

# Proof is in the Pudding

## HOW TO DEFEND AGAINST A LOST-PROFITS CLAIM

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### Fast Facts:

Lost profits must be proven by a reasonable degree of certainty.

Michigan courts have routinely dismissed lost-profits claims when the plaintiff lacks sufficient supporting evidence.

Under the right circumstances, an aggressive attack on the plaintiff's damages theory and evidence can be an effective way to defeat the plaintiff's entire case.

In the majority of civil cases, defense counsel focuses most of his or her attention on disproving the plaintiff's liability theory. In doing so, it is easy to overlook the equally important element of damages, which, of course, the plaintiff must prove like any other element of the claim. The challenge for defense counsel is to figure out how best to attack the plaintiff's damages case. This is no simple exercise, since focusing too heavily on the plaintiff's damages may make it appear that the defense is conceding liability and simply "fighting about the numbers," while paying too little attention can make it appear that the defendant has no "alternative damage calculation" and that the plaintiff is entitled to recover the amount it claims as long as it can prove liability. Thus, defense counsel is put in the difficult position of trying to balance the defendant's liability defenses against the damages defenses, so that both are emphasized but neither overwhelms the other.

This is primarily a trial issue, where defense counsel often faces the dilemma of deciding whether to present an expert witness to testify that the plaintiff's numbers are too high or whether defense counsel should rely on the liability defenses, which, if successful, would render damages irrelevant. Of course, these decisions must be made on a case-by-case basis, but under the right circumstances, mounting a direct challenge to the plaintiff's damages can be an effective strategy and can, in and of itself, lead to a verdict for the defense.

## Lost Profits—In a Nutshell

In many breach-of-contract and business-tort cases, it is common for the plaintiff to seek lost profits. Often this is the single largest aspect of the plaintiff's damages. It is also one of the most difficult kinds of damages to prove, which makes it particularly susceptible to attack. Put simply, lost profits are calculated by taking the plaintiff's anticipated sales revenue and subtracting variable and fixed costs.<sup>1</sup>

Anticipated sales revenue is the lost income from the sale of goods or services. It is typically determined by multiplying price times volume. Variable costs are unit-level costs that change in proportion to the business activity of the company, such as raw material costs and some labor expenses like sales commissions. Fixed costs are regular business expenses that do not depend on the business activities of the company, but are incurred regardless of whether the plaintiff makes any sales, such as monthly lease expenses, executive salaries, and overhead. Fixed costs are sometimes categorized as selling, general, and administrative expenses (SG&A). All three of these variables are necessary for the lost-profits calculation. A plaintiff's inability to meet the burden of proof with respect to any of them should result in a dismissal of the plaintiff's lost-profits claim.

Revenue and variable costs are often easier to show than fixed costs because they are often directly connected to the contract or transaction that forms the basis of the lawsuit. In other words, if the plaintiff can successfully demonstrate that there was a contract to sell X number of goods for Y dollars per piece and that it cost the plaintiff Z dollars to either manufacture or purchase the goods, then the plaintiff has likely met the burden regarding revenue and variable costs. Of course, proving X, Y, and Z may be difficult for the plaintiff for any number of reasons, including inadequate documentation or the inability to demonstrate future sales volume or revenue. Fixed costs can be even more difficult to prove because they not only require adequate proof of all costs associated with the plaintiff's business, but also require that the

plaintiff accurately attribute a percentage of those overall costs to the transaction at issue in the case.

