THE LITIGATION NEWSLETTER

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Chair's Letter

by: David C. Sarnacki

We are pleased to present this issue of the Litigation Section Newsletter, the first of three to focus on financial issues arising in our litigation practices. This issue will help you to center yourself on key issues in calculating lost profits and preparing appropriate document requests, addressing liquidated damages in construction contracts, and understanding fraudulent disbursements schemes.

Our plans are to provide you with additional resources on financial issues in our third and fourth issues of my year as Chair. You might recall that our first issue of the year was a theme issue on litigation management written by some of the best attorneys in the state. Our next issue will help you understand financial statements, and our final issue will help you deal with business valuations in the context of litigation. In order to bring you this valuable and practical advice on financial matters, we are looking beyond our membership to the very experts who assist us in our litigation practices. Each of these issues will highlight the expertise and experience of different litigation consultants who might be of assistance to you (or your opponent).

This particular issue is the product of a cooperative effort by your Litigation Section and the Plante-Moran Litigation and Valuation Services Group. The CPAs and management consultants in that firm, the 9th largest in the country, have a demonstrated history of bringing their technical skills, responsiveness and objectivity to bear on disputes facing real clients. They serve the business and legal communities on a daily basis on matters such as lost profit and lost wage/benefit calculations, business valuations, fraud and forensic accounting, and business insurance claims.

While Plante-Moran services clients throughout the state, I am grateful for the encouragement, support and assistance provided by Paul Taylor in the Grand Rapids office (616.774.8221). I have profited from Paul's advice and suggestions in formulating both the content for this issue and the topics for each of our theme issues on financial issues. Thank you Paul!

I trust that you too will profit from the practical advice contained in this and the next two issues. Read them. Keep them. Use them in the years to come.

IN THIS ISSUE

Document Request Checklist for a Typical Lost Profits Calculation

The need to prepare a lost profits claim can surface from many different situations and disputes such as breach of contract, patent or other intellectual property infringement, business interruption, and breach of fiduciary duty, among others. This article is intended to provide guidance as to the types of documents that an economic damages expert may like to study and analyze, if available. In addition, a brief description of the purpose of each document request is provided.

It is important for a Litigator to focus on the facts and circumstances of the dispute to determine which documents should be requested. For example, in certain circumstances both the Plaintiff's and the Defendant's financial statements and records may be appropriate such as when evaluating lost profits and unjust enrichment. However, in other circumstances, only the Plaintiff's financial statements and records may be needed.

Furthermore, the relevant time period for a document request is commonly considered to be monthly/quarterly/annual for five years prior to the alleged wrongful act and all subsequent periods. However, there is nothing "magic" about five years prior to the alleged wrongful act. The objective is to obtain documents during the period of time that will allow for a reasonable evaluation and calculation of lost profits in the dispute, if any.

It is important to note that if certain documents are not available or do not exist, then that may not preclude an economic damages expert from preparing a reasonable lost profits calculation. However, it is also true that certain documents are necessary to evaluate lost profits and a claim may be inadequate or unsupported without them.

In addition, different companies refer to documents with many different titles such as ledger, journal, report, analysis, and others. Care should be used when requesting documents so that a company produces documents responsive to the purpose of the request (as opposed to responding that a document with that title does not exist and is not generated in the company's ordinary course of business).

The main objective of this checklist is to assist a Litigator in gathering the best available information and data to evaluate and calculate lost profits, if any. This checklist is not represented to be comprehensive for all cases, as specific cases may have nuances that require different or additional documents to evaluate lost profits. However, the checklist is a solid guideline for potentially relevant documents in a typical lost profits calculation.

1. Contract, Purchase Order, Agreement, or other documents providing the legal basis of the lost profits claim and potential indication of damage period.

   Purpose: *To establish the terms and period of Agreement.*

2. Annual financial statements and tax returns of the Plaintiff and/or Defendant (depending on the facts and circumstances of the case) during the relevant time period.

   Purpose: *To evaluate the historical financial performance of the company before and after the alleged wrongful act.*

3. Documents reflecting the Plaintiff's and/or Defendant's monthly and annual unit and dollar sales of all subject products, such as sales journal/ledger reports.

   Purpose: *To evaluate in closer detail (unit information, monthly data, etc.) the timing and impact of the alleged wrongful act.*

4. All sales records used to record or summarize unit sales, gross sales, returns, allowances, discounts and net sales of all orders and shipments of all subject products.

   Purpose: *To determine the total sales and pricing history of the subject products.*

5. All documents indicating unit sales, gross sales, returns, allowances and discounts, net sales and net sales <u>by customer</u> of all subject products.

Purpose: *To identify the specific customers and geographical locations that were impacted by the alleged wrongful act.*

6. Documents reflecting the Plaintiff's and/or Defendant's monthly and annual costs and operating expenses associated with the manufacture and sale of the subject products.

