sufficient reason to expect the Vision product to yield a profit.”

# Example

- ▶ *Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc.*, 487 F.3d 89 (2<sup>nd</sup> Cir. 2007)
  - Co-Gen Plant and power sales agreements
  - 20 year deal
  - Tractebel quits!
  - Expert witness with range of damages from \$417 million to \$604 million
  - \$184 million swing
  - Trial court said that could not be proof of lost profits to a “reasonable certainty”

▶ *Tractebel v. AEP*

- Second Circuit reverses
- Claims the rules for lost profits as “direct damage” are different than lost profits as “consequential damages”
- Do not need to be as certain for “direct damages”
- “A person violating his contract should not be permitted entirely to escape liability because the amount of the damage he has caused is uncertain.”
- Good Article – G. Banks, *Lost Profits for Breach of Contract: Would the Court of Appeals Apply the Second Circuit Analysis*, 74 Alb. L. Rev. 637 (2011)

# It's the facts ...

- ▶ Look at the activity. Is it an established activity?
  - Yes! --fried chicken, car batteries, hotel door key/credit card readers
  - No! – voice prompted thermostats
- ▶ What are the facts of the entity/activity? Things your expert needs to “drill down into.”
  - Management Expertise and Experience
  - Availability of labor
  - Availability of capital
  - The Business Plan
  - Competition and Markets

# Evidence /Documentation – What do you need?

- ▶ Business Records ... Literally
- ▶ Business financial forecasts -- Management budgets (New Business)
- ▶ Historical Financial Statements (For every entity, subsidiary, etc.)
  - Balance Sheets, Profit & Loss Statements
  - Revenue by Customer Reports
  - General Ledger
  - Three to five years prior to the event (annually)
  - 12 months prior to the alleged event (monthly)
  - Monthly financial statements since the date of the event to current

# Evidence / Documentation

- ▶ Historical Financial Statements
  - What Form? Depends on the accounting software/  
version
    - Native format (Quick books, Peachtree etc.)
    - Excel Download (MAS 90/2000, etc.)
    - Fail Safe – pdf. format
- ▶ Tax Returns for the same period as Financials – Request all the schedules
  - Use to support financial statements that were produced
  - Possible differences due to cash versus accrual basis accounting

# Evidence / Documentation

- ▶ Debt and credit documentation -- Subpoena third-party banks
- ▶ Contracts – (customer, equipment, facilities, long term obligations)
- ▶ Corporate Formation Documents/ operating capacity limits
- ▶ Meetings with management
- ▶ Deposition testimony
- ▶ Industry trade publications/ professional associations
- ▶ Federal and government economic data
- ▶ Public company and competitive resources
- ▶ Economic/ market / local events

# PWC's Daubert Challenges to Financial Experts



- ▶ 12-year trend w/ cases citing Daubert/Kumho Tire
- ▶ Economists, accountants, and appraisers challenged the most
- ▶ Economists and accountants most likely to survive.
- ▶ Case type affects the frequency and outcome
- ▶ Lack of Reliability is the top reason to exclude financial experts
- ▶ Exclusions more common due to the misuse of accepted methodologies than from the introduction of unusual or untested analytical methods

# PWC's Daubert Challenges to Financial Experts



- ▶ Challenges raised every year from 2000-2009, but have fallen the past few years.
- ▶ Plaintiff's experts are challenged approx. three times as often as defense experts, but their exclusions rates were lower in six of the last eight years.
- ▶ The Circuit Court matters, with 40% of all Daubert challenges being adjudicated in the Second, Fifth & Sixth circuits.

