Best Practices Discussion

Measuring and Defending Economic Damages in Breach of Fiduciary Duty Tort Claims

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Breach of fiduciary duty tort claims often incorporate complex legal topics and damages analyses. Some of these legal and damages-related topics are summarized in this discussion. From a legal perspective, this discussion summarizes the law under which a plaintiff may seek to recover economic damages, the circumstances where lost profits may be awarded, and the effect on damages of a heightened standard of care placed on fiduciaries. This discussion then presents three methods that analysts commonly use to measure economic damages—the before-and-after method, the yardstick (or comparable) method, and the sales projections "but for" method.

Introduction

A fiduciary relationship is one in which one party holds a legal or ethical relationship of trust with another party (or group). Asset managers, trustees, and banks are a few of the common fiduciaries. Fiduciaries usually have power over the assets of beneficiaries, who may or may not hold legal title to those assets.

The trust fiduciary is under significant obligations to:

1. put the beneficiary's interest first,
2. avoid conflicts of interest, and
3. not profit without the beneficiary's knowledge and consent.

When the fiduciary's actions cause a break in this trust (a "bad act"), the beneficiary may bring a legal cause of action and may pursue lost profits. The path to recovering lost profits is somewhat unique to a breach of fiduciary duty.

This discussion summarizes the law under which a plaintiff may seek to recover economic damages, the circumstances in which lost profits may be awarded, and the effect on damages of a heightened standard of care placed on fiduciaries.

This discussion also summarizes three methods for measuring economic damages:

1. The before-and-after method
2. The yardstick method
3. The sales projections method

This discussion summarizes the variables that damages analysts may consider when measuring lost profits in breach of fiduciary duty tort claims.

Finally, this discussion integrates these topics into an illustrative example.

Legal Liability Background

Sources of Law

To understand legal liability in the context of a breach of fiduciary duty, legal liability and standards of care should first be understood. Broadly, legal liability arises from one of two bodies of law: tort law or contract law.

Contract law provides forward-looking remedies with the intent of placing the wronged party in the position in which they would have been, had the other party not breached the deal.

On the other hand, tort law is restorative and attempts to place a wronged party back to where they were before the harm. In this way, contract law is forward looking and tort law is rearward looking.

To know which body of law to apply to a situation, legal counsel typically looks to whether or not there is a contract. If there is a contract that has been breached, contract law applies. Where someone has been harmed in a way that was not a breach of contract, tort law applies.

As with most legal matters, exceptions abound. In the case of fiduciary relationships, many states have adopted laws allowing for tort claims even when a contract exists. States have also adopted laws providing for certain duties and obligations, whether or not these items actually appeared in the disputed contract or were even agreed to by the parties of the complaint.

States commonly have laws that provide specific guidelines for damages in a breach of fiduciary duty case.

To sum up the three types of applicable law: contract law applies when a contract exists, tort law applies when a contract does not exist, and state laws can modify or define those contracts and tort claims.

Elements of a Cause of Action

At their cores, both contract law and tort law generally require four basic elements to be shown by the party bringing a lawsuit:

1. A duty owed by the defendant to the plaintiff
2. A breach of that duty
3. Damage to the plaintiff (whether monetary or otherwise)
4. A causal link between the breach of duty and the damage

These four basic elements are the building blocks of nearly every civil lawsuit.

Of these four basic elements of contract law and tort law, duty reigns king. Plaintiffs want the duty to be broad and expansive—while defendants want the duty to be defined very narrowly to show their actions were not in violation of any duty.

In a contract claim, the concept of duty is replaced with the existence of a contract. The terms of a contract are essentially the duty of each party. The concept of duty is commonly used in the tort law context.

Determining the Duty of a Defendant

The process of defining a duty depends on the type of legal action. A defendant's duty in a contract is typically easier to ascertain than in a tort dispute, assuming a well-written contract. What a potential defendant needs to do to avoid liability can literally be in black and white.

The duty in tort law is sometimes fluid and guided by vague standards. A common, and the lowest, duty is to act as a reasonable person. That is, generally, everyone in every situation has a duty to exercise reasonable caution against every reasonably foreseeable plaintiff. Understandably, many lawsuits have revolved around the concept of reasonableness to identify what the defendant's duty actually was.

Where states have created tort causes of action, the duty element is often written into state statutes. The courts will interpret these statutes, but usually duty is more precisely defined in these circumstances.

