Thought Leadership Discussion

Reasonable Certainty of Lost Profits in a New Business or Venture

Brandon L. McFarland, John C. Kirkland, and Kristine D. Taylor

The controversy over the existence of lost profits related to new businesses has long been debated among legal counsel and forensic analysts. Regarding this issue, the view of most federal and state courts has shifted from a rule of law to a rule of evidence. Whereas the concept of lost profits for unestablished businesses was previously dismissed, the Modern New Business Rule grants new businesses potential credibility in recovering damages. This discussion (1) reviews the Modern New Business Rule along with its endorsement of reasonable certainty and (2) summarizes judicial decisions in which the standard of reasonable certainty is used in the measurement of lost profits damages.

Introduction

One of the challenges of measuring economic damages in a case that involves a new enterprise is deriving a reasonable estimate of profits lost due to the wrongful actions of another party. Due to lack of historical performance for the new enterprises, certain state and federal courts formerly abided by the New Business Rule, which dismissed any action by a new enterprise to claim lost profits. However, recent judicial decisions in damages cases where a new business or venture claimed lost profits have revealed a new standard that many courts now observe—the Modern New Business Rule.

Whether assuming a role in the plaintiff's or the defendant's damages case, it is important that the damages analyst ("analyst") and the legal counsel ("counsel") understand the standards by which courts assess damages and have knowledge of relevant court decisions. This discussion summarizes the following:

1. The shift in standards applied by both federal and state courts to address lost profits in damages cases involving new enterprises
2. The application of reasonable certainty in federal and state judicial decisions

New Business Rule

The New Business Rule ("NBR") traces its roots to 19th century American common law. At the time, courts sought to protect businesses and create an environment in which the nascent, industrializing American economy could grow.

The NBR originally held that "lost profits for a new business were not recoverable" for a new or recently formed business as future profits were too "uncertain, speculative, and contingent."[1]

The foundation on which the NBR is premised precludes a number of newly formed businesses from claiming lost profits in damages cases. This view provided an opportunity for one party to potentially breach a contract before the other party began to conduct its business operations.

Under the NBR, the nonbreaching party had little to no recourse against the breaching party. However, as time passed, most courts began to realize the inequities created by this interpretation and application of the NBR.

The Shift from a Rule of Law to a Rule of Evidence

More recently there has been a shift in the judicial interpretation of the NBR. The majority of state and federal courts now reject the application of the NBR as a per se rule in favor of a new interpretation and standard. "The development of the law has been to find damages for lost profits of an unestablished business recoverable when they can be adequately proved with reasonable certainty."[2]

This distinction between absolute certainty and reasonable certainty by the court is an important element of the new interpretation that allows new businesses to claim, and in some cases recover, lost profits. "What was once a rule of law has been converted to a rule of evidence."[3]

This shift in interpretations came about gradually and eventually resulted in what is commonly known as the Modern New Business Rule ("MNBR"). The MNBR holds that profits of a recently formed business are in fact recoverable, so long as the amount of lost profits can be "adequately proven with reasonable certainty."[4]

An important distinction between the NBR and the MNBR is that the NBR is a rule of law, whereas the MNBR is an evidentiary rule.

There are several scenarios in which the MNBR may be applied:[5]

1. **Post-Breach Profits for an Injured Business.** In this situation, a damaged business may eventually return to the projected growth curve that existed prior to the alleged wrongful act. For example, if a supplier breached its contract to provide a certain product or service, the business damaged by the breach may need time to find a replacement supplier. This may ultimately lead to lost profits.

   If the injured business is able to find a replacement supplier and return to its prior level of sales, the lost profits may only apply during the time needed to find a new supplier and return to previous growth. In this instance, a comparison of projected and actual profits during the time of recuperation may be used to calculate lost profits.

2. **Post-Breach Profits by Successor Business.** In some instances, a wrongful act may cause the injured business to vacate its location and a competitor business may take its place. Provided all other market factors remain the same, the profits generated by the successor business may be used as a substitute for calculating the lost profits of the damaged business.