   Purpose: *To evaluate the incremental costs of production and sale of subject products.*

7. All product line profit and loss statements, including schedules, reports and other documents which identify, in detail, the direct and indirect costs associated with the production and sales of all subject products.

   Purpose: *To evaluate the incremental costs of production and sales of subject products.*

8. Annual Standard Cost System data regarding the cost of each subject product including corresponding year-end variance reports.

   Purpose: *To determine the specific direct cost items identified by the company and indirect cost allocations made by the company related to the subject products in order to evaluate incremental costs in greater detail.*

9. All records which summarize and/or allocate overhead, indirect expenses or other burden pools, including manufacturing overhead, distribution, selling, general and administrative expenses.

   Purpose: *To determine the indirect cost allocations made by the company related to the subject products in order to evaluate expense items in greater detail.*

10. All analyses, breakdowns and/or classifications of expenses as either fixed or variable.

    Purpose: *To determine the company's assessment of cost structure that may assist in the determination of incremental costs.*

11. All financial projections, forecasts, and budgets prepared by the Plaintiff and/or Defendant that include the subject products during the relevant time period.

    Purpose: *To determine the financial and market expectations of the company and evaluate the company's ability to develop accurate projections.*

12. All documents reflecting the Plaintiff's and/or Defendant's capital assets dedicated to the production and sales of the subject products.

    Purpose: *To determine the cost of assets applied to the production and sales of the subject products.*

13. Detailed asset listings, ledgers or reports indicating acquisition date, estimated useful life, depreciation method, depreciation, book value, and market value of all assets related to the production and sales of the subject products.

    Purpose: *To identify the value of assets applied to the production and sales of the subject products.*

14. All capital expenditure requests relating to investments undertaken and/or expected to be undertaken with respect to the production and sales of the subject products.

    Purpose: *To identify the specific actual and expected future assets and costs incremental to the production and sales of the subject products.*

15. Documents reflecting the Plaintiff's and/or Defendant's capital structures and cost of capital.

    Purpose: *To assist in determining a present value discount rate for projected future lost profits, if any.*

16. All documents reflecting principal amounts, interest rates, and terms of all short-term/long-term loans and borrowings.

    Purpose: *To assist in determining the company's cost of debt used in the calculation of a present value discount rate.*

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Document Request Checklist –

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17. All documents relating to the Defendant's and/or Plaintiff's capital, hurdle rates, rates of return, or methods used to evaluate budget opportunities.

    Purpose: *To determine the company's assessment of cost of capital.*

18. All documents indicating increased costs or extra expenses incurred by the Plaintiff due to the alleged wrongful acts of the Defendant such as payroll records, business expense reports, time reports, and invoices.

    Purpose: *To evaluate potential increased costs and extra expenses incurred by the Plaintiff that result in lost profits on existing sales.*

Summary

A properly prepared and evaluated lost profits calculation requires the consideration of many factors. The document request checklist presented in this article is a solid guideline of the types of documents potentially useful in a typical lost profits calculation. The checklist is intended to be a general practice aid and does not include requests for specific types of documents that may be relevant in certain cases such as construction-related lost profits disputes, certain intellectual property disputes, business insurance claims, and fraud investigations, among others.

About the Author

Paul Taylor is a member of Plante & Moran LLP's Litigation and Valuation Services Group in Grand Rapids, MI. He has over 13 years of specialization in this area and has performed over 150 lost profits calculations. In addition, he has provided testimony in Federal and State courts as an economic damages expert.

The Plante & Moran, LLP Litigation and Valuation Services Group has over 30 staff in Michigan with deep expertise in litigation and valuation issues.

Detecting Employee Embezzlement Involving Fraudulent Disbursement Schemes – Top 10 Indicators of Fraudulent Disbursements

One of the common lessons learned by victims of embezzlement is that the defalcations could have been prevented if senior management, or others with oversight responsibility, had been more aggressive in implementing strong internal controls. The problem of detecting embezzlement in an organization is often compounded because those persons who commit the fraud are often in positions of trust, and in many cases, high level positions within an organization, such as controllers or purchasing managers.

The easiest and most prevalent embezzlement perpetrated within an organization is disbursement/payable fraud. Embezzlers, whether to satisfy a financial need linked to their personal lives such as divorce, college expenses, high medical bills etc., or to feed an addiction such as gambling, drugs or alcohol, usually start by committing small-scale embezzlements. They look for opportunities to perpetrate the fraud and test the waters of their organization's internal controls. If the embezzlement goes undetected, they become bolder. Over time, the dollar amounts and/or the frequency of the embezzlement usually increases, continually feeding their addiction or funding dramatic changes in their lifestyle.