Generally, the process to determine legal duty in a breach of fiduciary duty is summarized as follows. First, legal counsel may look to state statutes for specific duties. Second, legal counsel may then look to whether or not a contract existed between fiduciary and beneficiary. If so, the duty owed could be one or a combination of these two sources. Finally, if neither state statutes nor contracts apply, then legal counsel may analyze whether or not the fiduciary dropped below a reasonable standard of care, as defined by the local courts.

Statutory Duties Owed by a Fiduciary in Washington and Oregon

A fiduciary relationship is sacred to many states. The concept of reasonableness is replaced by a duty of loyalty and other duties depending on the exact relationship.

A trustee-beneficiary relationship is a good example of a fiduciary relationship. A trustee has a duty to keep beneficiaries reasonably informed about the status of the trust, avoid personal conflicts, and other specific requirements. Because states may have differing laws on fiduciary duties and damages, this discussion focuses on Washington and Oregon.

Washington imposes duties on trustees which specifically include a duty to inform the beneficiaries of "facts necessary for them to protect their interests" and to "administer the trust solely in the interests of the beneficiaries" amongst many other specific guidelines (RCW 11.98.072(1) and RCW 11.98.078(1)). Oregon has statutes with nearly identical language (ORS 130.710(1) and ORS 130.655(1)).

Washington and Oregon similarly provide guidelines for damages in the trustee-beneficiary context. They both state, in similar words, that a trustee who breaches their duties related to a trust is liable for the greater of the cost to restore the trust to the pre-breach condition or the profit the trustee made through breaching the trust.[1]

In this way, both states take a traditional torts approach to damages, but also give the beneficiary the profit of the bad act, if that profit was greater than the actual damages.

Breaches of fiduciary duties take many forms and result from several types of fiduciary relationships. As a result, legal counsel may analyze state statutes for heightened duties owed by fiduciaries and for increased damages when a breach of fiduciary duty occurs.

Lost Profits Considerations

In most civil cases, a plaintiff only needs to prove the facts by a preponderance of the evidence. Whether an issue is being decided by a judge or jury, the finder of fact need only to conclude that the plaintiff's allegations are more likely than not correct. This legal standard may generally be quantified as a 51 percent certainty that the plaintiff's allegations are correct.

Lost profits may be more judgment-based by nature. Accordingly, courts have not uniformly accepted this generous standard. A "reasonable certainty" standard is more common for the award of lost profits in either contract or tort cases. This standard is comparable to a "beyond a reasonable doubt" legal standard, which is only found in criminal court cases.

By either legal standard, a judge may want to see a pattern of profits that the plaintiff experienced beginning before the defendant performed the wrongful act. And, a judge may want to see reduced or lost profits after the defendant did the bad act.[2]

The length of time the judge may require may be as subjective as either standard of proof may be vague. In any event, a plaintiff will be standing on more solid ground with consistent profit and loss statements, pay stubs, tax returns, or similar financial data.

Lost profits without a consistent prior history, or without any history at all, are not necessarily barred so long as the evidence is based on sufficient facts. The Washington Supreme Court stated in the *Larsen v. Walton Plywood Co*. case, "lost profits will not be denied merely because a business is new if factual data is available to furnish a basis for computation of probable losses."[3]

The sort of lost profits data discussed in the *Larsen* decision was expert testimony based on speculative sales numbers which assumed the plaintiff had sales volumes disproportionate to competitors. The court found that this was not sufficient factual data as a result of the underlying speculations.

In *Gillespie v. Seattle-First National Bank*, another Washington case, the court stated the degree of proof required for lost profit recovery. "[L]ost profits must be proven with reasonable certainty, or conversely, damages which are remote and speculative cannot be recovered."[4]

In the *Gillespie* case, the court recognized the difficult balance between this heightened standard and the difficulty of proving lost profits. It stated that a "[p]laintiff must produce the best evidence available and if it is sufficient to afford a reasonable basis for estimating his loss, he is not to be denied a substantial recovery because the amount of the damage is incapable of exact ascertainment."

In the *Gillespie* decision, the court also went on to discuss expert testimony. The court discussed both:

1. how reliance on expert testimony is a sufficient basis to reach a finding of lost profits and
2. how "experts in the area" or qualified damages analysts ("analysts") are competent to pass judgment.

The *Gillespie* decision did not go on to further define "experts in the area."

From *Gillespie* and *Larsen*, one can deduce that, while the courts may put a blanket "reasonable certainty" instruction on lost profits, the emphasis on certainty goes to the existence of damages, and the emphasis on reasonableness seems to go to the method of damages measurement.