# Example --Astrostaff v. Black & Blue

- Astrostaff – an established PEO wants to go independent
- You don't need a policy, you just need a number

# Example --Astrostaff v. Black & Blue

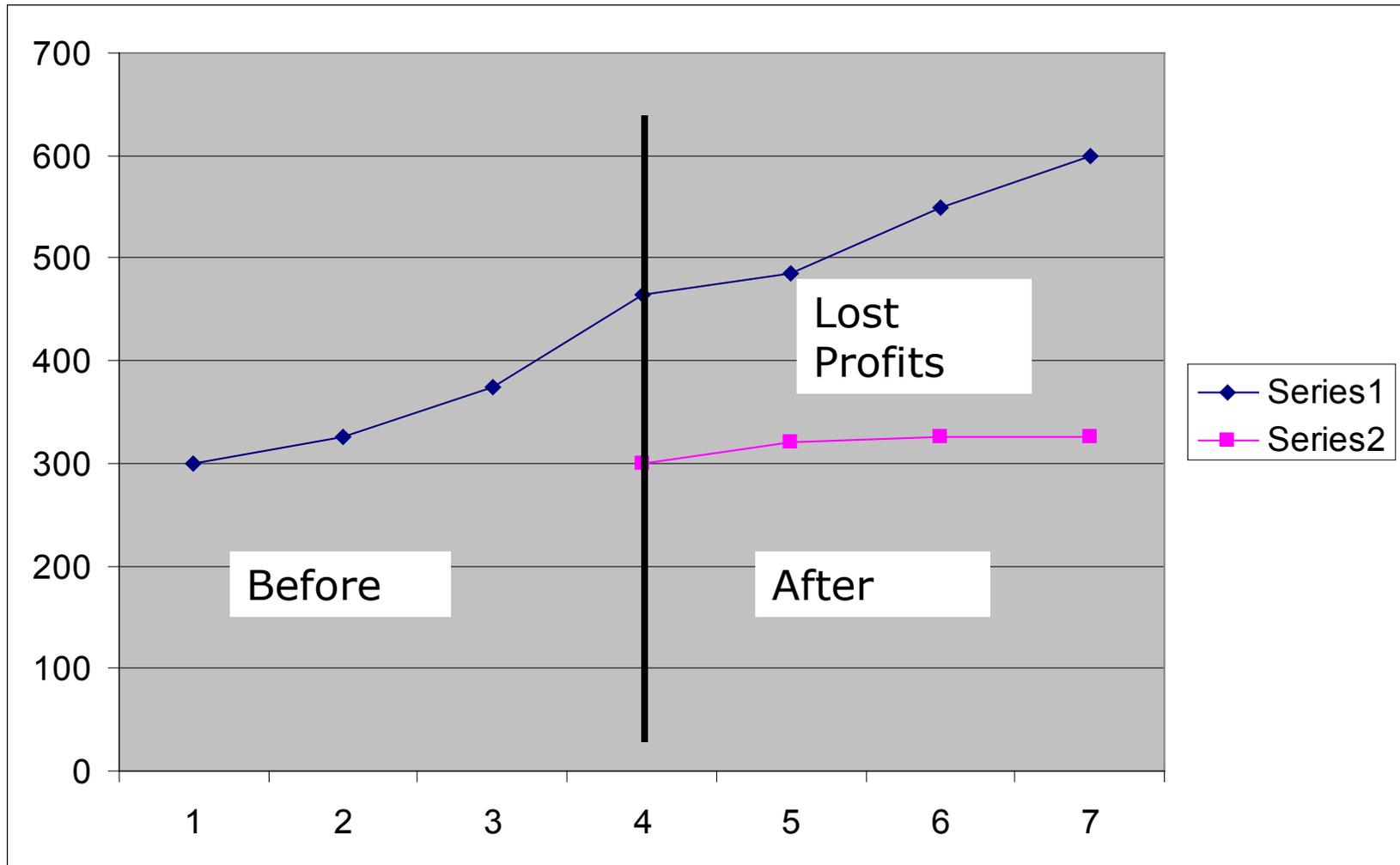
- Expert's list of items considered
  - Basic Economic Research – industry, markets, etc.
  - Specific PEO Industry Research
    - NAPEO Surveys
    - Articles
    - Data from public companies
    - Interviewed PEO WC Insurance expert
    - Analyzed WC Market and Issues
  - Construction & Manufacturing Industry Research

- Analyzed company
  - Interviewed all management
  - Reviewed all financial data
  - Reviewed all operating history – client list, retention, revenues per site
- Analyzed Business Plan
  - Infrastructure – Sales Rep's
  - Computer hardware and Software
- Analyzed Expansion Plan
  - Compared growth in past to plan
  - Compared growth to industry and other data
- Compared to other public PEO's (Administaff, etc.)