The first fruit of embezzlement is typically the purchase of a new car. As the embezzlements increase, it is not unusual for the embezzlers to get more extravagant, leading to the acquisition of recreational equipment, extensive home renovations, boats, and even second homes. If the embezzlers have addictions, their habits usually get worse.

Common fraudulent disbursement schemes include the following:

Duplicate payments to vendors. In this scheme, embezzlers may manipulate the accounts payable system to produce a second payment on a vendor invoice. The embezzler retrieves the check from the person signing the check for 'mailing' to the vendor, alters the payee on the check and cashes it. When the bank statements are received, the embezzler either destroys the check, inserts a different check with the same amount or alters the payee to the original vendor name.

Manual checks. In a variation of the above scheme, the embezzler writes a manual check to himself or herself for the same amount owed to a vendor. The embezzler cashes the manual check, and when the canceled check is returned, the embezzler alters the payee on the check so it appears to be written to a vendor.

Fictitious Vendors. In this scheme, the embezzler sets up a new 'vendor' in the accounts payable system, sometimes with a vendor name very similar to legitimate vendors used by the company. Fake vendor invoices are created by the embezzler, entered into the accounts payable system and set-up for payment.

Voided Checks. The most basic way to hide a check is to void it and not list it in the disbursements journal. When the bank statement arrives, the embezzler removes the check from the returned checks and destroys it. Now there is no record of the payment in the journal and no physical evidence of the check on hand. Since the embezzler is the one who reconciles the bank account, the embezzler reports that the bank balance and book balance match, when in fact they do not.

Although there are no foolproof methods for detecting and preventing embezzlement, the information contained on checks in monthly bank statements is valuable and may provide helpful clues in determining if embezzlement is occurring in your organization. Unfortunately, it is more difficult to detect embezzlements if the individual perpetuating the embezzlement gets to the bank statements first. In fact, embezzlers are sometimes the same individuals who perform the monthly bank reconciliations.

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Top 10 Indicators of Fraudulent Disbursements –
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To reduce the likelihood of employees tampering with the bank statements, some organizations have taken very aggressive measures such as having bank statements mailed directly to the homes of the chief executives/owners of businesses or to the offices of Board members who sit on the finance committee. Another common fraud prevention measure is to have the bank reconciliations performed by individuals completely independent of the accounting department.

Even if you are not the person who ultimately performs the bank reconcilations, you may want to consider reviewing the checks contained in the bank statements prior to sending the statements to the individual who has that responsibility. The following are the top 10 indicators of employee disbursement fraud that may surface when reviewing the checks and other disbursements records which will require additional follow-up:

1. **Vendors whose remit-to addresses are post office boxes.** Although many legitimate vendors use post office boxes as remit-to addresses, it is also a very common practice of embezzlers and requires further scrutiny. When reviewing invoices supporting these checks, you may want to determine if the phone numbers are legitimate. It never hurts to call a vendor. If the phone number on the invoice is missing, unlisted, a residential number, or is always answered by an answering machine, further investigation is required.

2. **Vendors whose addresses are the same as employee addresses.** It should not be too difficult to run computer reports from the accounts payable files and payroll files, sorted by address, and compare the reports side-by-side to see if there are any matches. A similar search should also be done on phone numbers.

3. **Look for out-of-sequence checks issued on bank statements.**

   Embezzlers often gain access to checks and sometimes use checks with higher check numbers (those contained in sealed boxes scheduled for use at a later time) in an effort to avoid detection.

4. **Look at the endorsees on the backside of the check.** Many times embezzlers fraudulently endorse vendor checks to themselves as a second endorsee. Scrutinize all checks with suspicious endorsements or dual endorsements.

5. **Scrutinize all checks on which a signature stamp has been used.** This can be especially effective if the organization's use of a signature stamp is the exception, not the rule.

6. **Look for checks issued to unfamiliar or unapproved vendor names.** Usually there are reasonable explanations for this to occur, but pursue it all the way to the source documents, such as purchase orders. In addition, embezzlers will often use vendor names that are variant spellings of well-known companies, hoping that their invoices will receive less scrutiny than start-up vendors.

7. **Account for all cancelled checks listed on the bank statement.** If you are the first person to open the bank statement, the checks should be intact. However, in the event that a cancelled check is missing from the statement, you may want to consider tracing that check with the bank.

8. **Checks to vendors that continually fall under the threshold requiring further authorization.** For example, if an organization's approval process requires all invoices over $1,000 to be approved by senior management, and there are frequent checks to vendors just beneath that threshold, further review of those vendors' invoices and purchase orders could also prove helpful.

9. **Examine voided checks.** A list of voided checks should be verified against physical copies of the checks. Bank statements should be reviewed to ensure that voided checks have not been processed.

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10. **Scrutinize checks payable to employees.** This examination may reveal blatant embezzlement, other schemes involving co-perpetrators, or duplicate expense reimbursements.