Effect of Heightened Duty of Care on Measurement of Lost Profits

Lost profits are recoverable in many tort claims. A plaintiff bringing a breach of fiduciary relationship is given a "leg up" through state law specifying the duties of a fiduciary or perhaps establishing profit to the breaching party as a floor for damages.

As a result, state law has the ability to widen the circumstances in which a breach of fiduciary duty may lead to a plaintiff's successful recovery. State law may also potentially increase the recovery amount. A state-by-state analysis of the particular type of fiduciary relationship is necessary.

Considerations in Lost Profits Awards

When analyzing a specific case, it would be prudent to first look to the applicable statutes to find a heightened duty. While the above statutes cannot be relied on in every type of fiduciary relationship, these principals of loyalty sum up the duties in most circumstances.

Next, with the duties of the fiduciary in mind, legal counsel may compare the wrongful act performed against this standard. If the defendant's actions fall below this standard, then there may be a breach. If a breach exists, legal counsel may look to whether actual damage resulted. Or, depending on the circumstances, counsel may look to whether a profit was made by the breaching party.

Finally, for proving the dollar measurement of lost profits, legal counsel and analysts should use factual data as a basis for calculations and avoid speculation.

Retaining a Qualified Damages Analyst

As discussed in the *Gillespie* decision, retaining a damages analyst may be advantageous for parties engaged in breach of fiduciary duty tort claims. The services performed by an analyst (1) may assist the parties in obtaining a favorable settlement or judgment and (2) may reduce the total litigation-related expenses.

The parties in a lawsuit and their legal counsel ("counsel") may have relevant insights into the estimation of economic damages. However, economic analysis typically is not counsel's area of expertise—their area of expertise is legal defense. Conversely, an analyst's area of expertise is economic analysis.

Analysts, therefore, typically are expected to simply have more financial analysis experience and relevant qualifications than legal counsel and other parties in tort claims. In addition to measuring economic damages, analysts often add value by:

1. assessing the merits of a case,
2. weighing the risks of going to court, and
3. reviewing and critiquing materials prepared by opposing damages experts.

Through the above-listed services, the odds of obtaining a favorable settlement or judgment may increase substantially.

The parties in tort claims understandably often seek to minimize total legal expenses. Therefore, these clients may have reservations with regard to retaining an analyst to estimate economic damages.

However, hesitancy to retain an analyst actually may result in higher total legal expenses. If an analyst is not retained, legal defense teams or other parties may expend considerable resources preparing economic damage analyses, which may include educating themselves on unfamiliar topics.

By contrast, an analyst is often able to efficiently prepare analyses relying on past experience, knowledge, and operational systems already in place. Retaining an analyst also may lower the total costs by simply allowing the retained parties to focus on areas in which they are proficient—the legal representatives can efficiently manage the legal strategy while analysts focus on the economic damage analysis.

However, when an independent analyst is retained in a legal dispute, the analyst is obligated by professional and ethical standards to advocate for his or her position only. That is, the analyst should present an impartial and unbiased position rather than advocating for the client's position.

Measuring Economic Damages

The methods to measure economic damages may vary in form or fundamental methodology based on the cause of the economic damages. However, most economic damages claims may be measured based on the following three methods:

1. The before-and-after method
2. The yardstick method (also referred to as the "comparable method")
3. The sales projections method (also referred to as the "but for" method)

Analysts may use these three methods to measure lost profits. There is no legal requirement to use more than one method to measure damages. However, analysts may use more than one method to support the reasonableness of the damages conclusion.

The Before-and-After Method

In the before-and-after method, analysts compare:

1. economic income from the time period in which profitability was affected by the alleged damaging acts (the "damage period") to
2. results attained prior to or after the damage period (the "comparison period").

If performed accurately, this comparison allows the analyst to identify lost profits resulting from the alleged wrongful acts.

In order to apply this method, the analyst should identify and quantify the effects of all other factors that may affect profitability in either the damage period or the comparison period.

For example, if the analyst measures damages for a real estate development company by comparing income from the 2009 to 2010 damage period with income from the 2005 to 2008 comparison period, the analyst should also consider the impact of the severe decline in real estate activity during the damage period.

The reliability of the before-and-after method may be compromised to the extent that significant adjustments have to be made for the results of additional external factors.