3. **Business Enterprise Ceases**. In some situations, the damaged business may cease all operations. In such a case, to meet the reasonable certainty standard, the elements that are necessary for the success of a particular business must be identified. These critical success factors are business-specific and should be determined by the nature, industry, and market of each enterprise.

4. **Short-Term Pre-Breach Operations**. It is possible for a new business to have only operated for a short period of time before being affected by an alleged wrongful act. "Even if the business operated for less than one year, sufficient information may exist to extrapolate lost profits as a result of the breach."[6]

   Data gathered for even a few months may be comparable to industry statistics. A new business may demonstrate reasonable certainty by comparing its data with similar new business trends.

Although courts have started to acknowledge scenarios in which unestablished businesses may recover lost profits, the requirement of reasonable certainty is often strictly followed.

Reasonable Certainty

In determining the validity of a calculation of lost profits, courts consider the establishment of reasonable certainty in an analyst's measurement of lost profits.

In *Morris Concrete, Inc. v. Warrick*, the court describes reasonable certainty as follows: "In order that it may be a recoverable element of damage, the loss of profits must be the natural and proximate, or direct, result of the breach complained of and they must also be capable of ascertainment with reasonable, or sufficient, certainty . . . absolute certainty is not called for or required."[7]

While there is no law or single measure for reasonable certainty, section 352 of the Restatement (Second) of Contracts states, "Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."[8]

Although federal and state courts provide varying case-specific decisions, they generally agree on certain guidelines:

1. The conduct of the defendant upon which the claim is based directly caused the damages to the plaintiff.

2. The plaintiff can estimate the amount of damages, and the estimation employs a reliable method of measurement.
3. The length of the damage period is reasonable.
4. The plaintiff based its assumptions upon the best available evidence, and both internal and external factors were considered within the measurement of damages.

For well-established companies, damages measurements should acknowledge past performance as reliable predictors of the future. For a new or speculative business, parties may measure damages with reasonable certainty by the use of expert testimony, business records, economic and financial data, and other verifiable data. However, new businesses face significant challenges in proving lost profits due to the lack of or limited historical record of performance.

Some of those challenges include the following:[9]

1. Reliability of expected profits projections
2. Selection of guideline companies to apply a yardstick method[10]
3. Determination of the length of the damages period
4. Demonstration of specific business risk, cost of capital, and discount rates as applicable to future lost profits
5. Verification of existence of a market and probable acceptance of the product/service
6. Capacity to scale operations and meet expected projections
7. Confirmation of management expertise

The inherent challenges of proving lost profits in a damages case where the plaintiff is a new business result in increased scrutiny by both federal and state courts as evidenced by the judicial decisions summarized below.

Energy Capital Corp. v. United States

In *Energy Capital Corp. v. United States* ("*Energy*"), Energy Capital Corporation ("Energy Capital") brought a breach of contract action against the Department of Housing and Urban Development ("HUD") in the Court of Federal Claims (the "Claims Court") and was awarded lost profit damages. This judicial decision was subsequently appealed by the U.S. government.

Upon review, the United States Court of Appeals for the Federal Circuit ("Appeals Court"), affirmed the decision by the Claims Court to award Energy Capital lost profits.

Background[11]

Formed in 1994, Energy Capital Corp. was established to provide financing that would allow institutions and businesses to optimize their energy consumption. One opportunity that Energy Capital identified was the affordability and lack of financing available for energy improvements in HUD housing.

A major hurdle to the development of an affordable financing program was the regulatory restrictions on HUD housing already in place. Mortgages for HUD housing were provided mainly by the Federal National Mortgage Association ("Fannie Mae") and were insured by the Federal Housing Authority ("FHA"). The restrictions imposed by Fannie Mae and the FHA would not allow the homeowners of HUD housing to place additional mortgages on their properties.