In summary, there are no foolproof methods for detecting and preventing fraud within an organization. However, embezzlers often leave clues and many times those clues are contained on checks in the bank statements and other disbursements records. If something doesn't feel right, it probably isn't. Diligent reviews of checks may lead you to an unwelcome discovery, but it may also provide you with the comfort of knowing that you have taken effective action to detect and possibly prevent a future fraud from occurring in your organization.

This article is not intended to represent a comprehensive list of all potential indicators of employee disbursement fraud but a list of the most common indicators identified in our professional experience as fraud examiners.

About the Authors

David Wells, **CPA**, **CFE**, and **Paul Taylor** are members of Plante & Moran LLP's Litigation and Valuation Services Group in Southfield, MI and Grand Rapids, MI, respectively. The Plante & Moran, LLP Litigation and Valuation Services Group has over 30 staff in Michigan with deep expertise in fraud investigation issues.

Financial Considerations in Establishing Liquidated Damages Clauses in Construction Contracts

by: Mark A. Robinson, CPA, PE
Plante & Moran, LLP

The relationship between liquidated damages clauses and the potential amount of an owner's delay damages continues to challenge many owners when forming construction contracts. At the time of forming the contract, the contradictory general rule that the liquidated damages amount be a reasonable forecast of just compensation for an owner's potential harm and also be difficult to estimate, positions the liquidated damages clause to be the subject of many legal disputes.

The owner, who was trying to avoid the troublesome and sometimes costly proof of delay damages through the use of a liquidated damages clause, will be faced with attempting to recover actual damages should the liquidated damages clause be found unenforceable. With the increasing sophistication of project planning techniques, the courts are often provided with information regarding the owner's expectations at the time of contract formation. These enhancements in the evidence available to assist in establishing expectations, combined with the courts' growing willingness to award damages in disputes involving unestablished businesses, creates the necessity for a review of liquidated damages and the potential owner delay damages they are intended to represent.

The economic damages associated with a contractor's extended performance on a construction project are usually relatively easy to determine when compared to valuing the losses incurred by an owner whose project has been unreasonably delayed. Generally, the contractor attempts to recover the additional costs of performance due to the delay, which, if the accounting records are properly kept, have been accumulated and categorized by the specific project and possibly the specific delay. The owner, however, does not typically have a wealth of historical documents from which to prove economic harm. The owner's losses are usually a result of not achieving time-sensitive expectations and therefore are more challenging to quantify. Due to the challenges in preparing a delay claim, owners typically prefer to use liquidated damages clauses that establish an amount, usually expressed as a daily rate, to be a reasonable measure of the economic loss that would be suffered by the owner should the project be delayed beyond the contractually allowed completion date.

Although conceptually a straightforward and well-intentioned idea, liquidated damages clauses have been an issue in many construction disputes. When a liquidated damages clause is contested, the contractor typically attacks the claim from two fundamental directions. The first direction is that of disclaiming responsibility for the magnitude of the delay that is claimed to be due to the contractor's actions. With a detailed review of the contract documents coupled with the use of sophisticated delay analysis, the contractor will attempt to prove any delays were excusable delays and therefore eligible for a contract time extension. The second general approach that may be followed by the contractor will be to challenge the magnitude of the liquidated damages. The amount specified in a liquidated damages clause must be a reasonable projection, at the time of the contract formation, of the owner's potential loss should there be a delay in the project's contractual completion date. The amount specified must not be intended to serve as a "penalty" to the contractor. Should an amount be judged as a penalty and not as liquidated damages, the court may not enforce the clause.

Why Liquidated Damages Clauses Can Work Against The Owner

In order to avoid a legally unenforceable liquidated damages clause, owners may specify liquidated damages in contracts that are low estimates of their potential actual damages. In the vast majority of cases, should the owner decide to pursue delay damages and the liquidated damages clause is deemed enforceable, the owner would be precluded from recovering any greater actual damage. The intentional act of stating a negligible liquidated damages amount, therefore, in effect serves to protect the contractor and not the owner. The liquidated damages amount places a ceiling on the contractor's liability and leaves the owner unprotected for damages beyond the liquidated damages amount.

The inclusion of a liquidated damages clause and the understatement of the liquidated damages amount may work against the owner in another way. Owners sometime feel that at the very least, the presence of a liquidated damages clause will ensure that the project will be completed within the contractually required time frame. The contractor may decide it is not economically logical to meet the contractually allowed completion date. By knowing the cost for completing the contract late, a contractor can decide that it is more economical to incur the liquidated damages costs than to expend the acceleration efforts and associated costs in order to bring the project in on time. However, if the liquidated damages amount was established at an amount that would accurately reflect the owner's delay damage, the owner would theoretically be indifferent to the contractor's decision.