Another potential limitation of the before-and-after method may be the availability of data. The before-and-after method requires sufficient operating data for the analyst to identify meaningful profits from the damage period and the comparison period. These data may not always be available due to factors such as a limited operating history, challenges identifying or clarifying a distinct damage period, and other factors.

The Yardstick (or Comparable) Method

In the yardstick method, analysts compare the performance of the subject company to benchmark data from the same time period. The benchmark data may be the operating results of guideline companies, relevant industries, or the subject company branches or divisions that were unaffected by the alleged wrongful acts.

In order to correctly apply this method, the analyst should select benchmark data that are sufficiently similar to the subject company. The credibility of results from the yardstick method may be reduced to the extent that benchmark data are dissimilar to the subject company.

Analysts may consider qualitative and quantitative similarities between the subject company and the benchmark data. Regression analysis is a useful tool to analyze quantitative similarities. For example, an analyst could perform a regression analysis to compare the subject company's sales to total industry sales over a certain number of years.

Analysts also should consider any other changes in the subject company operations that may have affected the performance of the subject company relative to the benchmark data over the period reviewed (e.g., changes in management, product redesign).

The Sales Projections (or But-For) Method

In the sales projections method, also called the "but-for" method, analysts compare (1) economic profits from the damage period with (2) projected economic profits if the alleged wrongful acts had not occurred.

The sales projections method is a common economic damages measurement method.[5] The availability of data may be a contributing factor to the relatively high application of this method. Many businesses regularly prepare projected operating results, which, if prepared prior to—and without consideration of—the alleged damaging acts, may be used as reasonable projected economic profits, absent, or "but for," the impact of the alleged wrongful acts.

Additionally, financial projections by industry are available for many industries from a variety of private and public data sources. These industry projections may often be used in the sales projections method. However, courts often prefer projections prepared specifically for the subject company rather than general industry projections.

The reliability of the results derived from the sales projections method depends on the reliability of the projected results. Therefore, analysts should carefully consider the reasonableness and accuracy of projections.

As part of the analysis, analysts may consider the historically demonstrated ability of the subject company to achieve projected goals. Analysts may also consider the reasonableness of the projected results and key underlying assumptions such as capital expenditures, cash requirements, resulting market share, and other factors.

Measuring Damages

After identifying lost profits in each period using one or more of the previously discussed measurement methods, the total damages may be measured using either:

1. ex-ante damages measurement methods or
2. ex-post damages measurement methods.

In an ex-ante damages measurement, lost profits are discounted at a risk-adjusted rate from the terminal date to the date of the alleged wrongful acts. The analyst may then add interest damages from the date of the alleged wrongful acts to the date of the trial based on the prejudgment interest rate.[6]

Ex-ante damages measurements typically consider only information that was known or knowable as of the date of the breach.[7]

In an ex-post damages measurement, the analyst discounts future lost profits (from the current date to the terminal date) back to the current date based on a risk-adjusted rate. For historical lost profits, the analyst does not apply a discount rate and instead totals the undiscounted lost profits from the date of breach through the current date. Ex-post damages measurements rely on all information available as of the date of trial.

If the damages award is taxable to the plaintiff, it may be appropriate to recommend to the court that the total damages award include both the (after-tax) damages measurement and the income tax expense related to the damages measurement.[8]

Damages Measurement Illustrative Example

A hypothetical example of the application of the sales projections method is presented next.

Jim Cheatum, a shareholder-elected manager at Clean Grocery, has a key role in business management decisions. At a Christmas party in 2011, Cheatum learns that earlier that day there was a toxic waste spill next to the onion farm from which Clean Grocery routinely purchases produce.

Unhappy with his current salary at Clean Grocery, Cheatum decides not to voice this news to other members of management or act on this information for the betterment of Clean Grocery. Instead, he approaches a competing grocery store and offers to keep this information secret if they offer him a better job. Cheatum is offered—and he accepts—a new job.

Two weeks later, the local newspaper publishes an article about Clean Grocery's poisonous onions. Sales at the grocery store plummet and remain depressed for years afterwards. Additionally, Clean Grocery incurs significant expenses associated with recalling damaged produce as well as ongoing marketing campaigns to rebuild its image to the public.

When Cheatum's knowledge of the toxic waste spill and subsequent lack of action are exposed in 2016 through Cheatum's social media account, Clean Grocery shareholders elect to pursue economic damages from Cheatum.