# Quantification of Lost Profits

- ▶ Causation is often assumed by the expert
  - Proof of causation is on the lawyer
  - Proof of foreseeability too
- ▶ Demonstrate Lost Profits with Discounted Cash Flow

# Discounted Cash Flow Model



# Methods

- ▶ Before and After
  - Compare historical trend -- past profits, growth rates, assumed growth rates, markets, competition, infrastructure, etc.
  - Injury period
- ▶ Yardstick
  - Comparable companies, industry trends or data
- ▶ Market Share or Specific Contract

# Issues

## ▶ Discount Rates

- Start with “risk free” rate then build up
  - Example of the build up from Astrostaff
- Can dramatically effect result
  - *Knox v. Taylor* – 992 S.W.2d 40 (Tex. App. – Houston [14<sup>th</sup>] 1999, no pet.) Libel and tortious interference with surety business; Expert opines \$11,000,000 in damages, using 25% growth rate and 7% discount rate
  - Defense expert, using same model with 2.8% growth based on industry data and 30% discount -- \$1,000,000

## ▶ Growth Rates

- Why do they always grow?
- Support with historical rates, industry data, economic forecasts for the area or the market

# Examples

## Before and After

- ▶ *Astrostaff, Inc. v. Black & Blue*
- ▶ Compare past data – 5 years of profits
- ▶ Add the business plan – infrastructure in place
- ▶ NAPEO data and Other major companies
- ▶ Models ranged from \$34 million to \$68 million

# Examples

- Yardstick Method
  - *America's Favorite Chicken Co. v. Samaras*
    - 929 S.W.2d 617 (Tex. App. – San Antonio 1996, writ denied)
    - Two franchises to be awarded
    - Never opened
    - Used data from Popeye's other franchises
    - "... more than a scintilla of evidence..."

# Examples

## ▶ Market Share

- *Brennan's Inc. v. Dickie Brennan & Company, Inc.*, 376 F.3d 356 (5<sup>th</sup> Cir. 2004)
- Used customer counts as a percentage of attendance at the New Orleans Convention Center.

# Defending Against Lost Profits

- ▶ ***Qualified, Relevant & Reliable***
- ▶ The Expert – Qualifications /Lack of Independence
- ▶ The Data – Is there a “Fit” or an Analytical Gap?
- ▶ The Assumptions – Same
- ▶ The Methodology – Failure to follow accepted methodologies – i.e. Discount to PV, faulty Yardstick, faulty cost analysis
- ▶ The Opinions – Oversteps Expertise/ Causation
- ▶ The Report – Federal Court (failure to comply with Rule 26)
- ▶ The Disclosure/ Designation – follow the rules!

# Recent Daubert motion

- ▶ *CDW LLC v. NETech Corp.*, 906 F.Supp.2d 815 (S.D.Ind. 2012)
- ▶ Seller of technology products sued competitor who hired away Indianapolis branch manager
- ▶ Expert calculates damages to Indianapolis branch by comparing to average profits of other CDW branches
- ▶ No analysis of economics or market forces affecting other locations compared to Indianapolis
- ▶ No analysis of Indianapolis market to be able to compare
- ▶ An "average of unknowns is also an unknown" citing *Eleven Line, Inc. v. North Texas State Soccer Ass'n, Inc.*, 213 F.3d 198 (5<sup>th</sup> Cir. 2000)

# Another Recent Daubert motion

- ▶ *Quantum Fitness Corporation v. Cybex International, Inc.*, 2015 WL 5456995 (S.D.Tex 2015)
- ▶ Seller of fitness equipment, lost Houston sales rep to competitor
- ▶ New commercial facilities and residential communities were primary driver for direct sales of equipment
- ▶ Expert was able to demonstrate this fact with statistical correlation analysis
- ▶ Then used multi-family building permit data for the market area with a one year lag time (to allow for construction)
- ▶ Court found that any complaint about use of statistical correlation data went to the weight of the evidence
- ▶ Also held that use of building permit data had sufficient factual and methodological support.