Over time, Energy Capital was able to come to an agreement with HUD and eliminate the financing restrictions put on HUD housing. This agreement was known as the Affordable Housing Energy Loan Program ("AHELP"). The AHELP agreement allowed Energy Capital to originate $200 million in loans to owners of HUD properties over three years.

These loans would include provisions referred to as a "spring subordinated lien" and a "cross-default provision." This means that if a property owner defaulted on the energy efficiency loan originated under AHELP, the first mortgage on the property would also go into default.

At the same time, the energy efficiency loan would "spring" into the senior mortgage position. In turn, Energy Capital would structure the loans so that the anticipated savings of the energy improvements would be 110 percent of the loan payments annually. These loans would bear an interest rate of 3.87 percent above the Treasury rate.

Fannie Mae would fund the loan and be paid back at an interest rate equal to the Treasury rate plus 1.87 percent—Energy Capital would keep the other 2 percent. As part of its agreement to fund up to $200 million in loans, Fannie Mae agreed to buy back the loans from Energy Capital in the future.

On February 7, 1997, an article in the *Wall Street Journal* stated that Energy Capital had received the AHELP contract in exchange for fund raising for President Clinton. HUD terminated the AHELP agreement on February 10, 1997.

The Court's Decision

The Claims Court started from the premise that in order to demonstrate entitlement to lost profits, Energy Capital was required to establish (1) causation, (2) foreseeability, and (3) reasonable certainty.[12]

In addition, the court took the position that because AHELP was a new venture, Energy Capital would have a difficult burden establishing that its claim for lost profits was reasonably certain.

During the appeals process, the government argued that because the agreement with Energy Capital was a new venture, the court should adopt a per se rule that lost profits may never be recovered from a new business venture that was not performed.[13]

The Appeals Court declined to adopt this rule for the following reasons, among others:

- The benefits that were expected from the contract, "expectancy damages," are often equated with lost profits, although they can include other damage elements as well.[14]
- To recover lost profits for the breach of contract, the plaintiff should establish by a preponderance of evidence that (1) the loss was the proximate result of the breach, (2) the loss of profits caused by the breach was within the contemplation of the parties because the loss was foreseeable or because the defaulting party had knowledge of special circumstances at the time of contracting, and (3) a sufficient basis existed for measuring the amount of lost profits with reasonable certainty.[15]

In addition, the Appeals Court did not agree with the government's argument that because AHELP was a new venture, there was no evidence of a track record and it would be impossible to measure lost profits.

To support its decision, the Appeals Court cited the following statement by the Alabama Supreme Court:

> The weight of modern authority does not predicate recovery of lost profits upon the artificial categorization of a business as "unestablished," "existing," or "new" particularly where the defendant itself has wrongfully prevented the business from coming into existence and generating a track record of profits. Instead the courts focus on whether the plaintiff has adduced evidence that provides a basis from which the jury could with "reasonable certainty" calculate the amount of lost profits. . . . The risk of uncertainty must fall on the defendant whose wrongful conduct caused the damages.[16]

Ultimately, the Appeals Court upheld the opinion of the Claims Court that "while the evidentiary hurdles to recovering lost profits for a new venture are high, such profits may be recovered if the hurdles are overcome."[17]

Commentary

In *Energy Capital Corp. v. United States*, the Claims Court and the Appeals Court rejected the per se NBR that lost profits cannot be determined for a new business or venture because future profits are too speculative and uncertain. Instead, both courts expressed support for the MNBR and applied the standard of reasonable certainty.

In *Energy*, the court was provided a business plan and the fees that were agreed to by all parties involved. The capital to finance the project was also in place. The only matter that was left to speculation was the extent to which Energy Capital could execute on the $200 million loan program.

The Appeals Court addressed this in its opinion by commenting that the Claims Court "drew reasonable inferences based upon the evidence" and that this "was not a case in which the trial court engaged in unsupported speculation."[18]

In comparison to *Energy*, the trial court in *Neely v. United States* ("*Neely*") awarded the plaintiff lost

profits after it determined that the profits earned by a third party were sufficient to prove reasonable certainty.

