

CALCULATING LOST PROFIT DAMAGES FOR AN UNESTABLISHED BUSINESS

New businesses, like established companies, can experience significant damages due to breach of contract, intellectual property infringement, business interruption, fraud and other causes of action.

Previously, new businesses were generally unable to recover lost profits or lost value due to the “new business rule” wherein the courts considered lost profits claims to be speculative when a company had no clear operating history to show. Over time, a growing number of courts have ignored this rule and looked to the quality of the evidence, allowing recovery of damages that can be adequately proven with reasonable certainty. The courts are recognizing that a new business should not be precluded from recovering its damages where the defendant’s very actions have prevented the plaintiff from establishing a track record.

Courts have continued to require that the best possible case be presented, and they have denied some claims for lack of evidence that a loss actually occurred. In many cases, the courts have distinguished between the standard required to show the existence of a loss and that required to calculate a loss, with a lower threshold generally applied to calculate the loss.

RISK FACTORS TO CONSIDER

A new business has risks, and there are many studies showing high failure rates for these ventures. In a claim for lost profits, it is important to give consideration to factors that influence the likelihood of success for the new business:

- Barrier to entry in the industry
- Existence of a business plan
- Management expertise and experience
- Availability of capital
- Adequacy and management of cash flow
- Reliance on innovation
- Economy and state of industry
- Experience of others similarly situated
- Quality of financial information

METHODS TO CALCULATE LOST PROFITS

Application of the two methods typically used to calculate lost profits, the “before and after method” and the “yardstick” method, can be challenging to apply in the case of a new business. The before and after method may be difficult to apply for the new business if the “before” period is insufficient to compare to the “after” period, or is characterized by start-up features such

as operating losses. The yardstick method, where the new businesses’ expected operating results are estimated based on results of a comparable business, can be challenged based on how close the comparable business is to the subject new business in terms of size, location, industry, product life cycle, technology, management capability, access to capital, competition and other factors. Some of the available methods to calculate lost profits include:

- Plaintiff’s prior experience
- Plaintiff’s subsequent experience
- Plaintiff’s experience at other locations
- Plaintiff’s pre-litigation operating projections
- Plaintiff’s lost customers
- Contract and bid documents
- Defendant’s subsequent experience
- Comparable experience of others
- Market surveys and analyses
- Industry averages
- Recovery of expenses

In this day of Daubert challenges, it is critical that the approach to calculate damages is rational and provides the trier-of-fact a basis upon which to assess the evidence. ¹



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