An analyst is retained in this dispute to measure the economic damages resulting from Cheatum's breach of fiduciary duty. The analyst elects to use the sales projections method based on consideration of a five-year projection prepared on December 15, 2011, before Cheatum's breach of fiduciary duty. After reviewing the historical and projected financial data, the analyst compiles the Clean Grocery financial fundamentals presented in Exhibit 1.

After the toxic waste spill and resulting negative media coverage, Clean Grocery was not able to achieve the projected results. Clean Grocery lost considerable sales not only of onions, but of all its groceries. Additionally, Clean Grocery incurred significant recall and marketing costs associated with the wrongful acts.

After an analysis of the financial projections, the analyst concludes that the projections reasonably represented the expected operating performance of Clean Grocery "but for" Cheatum's alleged breach of fiduciary duty.

The projected and actual financial performance of Clean Grocery is summarized in Exhibit 2.

The analyst then reviews the Clean Grocery operating environment to identify any other factors that may have affected its ability to achieve its projected earnings. The analyst estimates that other changes in the operating environment—including the employment termination of an additional key member of management and increased competition—accounted for approximately 40 percent of the identified lost profits.

The analyst concludes that the remaining 60 percent of the lost profits was a direct result of the damaging acts. The calculated lost profits resulting from the wrongful acts are presented in Exhibit 3. A graphical representation of this analysis is presented in Figure 1.

The analyst selects the ex-post damages measurement method because much of the risk of achieving the projection was accounted for in the reduction of lost profits for other changes in the operating environment. Because this particular damages award would be taxable, the analyst concludes that pretax income represents the appropriate level of income to restore the plaintiff to its economic position before the wrongful event.

Based on the data presented in Exhibit 3, the analyst measures lost profits attributable to the wrongful acts from 2012 through 2016 of $6.2 million.

Exhibit 1
Clean Grocery Financial Fundamentals Summary
As of December 15, 2011

	For the Fiscal Year Ended December 31,											
	Historical					Projected					*CAGR*	*CAGR*
	2007	2008	2009	2010	2011 [a]	2012	2013	2014	2015	2016	*2007-2011*	*2012-2016*
	$000	$000	$000	$000	$000	$000	$000	$000	$000	$000	*%*	*%*
Revenue	50,120	52,110	53,988	55,001	56,205	57,891	59,570	61,476	63,198	65,093	*2.9*	*3.0*
Annual Change	*NA*	*4.0%*	*3.6%*	*1.9%*	*2.2%*	*3.0%*	*2.9%*	*3.2%*	*2.8%*	*3.0%*		
Pretax Income	5,012	5,207	5,400	5,508	5,624	5,736	5,937	6,115	6,280	6,456	*2.9*	*3.0*
Annual Change	*NA*	*3.9%*	*3.7%*	*2.0%*	*2.1%*	*2.0%*	*3.5%*	*3.0%*	*2.7%*	*2.8%*		

CAGR = Compound annual growth rate
NA = Not applicable
[a] Estimated based on annualized financial data as of December 15, 2011.