Why Knowledge of Owner Delay Damages Is Essential

There are at least three reasons why an understanding of owner delay damages is essential:

1. Setting a proper liquidated damages clause amount.

   The liquidated damages amount is to be an amount that accurately reflects the owner's expected delay damages at the time of the contract formation. Knowledge of the components of owner damages is important to establishing a proper dollar amount to specify.

2. No liquidated damages clause in contract.

   Since not all contracts contain liquidated damages clauses that attempt to value the owner's delay damages, the owner and contractor should know what types of actual delay damages may be recoverable by the owner.

3. The liquidated damages clause may be found unenforceable.

   Should the liquidated damages clause be found unenforceable, the owner may still be able to recover actual damages. As in the case of a contract without a liquidated damages clause, the various components of owner economic loss should be fully understood in preparing the claim.

Direct Versus Consequential Damages

There are two principal classifications of damages in litigation involving delay. The first, direct damages, are those damages that are seen as arising "naturally" or "ordinarily" from the breach. More specifically, direct damages in a delay litigation are those damages that are normally expected as a result of delaying the project. The second form of damages is consequential damages. Consequential damages are those damages that arise from special circumstances not ordinarily predictable at the time of the forming of the contract.

A significant distinction between the two principal classifications of damages is in the requirements to prove and recover the loss. If a damage is determined to be a direct damage, the loss is relatively easy to recover. However, for the recovery of consequential damages, consideration might be given to factors such as the relationship between the contracting parties, the particular facts and circumstances concerning the agreement, the contractor's knowledge of the owner's urgency and intended use for the project, and other factors.

Direct Damages

An owner's direct damages associated with a contractor's inexcusable delay of a project are many times expressed as either the rental value of the project for the period of the delay or as a reasonable return for the period of delay computed on the amount of capital the owner has invested in the project.

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Rental Value

One of the most frequently used direct damage measurements is that of the rental value of the completed structure over the delay period. The rental value theory is used regardless of the owner's intentions to rent or not rent the building. In many situations, such as in the construction of a bridge or highway, it is very difficult to determine the structure's rental value and an alternate means of determining the damages might be employed.

Reasonable Return On Investment

One such alternate means of determining direct damages is through the computation of a reasonable return over the period of the delay on the capital that is invested in the project. This type of analysis assumes the construction project owner, had it not been for the delay, would have invested the capital that was unproductively retained during the delay into a currently available investment opportunity.

Other Elements Of Direct Damage

There are instances where other specific damages are seen as arising naturally from the breach and are thus appropriate direct damage valuations. It should be noted, however, that these same damages may be seen in other instances as not possessing the required direct linkage to the delay and therefore be pursued as consequential damages. Examples may include situations when an owner may be required to extend a current lease or obtain a lease for another building if the building being constructed is not ready for occupancy when planned. In addition, as a further example, an owner may experience additional interest costs due to the extended borrowing period caused by the delay.

Consequential Damages

The recovery of consequential damages requires satisfying a more stringent set of criteria than does the recovery of direct damages. From "*Recovery Of Damages For Lost Profits*" (Robert L. Dunn), the recovery of lost profits (consequential damages) is subject to three general principles: proximate cause, reasonable certainty, and foreseeability. Pending the proof of these principles, various forms of consequential damages may be recoverable.

Consequential damages may be viewed as belonging to one of three general categories. The first is the "extended construction cost" group that includes the additional costs the owner experiences with the project still under construction. The second group is "third-party claims" which include the damages done to parties that are not part of the contract for which the owner may be held responsible. The third group, "lost profits", represent the damage done to the owner through the loss of use of the new facility.

The following sections describe some of the types of consequential damages that may be considered in either a liquidated damages quantification or in the determination of an owner's delay damages.

Consequential Damages – Extended Construction Costs

Extended Overhead

An owner, similar to a contractor, may incur two types of overhead expenses associated with a construction project and may be able to recover both types of extended overhead for the period of delay. One type of overhead, home office overhead, is the collection of expenses that are not directly attributable to any one project. The typical types of home office expenses include the salaries for administrative personnel, rent and supplies for the office, and the expenses of the various support departments such as accounting. In order for these expenses to be claimed, consideration needs to be given to issues such as, among others, the association of these expenses to the disputed project and whether these expenses represent "incremental" expenses to the owner.

The second type of owner overhead that may be of consideration is that of job site overhead. Job site overhead typically includes the salary of any owner site personnel, the expenses of renting temporary site facilities such as trailers, and the expenses related to site utilities.

<u>Owner Equipment And Material Costs</u>

An owner may incur additional costs related to equipment and material as a result of the delay. Typically these increased costs are either from the additional storage of purchased goods or are from price escalation on postponed purchases. An owner may have purchased the furniture and fixtures for the building in advance and planned to have them installed around the contractually specified completion date. However, with the contractor's delay, the owner may be required to store the goods until a later date. Had the owner postponed the purchase of the furniture and fixtures, the owner may consider recovering price escalation costs if the goods had gone up in price since the originally planned purchase date.