In *Neely*, the company F.S. Neely brought action against the government for breach of a land lease to mine coal. Approximately four or five years after the breach, the leased lands were actually strip-mined by a third party.

In its decision, the Claims Court stated "that almost always, in the case of a new venture, the fact that there would have been a profit, had there been no breach, is too shrouded in uncertainty for loss of anticipated profits to form a reliable measure of the damages suffered."[19]

However, the court went on to conclude that since a third party had actually mined the land, "the profit realized from these operations, if, indeed, there were profits, would furnish some basis for a fairly reliable estimate of what plaintiffs profits would have been."[20]

In both cases, the court was clear that proving the reasonable certainty of lost profit claims is a difficult hurdle to overcome in a new business or new venture damages case. In addition, the court does not accept a per se rule and does not exclude a new business or venture from receiving lost profits. However, the plaintiff should prove that the analyst's measurement of lost profits is reasonably certain.

Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P.

In *Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P., and Christopher Wyatt* ("*Youtoo*"), Mr. Al-Saud (the "plaintiff") brought a breach of contract claim against Youtoo Media, L.P. ("Youtoo Media") and its chief executive officer Christopher Wyatt (collectively, the "defendants"). The breach of contract claim was related to a failure by the defendants to reimburse the plaintiff.

The defendants filed counterclaims. The U.S. Court for the Northern District of Texas (the "District Court") granted Mr. Al-Saud's motion for entry of judgment on jury verdict in his favor.

The District Court also rejected the defendants' counterclaims on the basis that the testimony of the Youtoo Media damages expert was too speculative. The parties appealed to the U.S. Court of Appeals for the Fifth Circuit (the "Fifth Circuit Court").

Background[21]

Mr. Al-Saud invested $3 million in the form of a reimbursable down payment to Youtoo Media while he contemplated whether to purchase an interest in it. Youtoo Media was a technology company that combined elements of social media and television in a way that allowed viewers to participate in broadcasts through their mobile device by sending pictures, videos, or texts.

The ultimate goal of Youtoo Media was to have its platform purchased by American broadcasters. In order to reach this goal, Youtoo Media believed it should demonstrate success in other markets. Youtoo Media felt that capital would be required to enable it to reach those markets. The search for additional funding brought Mr. Al-Saud and Youtoo Media together and led the parties to enter into a letter of intent in 2013.

Mr. Al-Saud made the $3 million reimbursable down payment as an initial investment in Youtoo Media that provided him with a three-month option to contemplate the purchase of an interest in Youtoo Media. However, Youtoo Media encountered financial difficulty and was forced by a lender to sell its intellectual property and assets to pay outstanding obligations.

After learning of the Youtoo Media troubles, Mr. Al-Saud requested that Youtoo Media reimburse the $3 million down payment. Youtoo Media refused and Mr. Al-Saud sued Youtoo Media for breach of contract. Youtoo Media filed a counterclaim for breach of fiduciary duty in order to seek lost profits attributable to the actions of Mr. Al-Saud.

The Court's Decision

The District Court rejected the Youtoo Media counterclaims on the premise that the testimony of the Youtoo Media damages expert was too speculative.

The Fifth Circuit Court upheld the District Court ruling for the following reasons, among others: (1) Youtoo Media lacked a history of profitability and (2) Youtoo Media had few signed agreements with potential customers. Therefore, the defendants' expert relied largely on "hoped for" partnerships and the earnings those partnerships might create.

Commentary

Both the District Court and the Fifth Circuit Court considered the fact that Youtoo Media was a newly established business and determined that this status did not preclude a reliable lost profits number. However, upon hearing and analyzing the testimony of the defendants' damages expert, both courts determined that the measurement of lost profits was too speculative to be deemed reliable.