# Example of Analytical gap ...

- ▶ *Capital Metro v. Central Tennessee*, 144 S.W.3d 573 (Tex. App. – Austin 2001, pet. denied)
  - Freight service provider on rail line; contract terminated, counterclaim
  - Plaintiff's expert – historical revenues; estimate of carloads and charges; projection of costs -- \$6.6 million
  - Court –
    - History of losses;
    - No identifiable contracts;
    - Forecasts based on “old” contract with Capitol Metro;
    - No independent confirmation of 7550 carloads he assumed;
    - No evidence they could even do that many;
    - No verification of revenue per carload;
    - No investigation of management practices; whether it had a business plan;
    - Admitted that variable costs were running 160% of revenue,
    - And other problems

## Analytical Gap -- *KT Rock v. Southwestern Energy*

- ▶ Rock contract – SWN to purchase 1,500,000 tons over three years. By end of year 2, only 500,000 tons purchased. Agree on plan for remaining rock to be produced and purchased, then dispute arises and KT sues.
- ▶ Claim for lost profits on rock not taken and paid for.
- ▶ Issues -- The physical and financial capacity to crush the remaining rock
- ▶ Plaintiff's expert was a CFA – “Chartered Financial Analyst”
  - He was not a CPA
  - Never took or qualified to take the CPA exam
  - Most CFA's (55%) work for institutional clients as in-house analysts, 15% work for broker dealers and 29% work for universities and the government

# KT Rock v. Southwestern Energy

The expert did not examine physical capacity of KT to perform the work

- ▶ He just assumed it could after speaking with the owner
- ▶ He did not speak with anyone else employed by KT
- ▶ Did not talk to anyone who worked in the field or at the quarries, and did not talk to anyone who ran the equipment
- ▶ He never saw the quarries and never saw the equipment
- ▶ He never investigated how a quarry operates.
- ▶ He did not look at any source material concerning other quarries; he did not talk to anyone else in the quarry business

# KT Rock v. Southwestern Energy

- ▶ He did no analysis of whether KT had sufficient employees or equipment to perform the Agreement.
- ▶ He did no analysis of whether KT operated at capacity or under capacity.
- ▶ He did no analysis of the effect that equipment breakdowns or declarations of force majeure during the Agreement had on KT's purported lost profits

# KT Rock v. Southwestern Energy

Financial capacity to crush the remaining rock

- ▶ Three year contract – KT's only contract
- ▶ Losses every year -- \$758,000 in Year 1, \$1,130,635 in Year 2 and \$759,665 in a shortened Year 3.
- ▶ But note obligations of \$61,121 per month or \$733,452 per year
- ▶ They had no capital, over \$2,600,000 in losses, but owed \$61,121 per month
- ▶ According to Plaintiff's expert, even if SWN had purchased the rock at 500,000 tons per year, KT would still lose over \$1,200,000.

# *The Premcor Refining Group, Inc. v. Kinder Morgan Petcoke, L.P.*

- ▶ Plaintiff's expert relied solely on Mr. Smith's Linear Programming Model - "LP Model"
- ▶ The "Black Box"
- ▶ But Smith had no experience doing lost profit or business interruption analysis
  - Smith was not a CPA
  - Not an accountant
  - Not an economist
  - Had never done a profit and loss analysis
  - He was a Valero employee