<u>Interest / Incremental Financing Expense</u>

Incremental financing expenses associated with a construction project can represent a significant portion of an owner's delay damages. Once a construction project is complete, an owner typically switches financing from a construction loan to a permanent loan. The permanent loan is usually at a lower interest rate than the construction loan since the permanent loan can be secured with a completed structure. In many cases, the damages related to the owner's incremental interest expense during the delay period could be viewed as having various components, two of which include:

1. Incremental construction loan interest cost.

   The additional interest expense due to the higher interest rate on the construction loan, as compared to the permanent loan, is typically quantified as an owner damage.

2. Incremental permanent loan interest cost.

   In certain cases, the interest rates that are available for a permanent loan may have increased during the delay period. The resulting increased interest expense due to this rate escalation may be appropriate as a damage component.

One of the primary considerations in addressing interest expense as a damage element is to make certain that double-counting does not occur in the calculation.

<u>Additional Professional Services</u>

Engineers, architects and construction managers who have contracted with the owner may require additional compensation from the owner in order to remain active during the delay and be in position to complete the project. These additional expenses associated with retaining design and management services may be recoverable.

Consequential Damages – Third-party Claims

When an owner has contracted a project using multiple prime contractors, a delay caused by one prime contractor can ripple through to the follow-on prime contractors' schedules. The delayed follow-on contractors may seek compensatory remedies from the owner, who, in turn, may include these compensatory damages paid to the other contractors in the claim against the contractor who caused the delay.

Consequential Damages – Lost Profits

Lost profits may be the largest component of the consequential damages claim and their form will usually depend on the type of structure or facility being constructed. Lost profits as a result of delay normally can be placed into two general categories that are descriptive of the lost profits causation: lost profits due to excess costs and lost profits due to lost revenues.

<u>Lost Profits Due To Excess Costs</u>

Lost profits due to excess costs are typically related to the owner's continued operation of inefficient or uneconomical facilities when the new facilities under construction would have produced a higher profit for the owner. The excess costs are then defined as costs that would not have been realized by the owner without the delay. Typically, the excess costs will involve differences in efficiencies at the old and new facilities and are related to labor, material, maintenance, overhead, or utilities. In other situations, the owner could experience excess costs when forced to satisfy customer commitments by reselling outside manufactured products instead of selling products that

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were to be manufactured in-house at a lower cost at the new facility.

Lost Profits Due To Lost Revenue

Lost profits due to lost revenue involves the owner losing some or all of the owner's relevant product or service market. As an example, a loss of renters due to the delay results in the owner's loss of rental income. In manufacturing situations, an owner may lose sales to others for the period of delay, be forced to cancel customer orders, or permanently lose a previously established market share to the competition.

Lost Profits Damage Determination

Regardless of the type of lost profits, there are certain similarities in their determination. Lost profits are determined as the difference between the "but for" or "should have been" profit and the "actual" profit. The challenge typically arises in construction delay litigation where the "should have been" profits are not known from historical records and need to be reasonably determined.

Lost Profits Damage Recovery – Types Of Evidence To Prove Damages

One of the greatest challenges in lost profits damage analysis is in the establishment of the "should have been" economic conditions (prices, costs, production volumes, etc.). Although an exact calculation is not required, one should have a reasonable basis for the computation and rely on the best available proof. The following points illustrate various types of evidence that may assist in achieving this goal:

1. Prior experience.

   Probably the first type of evidence to be considered in establishing the "should have been" economic condition of the owner is the extension of the profits experienced prior to the delay. Unfortunately for the owner, construction delay litigation usually involves what is considered an unestablished business with no prior record.

2. Subsequent experience.

   Should litigation start a considerable time after the actual completion, there may be enough post-delay operating financial information to consider in determining the "should have been" economic conditions during the delay. Care must be taken to avoid misusing data that is only relevant in the initial start-up of the facility.

3. Experience at other locations.

   In situations involving a chain of operations or a franchise, an owner may consider financial results achieved at established locations as a proxy for the unestablished location. Consideration may be given to factors such as location, the size of the operations, the operational characteristics, and other relevant factors of production that may be different between the two establishments.

4. Experience of others or industry data.

   In certain situations, considering the economic conditions at competitor establishments or statistics based upon industry data may obtain meaningful information for the "should have been" economic variables at the delayed project. As before, the key consideration is that of comparability between the projects.

5. Consideration of planning documents.

   In many projects, the various economic variables associated with the project are projected in feasibility or cost-benefit studies. Using information from this type of study has the disadvantage of not being based on actual performance but does have the advantage of being prepared specifically for the delayed project. Comparisons to industry data or the experience of others may help establish the credibility of the forecasts.