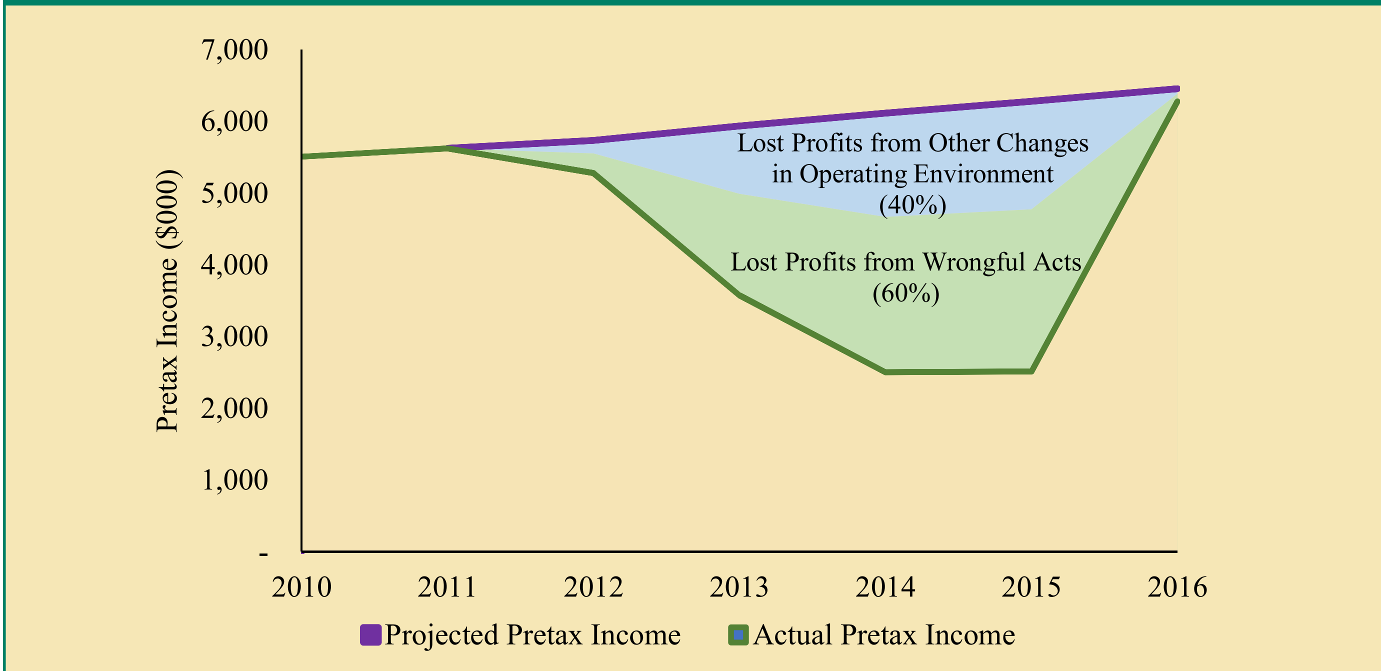
Exhibit 2
Clean Grocery Projected and Actual Financial Performance
As of December 15, 2011

	For the Fiscal Year Ended December 31,				
	2012	2013	2014	2015	2016
	$000	$000	$000	$000	$000
Projected Pretax Income	5,736	5,937	6,115	6,280	6,456
Actual Pretax Income	5,279	3,575	2,502	2,515	6,280
Difference	457	2,362	3,613	3,765	176

Exhibit 3
Clean Grocery Measurement of Lost Profits from the Wrongful Acts
As of December 15, 2011

	For the Fiscal Year Ended December 31,				
	2012	2013	2014	2015	2016
	$000	$000	$000	$000	$000
Difference between Projected Income and Actual Pretax Income	457	2,362	3,613	3,765	176
Less: Lost Profits from Changes in Operating Environment (40%)	(183)	(945)	(1,445)	(1,506)	(70)
Equals: Lost Profits Attributable to the Alleged Wrongful Acts	274	1,417	2,168	2,259	106

Figure 1
Clean Grocery Graphical Representation of Sales Projection Method Lost Profits Analysis



Summary and Conclusion

The measurement of lost profits often presents a challenge associated with the heightened standard of proof. However, damages from breaches of fiduciary duties are often more generously awarded than in other tort claims. These two seemingly opposite forces do not cancel each other out, but rather lead to a unique legal analysis.

If a fiduciary has breached a legal duty, and if profits have been lost, then a plaintiff may still establish these lost profits and their measurement with fact-based evidence rather than speculation. An economic damages analyst may give an opinion on lost profits using one or more of the methods in this discussion to satisfy this requirement.

Retaining a qualified damages analyst (1) often assists parties in obtaining a favorable settlement or judgment and (2) may minimize total litigation-related expenses.

This discussion was intended to be general legal information, not legal advice. Every legal claim is unique and there is no substitute for advice from legal counsel with knowledge of the specific circumstances of a case.

Notes:

1. See RCW 11.98.085 and ORS 130.805.
2. See Farm Crop, 109 Wn.2d at 928.
3. Larsen v. Walton Plywood Co., 65 Wash.2d 1, 390 P.2d 677 (1964).
4. Gillespie v. Seattle-First National Bank, 70 Wash. App. 150, 855 P.2d 680 (Div. 1 1993).
5. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed. (New York: McGraw-Hill, 2008), 1025.
6. John R. Phillips and Michael Joseph Wagner, "Economic Damages: Use and Abuse of Business Valuation Concepts" (Chapter 14) in *The Handbook of Advanced Business Valuation,* Robert F. Reilly and Robert P. Schweihs, eds. (New York, McGraw-Hill, 2000), 286.
7. Robert F. Reilly, "Measuring Damages to Intangible Assets," *Valuation Strategies* (November/December 2015): 30.
8. Phillips and Wagner, "Economic Damages: Use an Abuse of Business Valuation Concepts," 279.

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