Although the courts involved in the *Youtoo* decision reached a different conclusion than the courts involved in *Energy* and *Neely*, the decisions

were premised on the modern interpretation of the NBR—that is, that a newly formed business or enterprise may be entitled to damages for lost profits if it can prove with reasonable certainty that such profits would have been earned but-for the breach.

Summary and Conclusion

Although new businesses face significant challenges in validating a claim of lost profits, the MNBR allows recently formed businesses and ventures to recover economic damages as long as the business provides adequate reasonable certainty.

In *Energy*, *Neely*, and *Youtoo*, the courts did not dismiss the cases based on the new nature of the involved ventures. Instead, the courts determined a verdict founded upon the reliability of evidence as a basis to measure lost profits.

Energy Capital provided thorough documents such as its business plan and contracted fees of all parties involved, which left little for the court to speculate, and as a result received a favorable court decision.

While also a new venture, Youtoo Media on the other hand lacked a history of profitability and could not supply objective confirmation of future profit which resulted in the rejection of their counterclaims. In reviewing cases such as these, analysts may better understand the role of reasonable certainty in supporting lost profits claims.

New businesses now have the ability to contest inequities caused by harmful conduct against them, however, the responsibility lies with analysts and counsel to thoroughly understand the implications of reasonable certainty.

An understanding of these judicial decisions can assist an analyst to:

1. better understand the judicial application of reasonable certainty in light of the shift toward the MNBR,
2. identify the hurdles in proving reasonable certainty in a lost profits analysis involving a new business or venture, and
3. recognize supportable scenarios where federal and state courts have awarded lost profit damages.

Notes:

1. Robert L. Dunn, *Recovery of Damages for Lost Profits* (Westport, CT: Lawpress Corporation, 2005), vol. 1, 376.
2. Ibid., 378.
3. Ibid.
4. Ibid.
5. Mark Gauthier, "Recovering Lost Profits for Start-Up Companies," *Business Law Today* (December 14, 2017), found at https://businesslawtoday.org/2017/12/recovering-lost-profits-for-start-up-companies/.
6. Ibid.
7. Morris Concrete, Inc. v. Warrick, 868 So. 2d 429, 440 (Ala. Civ. App. 2003).
8. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, *Litigation Services Handbook*, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), 4.9.
9. Scott A. Barnes, "Lost Profits and Lost Value in Litigation Involving Startups, New Ventures, Emerging Companies and New Technologies" found at (https://docplayer.net/90185629-Lost-profits-and-lost-value-in-litigation-involving-startups-new-ventures-emerging-companies-and-new-technologies.html).
10. "The yardstick method involves using a benchmark to estimate what would have occurred if the damages event had not taken place. Common benchmarks used in a yardstick method damages analysis include other companies in the same or a similar industry as the owner/operator or industry data for the industry that the owner/operator participates in." Source: Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, 2014), 200.
11. Energy Capital Corp. v. U.S., 302 F.3d 1314, 1317 (Fed. Cir. 2002).
12. *Id.* at 1320.
13. *Id.* at 1324.
14. *Id.*
15. *Id.* at 1325.
16. *Id.* at 1327.
17. *Id.* at 1328.
18. *Id.* at 1329.
19. Neely v. U.S., 285 F.2d 438, 152 Ct.Cl. 137 (1961).
20. *Id.* at 147.
21. Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P., 754 Fed.Appx. 246 (5th Cir. 2018).

Brandon McFarland is a senior associate in our Atlanta practice office. Brandon can be reached at (404) 475-2301 or at blmcfarland@willamette.com.

John Kirkland is an associate in our Atlanta practice office. John can be reached at (404) 475-2303 or at jckirkland@willamette.com.

Kristine Taylor was a summer associate in our Atlanta practice office. She is currently a senior at Emory University expecting to receive a bachelor in business administration with a concentration in finance and in strategy and management consulting. She can be reached at kristine.taylor@emory.edu.