## **Plaintiff's Expert had no experience using LP Models**

- ▶ No training on LP models
- ▶ Read no literature about LP models
- ▶ Could not run the model if we gave it to him
- ▶ Did not review how the model creates plan to actual, plan to budget or budget to actual
- ▶ Did no confirmation review on input or output as to market prices
- ▶ Did not review the optimizing parameters of the LP model to check for accuracy – (Did not have a clue how this would be done)
- ▶ Did not see if the financial formulas the LP model uses are accurate
- ▶ Did nothing to confirm that the product specification formulas are accurate

- ▶ Did nothing to see if the model accurately recorded feedstock and properly accounted for all products
- ▶ Did not review the terms of the contracts for oil feedstock
- ▶ Did not review constraints on the model that various crude stocks would create
- ▶ Did not know what “PIMS” meant [Process Industry Modeling System]
- ▶ Did not get a copy of the model
- ▶ Did not run the model
- ▶ Did not review the case files
- ▶ This is only the second case where he has even been exposed to an LP Model [on earlier case he simply took result and subtracted various costs]
- ▶ He had never done a lost profits analysis using an LP model

# Examples

- ▶ *Astrostaff* ...The unsupervised defense expert

Market Value of Invested Capital

	2003	2004	2005	2006	2007
Net Income	1,158,093	1,192,836	1,228,621	1,265,479	1,303,443
Add					
Depr.	50,000	50,000	50,000	50,000	50,000
Amort.	209,427	209,427	209,427	209,427	209,427
Interest Exp.	253,226	253,226	253,226	253,226	253,226
(less tax effect)	-86,097	-86,097	-86,097	-86,097	-86,097
FA Additions	-75,000	-75,000	-75,000	-75,000	-75,000
Cash Flow	1,509,649	1,544,392	1,580,177	1,617,035	1,654,999
WACC	15.00%	16.00%	17.00%	18.00%	19.00%
Xpresent Value Factor	0.8696	0.7432	0.6244	0.5158	0.419
Discounted Cash Flow	1,312,791	1,147,792	986,663	834,067	693,444
Total Cash Flows	4,974,757				
Terminal Value					
Year 5 CF x 10	16,549,990				
Present Value Factor	0.419				
Total	6,934,446				
Cash Flows	4,974,757				
less: debt	-2,150,502				
Equity Value	9,758,701				
75% Probability	7,319,026				

75% Probability  
\$ 7,319,026 NPV

Assumptions:

3% growth rate  
6% gross profit %  
4.0% overhead  
Based on 2001 1120 &  
Yr. 2002 Estimates

Note:

Stock Sale Info. on Patrick Matthews should be obtained.

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## Shuman Ex. 18 Converted to Lost Profits

### 29% Growth Rate

	2003	2004	2005	2006	2007	
Growth Rate	29%	29%	29%	29%	29%	
Net Income	1158093	1,450,427	1,871,051	2,343,355	2,934,882	3,675,726
Add						
Income Tax @34%	747,190	963,875	1,207,183	1,511,909	1,893,556	
Depreciation	50,000	50,000	50,000	50,000	50,000	
Amortization	209,427	209,427	209,427	209,427	209,427	
Interest	253,226	253,226	253,226	253,226	253,226	
FA Additions	-75,000	-75,000	-75,000	-75,000	-75,000	
Cash Flow	2,635,270	3,272,579	3,988,191	4,884,443	6,006,934	
WACC	15%	16%	17%	18%	19%	
Present Value Factor	0.8696	0.7432	0.6244	0.5158	0.419	
	2,291,631	2,432,181	2,490,227	2,519,396	2,516,905	
Total Cash Flows		<b>12,250,339</b>				
Terminal Value						
Year 5 CF x 10	60,069,343					
	0.419					
Terminal Value Discounted		<b>25,169,055</b>				
Total		<b>37,419,394</b>				
Add 2002 Abbington (\$233,000 x 9 months)		<b>2,097,000</b>				
Lost Profits		<b>39,516,394</b>				

**\$39,516,394**

# Examples

- ▶ The “AIM” Debacle – Atlanta Insurance Managers
  - Buy a captive – Realm Ins. Co. – “C” rated
  - Add “A” rated reinsurance – Max Re
  - Great program, if you actually acquire Realm
- ▶ *Equity Concepts, Inc. v. McQueary Henry Bowles Troy Inc.*