6. Expert testimony.

   Specialized knowledge in the determination of the various economic factors associated with the "should have been" economic condition of the owner may be beneficial.

Consequential Damages – Other Damages

Depending on the particular facts and circumstances, other types of owner damage may be recovered. For example, additional costs associated with renegotiating contracts with movers or, in certain cases of extended delay, the owner may experience loss due to the economic depreciation of the structure and any installed material or equipment. The opinion of qualified counsel and experts should be obtained in determining all relevant components and magnitudes of the damage claim or liquidated damages amount.

Conclusion

The use of an liquidated damages clauses can benefit a construction project if it is properly evaluated. However, the lack of attention to the proper valuation of the liquidated damages amount can defeat one of the main intentions for the liquidated damages clause and send the matter into litigation. Knowledge of an owner's actual damages and a well-supported analysis will greatly enhance the probability of achieving the goals of using a liquidated damages clause.

About the Author

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Ten Overlooked Issues In Lost Profits Calculations

The quantification of economic damages is a significant part of most commercial litigation matters. Frequently, the proper expression of damages is in the form of "lost profits" where it is common to use the "incremental approach" in the computation. Presentation variations used with this approach include the "before-and-after" method, the "yardstick" method, and various projection-based methods. However, regardless of the method, the objective of the incremental approach in each case is to quantify the additional profits the plaintiff would have earned "but for" the wrongful act(s) of the defendant.

In general, the process is straightforward. The first step in determining lost profits is quantifying the revenue that was foregone or lost by the plaintiff as a result of the defendant's wrongful act(s). Next, any incremental cost that would have been required to generate the revenue is subtracted to arrive at the amount of lost profits. Finally, the lost profits calculation is adjusted to present value.

Although the general process is straightforward, there are many important factors that can be overlooked. The following sections summarize 10 frequently overlooked factors that may have a significant impact in a lost profits calculation.

1. Lost Revenue

While lost revenue is the starting point in all lost profits calculations, sufficient attention is not always given to important factors that can affect volume or price. In most cases, it is necessary to assess market demand for the incremental volume of goods or services the plaintiff claims it could have sold absent the defendant's wrongful act(s). This analysis of the relevant market may include an evaluation of geographical coverage, consumer buying preferences, and acceptable substitute products, among other factors.

To establish the price at which the lost volume would have been sold, it may be necessary to analyze and reconcile the price achieved by the plaintiff in actual sales, the terms of a contract, the price negotiated with a replacement supplier, the price achieved by the defendant, and any other pricing factors that could surface during the relevant market and lost volume analysis.

2. Incremental Costs

Once the plaintiff's lost revenue is established, the costs that would have been incurred to generate those lost revenues must be determined. These additional costs are frequently referred to as "incremental costs" or "saved costs."

In evaluating incremental costs for a lost profits calculation, the starting point usually is the company's financial statements. As a company prepares their internal and external financial statements for a variety of audiences and purposes, the purpose of the financial statement frequently dictates how a company classifies its costs. It is important to not overlook the objective of the analysis and be influenced by the cost classifications that may have been assigned by a company's accounting department, i.e., fixed, variable, direct, etc.

In a lost profits calculation, the focus is on identifying all the costs that would vary/increase in order to support the level of claimed lost revenue – or, from an alternative viewpoint, the costs that were saved because there was less or no revenue. For example, material costs would increase with increased revenue or be saved if there is reduced or no sales. On the other hand, the cost of lighting a factory, while typically classified by a company as a variable cost, would not increase with increased revenue (assuming additional shifts are not added) or be saved if there is reduced revenue.

3. Capacity

One of the often overlooked considerations in a lost profits calculation is a plaintiff's capacity constraints. When claimed lost sales volumes go beyond a company's existing capacity, it is important to not overlook the additional expenditures that would be necessary to generate the claimed level of lost revenue. For example, a company may need to purchase new machinery and equipment to produce the volume of product included in the lost revenue calculation. In addition, if a company does not have sufficient production or warehouse space, a facility expansion may be needed.

Relevant capacity issues may extend beyond the physical assets needed to produce and sell products and services. A sample of additional capacity issues and related costs that may need to be addressed include the ability to finance additional production capacity, the ability to find and add to the existing work force, the ability to obtain the required raw materials, and the ability to market and distribute the claimed lost sales volume.

Capacity limitations can result in a reduction of a plaintiff's claimed lost revenue or an increase in the plaintiff's incremental costs (personnel, financing, and/or asset related) associated with the claimed lost revenue.

4. Extra Expenses

In addition to a plaintiff's claim for lost profits on lost revenue, the plaintiff may have additional economic losses. Extra expenses adversely affect company profitability and should be identified, quantified, and included in a damage claim, if incurred. Examples of extra expenses include the costs to find an alternative supplier, additional storage expense, repairs related to defective equipment, labor costs to correct problems, and expediting costs, among many others.

