

Damages in Breach of Contract Cases

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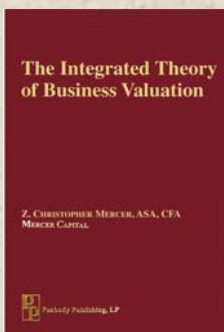
Damages calculations in breach of contract cases are nothing more than an attempt to determine the amount of money that will make a plaintiff “whole” after suffering some alleged wrongdoing (breach of contract) at the hands of a defendant. In general, this means calculating the present value of the lost profits of the plaintiff caused by the alleged breach of contract.

Business appraisers recognize that the value of a business enterprise is the present value of the future cash flows associated with that business enterprise. The cash flows associated with a contract can be thought of as a sliver of the cash flows of the business enterprise, so some of the same valuation techniques (particularly discounted future benefits methodologies) can be applied in damages calculations. Using the discounted future benefits method to determine damages related to the breach of a contract is a fairly simple exercise from the point of view of the arithmetic involved. The analyst determines the amount and timing of the foregone cash flows related to the breach of the contract and then determines an appropriate discount rate at which to reduce those cash flows to the relevant date (typically, the date of the breach). However, neither step of this process is as straightforward as it might at first appear, and a number of analytical decisions must be made in any damages calculation.



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The first job of the analyst is to examine the facts of the case and the contract itself to formulate a *theory of damages*. The theory of damages refers to the logical framework underpinning a calculation of damages, and the theory of damages often provides vital clues as to how to proceed with the analysis. The theory of damages will often start with a “but for” statement, and it generally ends with a statement that will dictate the analyst’s approach to the problem. If, for example, a customer defendant breaches an exclusive supply arrangement by buying from another vendor, the theory of damages might be as follows: “But for the bad acts of the defendant (i.e., the breach of the exclusive supply agreement), the plaintiff would have sold more units to the defendant.”

It is important that the analyst develop the theory of damages more fully. This further development of the theory of damages often occurs during the analysis itself. After an analysis of unit sales before and after the breach, the above theory of damages might develop into: “But for the fact that the defendant began buying 300 units per month from a third party, the plaintiff would have continued to sell the additional 300 units per month to the defendant.” Note that this theory of damages is more specific, and it leads to additional analytical questions, such as “How much profitability is associated with the sale of 300 units per month?” and “For how many months has or will the plaintiff suffer the loss of the profits associated with the sale of 300 units?”

Answering these questions allows the theory of damages to develop even more fully: “But for the fact that the defendant began buying 300 units per month from a third party, the plaintiff would have continued to sell an additional 300 units per month to the defendant, each of which would have resulted in an additional \$100 per month of net cash flow to the plaintiff for the 18 months remaining until the expiration of the contract.”

The development of the theory of damages and the clear statement of the logical underpinnings and assumptions of the analysis are of vital importance. It allows a user of the analysis to understand why certain calculations are appropriate rather than others, and it also allows a user of the analysis to quickly determine its relevance by determining whether the user agrees with the underlying theory of damages. While the analyst should always seek to develop the most logical theory of damages, there is sometimes a need to explore alternative theories of damages and prepare alternative calculations. The calculation of damages, much more so than the determination of value in the typical appraisal situation, varies with the parties’ differing interpretations of both the law and the facts.

As an example, Mercer Capital was involved in a case where the date on which the damages occurred was one of the items in dispute. Our clients had a legal theory that said that the damages occurred on Date 1, and we calculated the damages at \$X. The other side in this case had a legal theory that said that the damages occurred on Date 2, and their expert calculated the damages at \$Y, using a methodology that we did not believe was appropriate. The trier of fact determined that Date 2 was the appropriate date for the determination of damages. Fortunately, we had prepared an alternate calculation as of Date 2 that the trier of fact found more credible than that of the opposing expert, so our client still managed a partial victory.

Because the theory of damages can change somewhat given the decisions of the trier of fact in the case, it is important that analysts work closely with counsel in order to develop the theory of damages. This does not mean that the analyst loses any independence from the parties in the case or that the analyst should be an advocate for the position of one side or the other. As expert witnesses, we are advocates only of our own opinions, not of the specific positions taken by the parties or the lawyers in the case. However, it is important that the theoretical underpinnings of the opinions rendered by the experts in the case are consistent with the arguments of the parties in the case, and it is important that the opinion make clear what portion of the testimony is the independent opinion of the expert and what portion is a restatement of the assumptions of counsel.

It is also important to explicitly define *profit* for the purposes of a lost profits calculation. Typically, damages that are the result of a breach of contract should be calculated based on the lost *incremental* profitability of the plaintiff. Typically, the analyst will seek to determine the incremental profitability associated with the contract and will not allocate the fixed costs of the organization to the contract. Any analysis presented to a trier of fact should make it clear what expenses were considered in the analysis and why. It should also be clear what expenses were not considered, and why not. Once again, this will assist in allowing the trier of fact to determine whether the conclusions reached are consistent with the theory of damages that the trier of fact determines is appropriate.

Once the appropriate measure of profitability has been defined and the lost cash flows associated with the breach of contract have been determined, it becomes necessary to discount those cash flows to the damages date. It is important that the analyst carefully consider what discount rate is appropriate, as the discount rate will vary on a case by case basis. The discount rate used should reflect the risk of the cash flow stream being discounted to the present, and it must be appropriate to the cash flow or profitability stream selected. The discount rate might be determined as the weighted average cost of capital of the plaintiff, the required return on the plaintiff's equity, the required return on the defendant's unsecured debt obligations, or some other rate more appropriate to the specific facts and circumstances of the case. In any event, it is important that the analyst clearly communicate what discount rate was used and why so that a trier of fact can determine whether the discount rate used was appropriate.

Mercer Capital has experience in preparing credible analyses of business damages in a number of contexts, including breach of contract cases. If you or one of your clients is involved in a dispute involving business damages, please feel free to call a member of our Litigation Support Team to discuss the matter in confidence. ◆

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