# Equity Concepts

- ▶ Workers Comp. Claims Expense – Too much accrued
  - In business from 8/01 to 11/02 -- 16 months
  - \$22 million gross sales
  - Losses for both tax years of (\$45,6432) and (\$396,857)
  - But it was a Sub–S Corporation
    - Previous insurer had estimated claims exposure and sent to client -- Client took the deduction
    - \$378,000 for 2001 and \$1,200,000 for 2002
  - Switch from accrual of WC claims expense to actual cost
    - Profit for 2001 -- \$232,222
    - Profit for 2002 -- \$500,446
  - Lost Profits Model = \$9 million

# Equity Concepts

- ▶ Florida is a required WC State – Business shut down
- ▶ The Florida Yardstick – Former Partners take over another PEO
  - Matrix PEO -- What a Yardstick!
  - In two years from \$11 million to over \$ 200 million
  - 2% Net income (equal NAPEO average)

# Examples

One that did not work - Mr. Hancock wanted a tractor

*Page v. Hancock*, 200 S.W.2d 421 (Tex. App.-- Austin, 1947) --  
Quotes:

- Mr. Hancock was not presently engaged in any business
- He had never owned a tractor, never operated one and never seen one operated.
- He had never figured the cost of operating a tractor, nor what the gross revenue from such an operation would be, except what others had told him
- He would not be able to operate the tractor himself, but would have to employ someone to run it for him.
- He had in mind a man who would run the tractor
- But since that person had never operated a tractor, he would have to employ someone to teach him

# How not to answer a question

- ▶ Pat Troy, employee, on her conversation with the agent for the broker testifies – “I told her I thought it was a scam”
- ▶ Bill Henry -- CEO

2 Q. (BY MR. McFARLAND) Would you approve of any  
3 McQueary Henry agent, insurance agent, having anything  
4 to do with an insurance program that was a scam?  
5 A. That is a very broad statement, a very broad  
6 question. It depends on what they were doing.

# Cases

## *Alaska Rent-A-Car, Inc. v. Avis Budget Group, Inc.*, 738 F.3d 960 (9<sup>th</sup> Cir. 2013)

- ▶ Avis licensee in Alaska sued Avis Budget for breach of contract. Case was based on Budget entering the market in Alaska. Avis had bought Budget out of bankruptcy.
- ▶ Expert compared Budget's growth post-bankruptcy with Alamo which was bought out of bankruptcy by Cerberus. Because Budget was associated with Avis, it grew faster. The difference was considered attributable to the breach.
- ▶ Used Alamo's national rate of rebound.
- ▶ Applied the data to Juneau airport market. After entering market, Budget captured 23.3% of Juneau market. 48% from Alaska Rent-A-Car and 52% from others. Applied that percentage state wide.

## *Alaska Rent-A-Car, Inc.*

- ▶ Calculated Budget's post-bankruptcy market share. Assumed but for breach, the growth would have been at
- ▶ Alamo's national rate. Assumed that half of the faster recovery came at the expense of Alaska Rent-A-Car.
- ▶ \$4.079 million in past and \$11.708 million in future lost profits
- ▶ Affirmed – challenged differences between Alamo and Budget; Juneau market and entire state and others
- ▶ All went to the weight of testimony not admissability.

## *Arthur J. Gallagher & Co. v. Babcock*, 703 F.3d 284 (5<sup>th</sup> Cir. 2012)

- ▶ Babcock and others sold insurance service business to Gallagher and signed non-compete agreements. Left after 4 years and went to a competitor.
- ▶ Gallagher CFO compared average profits by Babcock group for 3 years before departure. Subtracted profits of business that stayed after departure. Multiplied by 6.5, normal life of client with the firm and got \$2.6 million. Also compared estimated expected profits from acquisition compared to expected profit from remaining business. Jury awarded \$1.2 million.
- ▶ Flaw in the analysis was that 19 clients left Gallagher, but only 13 followed Babcock et al. Analysis attributed all loss to Babcock departure.
- ▶ Gallagher claimed that the specter of litigation may have "spooked" those additional clients. Court held this to be too speculative. Award vacated.