5. Increased Costs on Actual Sales

In some circumstances, a company may incur higher costs on the revenue it has achieved. For example, the purchase of raw materials in smaller quantities usually results in a higher price per unit due to the inability to receive a quantity discount from a supplier. The lower gross profit, in this example, is as much a damage as the lost profits from the lost revenue. Also, an increased cost claim that is common in construction cases is for the loss of labor efficiencies due to the defendant's wrongful act(s). Depending on the facts and circumstances of the case, there may be many other types of increased cost-related damages.

6. Damage Period

In many contract disputes, the damage period is assumed to be the remaining term of the contract. However, in some long-term contract cases, it may be appropriate to limit the damage period to something less than the full contract period. In other circumstances, a plaintiff may suffer economic damages beyond the end of the contract period due to wrongful acts of the defendant during the contract period. In tort actions, the plaintiff may be limited to the duration, for example, of a patent's term. However, in certain patent cases, damages may extend beyond the patent term in the form of "accelerated market entry" damages that reflect the unfair benefit the defendant obtained by infringing the patent at a time close to the patent expiration.

In each case, one must take into consideration the specific facts and circumstances of the case, the type of action, and the facts surrounding the legal principles of recovery in order to establish the damage period.

7. Mitigation

A plaintiff is required to act reasonably to mitigate damages. Any alleged failure to do so must be established by the defendant. Proof of mitigation of damages requires only a showing that the plaintiff took reasonable steps to reduce its losses.

Proper thought and investigation during the discovery process can identify and assist in the quantification of mitigation activities. For example, a plaintiff may secure a substitute contract that generates profit for it during the alleged damage period. If it can be demonstrated that the profits from the substitute contract could not have been earned but for the breach, then the substitute profits should be offset against the lost profits claimed. However, if it was possible for the plaintiff to complete performance on both contracts,

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profits from the substitute contract should not be deducted from the lost profits claimed.

8. Additional Working Capital Requirements

   For lost revenue calculations that include material growth, it is important to consider the potential for additional working capital needs of the plaintiff company. As a company grows, it typically needs additional cash to fund higher levels of inventory, additional payroll costs, and higher levels of accounts receivable. These cash needs are normally offset partially by increased accounts payable. However, typically there is need for additional "net" working capital in order to support a growing company. This net working capital need may be material and carries a related interest cost that would reduce a lost profits claim.

9. Pre-judgment Interest and Present Value Discounting

   The time value of money is a fact of life that has a significant affect on all economic endeavors. It also needs to be considered in the calculation of lost profits. From an economic point of view, it needs to be considered in relation to losses that occurred long before the verdict and losses that would not be realized until long after the verdict. This is complicated by the fact that legal precedent and statutes do not always mirror economic reality. The use of simple interest under some aspects of the law rather than compound interest is but one example. Additional factors may intervene, such as the Michigan statute that provides for statutory interest running from the date a case is filed which may differ from the date of initial harm. All this makes it imperative that the litigation team determine what the particular court allows or requires.

   The point that may be overlooked is that, generally speaking, all entities have a weighted average cost of capital that should be considered for computing the present value of the claimed lost profits. A company's weighted average cost of capital reflects investors' expectations for a rate of return commensurate with the level of risk associated with the company. Companies invest to earn at least their weighted average cost of capital so that its investors can receive expected returns. The weighted average cost of capital is a rate sufficient for a company to meet its interest obligations and repay its debt principal, while also allowing for an equity return that is consistent with its type of business. A company's weighted average cost of capital rate should be considered for both pre-judgment interest and present value discounting purposes based on financial and economic theory.

10. Taxation

   It is important to note, as a general rule, lost profits are calculated on a pretax basis. Lost profits damage awards are taxable to the plaintiff and deductible by the defendant. Therefore, calculating lost profits on an after-tax basis effectively would result in double taxation.

Summary

A properly prepared/evaluated lost profits calculation requires the consideration of many factors. It is important that the litigation team focus on obtaining information related to these factors throughout the discovery process. The best information available may be found in tax returns, financial statements, budgets/forecasts, detailed accounting records/journals, production records, management records, management interviews, interrogatories, deposition testimony, and industry research, among many other potential sources of information.

About the Authors

Mark Robinson, **CPA**, **PE**, and **Paul Taylor** are members of Plante & Moran LLP's Litigation and Valuation Services Group in Southfield, MI and Grand Rapids, MI, respectively. Each has over 13 years of specialization in this area and has performed over 150 lost profits calculations. In addition, they have provided testimony in Federal and State courts as economic damages experts.

The Plante & Moran, LLP Litigation and Valuation Services Group has over 30 staff in Michigan with deep expertise in litigation and valuation issues.

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