*Atlas Copco Tools, Inc. v. Air Power Tool & Hoist, Inc.*, 131 S.W.3d 203 (Tex.App-Fort Worth 2004, pet. Denied)

- ▶ Court reversed award based on a speculative future loss period and for failing to tie loss profits analysis to established facts and historical operating results.
- ▶ Expert also improperly deducted incremental costs and other expenses incurred in carrying on the business as required by Texas law.
- ▶ The Experts assumptions pertaining to the length of the damage period, sales growth and the failure to account for certain expenses, created an “analytical gap” between the Expert’s opinion and the facts, figures or data specific to the case.

*Fluorine On Call v. Fluorogas Ltd*, 380 F.3d 849 (5<sup>th</sup> Cir. 2004)

- ▶ The court determined that the available remedy was a loss in market value of an exclusive license for a new business with no history of profitability.
- ▶ The expert's analysis was characterized as future lost profits which the court found to be speculative.
- ▶ Court held that the loss in value measure of damages is the "market value of the asset at the time of breach – not the lost profits that the asset could have produced in the future."
- ▶ .... "the market value of an income-producing asset is inherently less speculative than lost profits because it is determined as a single point in time. It represents what a buyer is willing to pay for the chance to earn speculative profits."

*Alcatel USA, Inc. v. Cisco Sys. Inc.*, 239 F. Supp.2d 660 (E.D.Tex 2002)

- ▶ Court questioned an acquisition price damages methodology in summary judgment proceedings that assumed all the value of a company rested on the alleged misappropriated trade secrets
- ▶ Defense argued there were no lost profits and the plaintiff could not recover pursuant to any conceivable damage theory
- ▶ Court identified reasonable-royalty damage method as an appropriate approach to recover damages when the trade secret has not been destroyed, where the plaintiff is unable to prove specific injury, and where the defendant has not gained any profits to use in valuing the secrets.
- ▶ Court further addressed that when “damages are uncertain”, the uncertainty should not “preclude recovery” and the plaintiff should be afforded every opportunity to prove damages once misappropriation is shown.

# Q & A

**D. MITCHELL MCFARLAND** is a shareholder with the Houston office of Munsch Hardt Kopf & Harr, P.C. Mr. McFarland's practice has covered a broad array of civil defense litigation, with special emphasis on complex commercial litigation for the energy industry, construction litigation, partnership disputes, personal injury litigation and products liability. Mr. McFarland was a member of a national trial team defending a manufacturer of silicone breast implants and he was Texas regional counsel for major defendants in welding fume litigation, hernia patch litigation and contact lens solution claims. He recovered a jury verdict of over \$18,000,000 for losses due to delay for the owner of a major interstate pipeline related to the construction of six compressor stations. From 2003 to 2006 he obtained settlements exceeding \$32,000,000 on lost profits claims for several professional employment organizations in suits against brokers for failure to obtain workers compensation insurance coverage. He recently achieved a take nothing award for a major terminal company on a claim for \$64,000,000 in lost profits by a refinery. In 2004 he was an Instructor at the International Association of Defense Counsel Trial Academy at Stanford University and he appeared as a speaker at the DRI Preeminent Trial Lawyer Seminar in 2005 and 2006. Mr. McFarland received both his undergraduate and graduate degrees from the University of Texas at Austin, earning a BBA in Accounting, with highest honors, in 1975 and a J.D. degree, with honors, in 1979.



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# *Thanks.*

Please join us for our next conference, “Protecting Privilege in Post-Accident Investigations - Successfully Asserting Attorney-Client Privilege, Self-Critical Analysis Privilege, Work Product Doctrine and Mores,” scheduled on Tuesday, March 22, 2016 at 1pm EDT.

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