## How to Challenge a Lost-Profits Claim

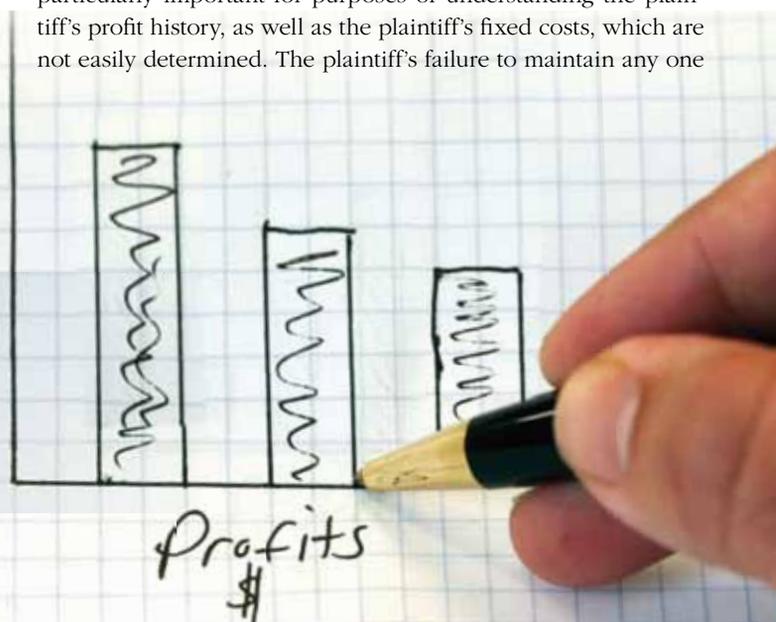
To obtain damages for lost profits under Michigan law, the plaintiff must prove them to a reasonable degree of certainty, as opposed to basing them on mere conjecture or speculation.<sup>2</sup> This standard, although not clearly defined by Michigan courts, can present problems for a plaintiff that does not maintain sufficient documentation or detailed business records. In those instances, the defendant can mount a serious challenge to the plaintiff's lost-profits claim and even achieve a dismissal.

To challenge a lost-profits claim or, for that matter, any other kind of damages claim, it is necessary to understand the plaintiff's business, particularly the types of costs the plaintiff incurs to generate sales. For example, does the plaintiff:

- have raw material sub-suppliers?
- hire contract workers or pay commissions to salespersons?
- lease or own its machinery and the facility in which it operates?
- rent warehousing facilities or require third-party shipping services?

This information can be obtained through written discovery requests and depositions. Early in discovery, defense counsel should send detailed and thorough interrogatories and document requests to obtain all information and documents relating to the plaintiff's lost revenue, variable costs, and fixed costs. Counsel should also request documents relating to the plaintiff's past profits because, under Michigan law, a showing of past profits is the most legitimate method to establish future losses.<sup>3</sup> Requested documents should include contracts, invoices, and correspondence with customers and sub-suppliers; equipment and real property leases; labor or payroll reports; shipping records; tax returns; and financial statements (balance sheets, income statements, and profit/loss statements). Tax returns and financial statements are particularly important for purposes of understanding the plaintiff's profit history, as well as the plaintiff's fixed costs, which are not easily determined. The plaintiff's failure to maintain any one

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of these categories of documents could result in an inability to prove the value of one or more of the variables used in the plaintiff's lost-profits calculation, resulting in the plaintiff's failure to meet the burden of proof on the claim.

If the plaintiff is not forthcoming with this information and documentation, defense counsel must file the appropriate motions to compel and obtain court orders requiring the plaintiff to produce all documents and information relating to the alleged damages. Once these orders have been obtained, the plaintiff must produce all the information it has, which allows defense counsel to fully analyze the plaintiff's damages claim and determine whether, and how, to attack it. Alternatively, if the plaintiff simply does not have the information and documents necessary to prove damages, a court order will force the plaintiff to confirm this fact, thereby acknowledging an inability to meet the burden on an essential element of the claim.

## Summary

In addition to obtaining thorough discovery from the plaintiff regarding its cost structure and profit model, defense counsel should obtain documents and, in some cases, deposition testimony from important third parties, such as the plaintiff's suppliers, accountants, landlords, and former employees. Thus, if the plaintiff has insufficient documentation to establish the damages claims, defense counsel may be able to obtain from third parties the information necessary to mount a serious challenge. If neither the plaintiff nor the relevant third parties have maintained adequate documentation to show the plaintiff's revenues, costs, and margins, then defense counsel can argue that information critical to the plaintiff's damages has been requested from every conceivable source, that the information is not available, that the plaintiff cannot prove its damages case without the information, and that, as a result, the plaintiff's lost-profits claim should be dismissed. Indeed, Michigan courts have routinely dismissed lost-profits claims when the plaintiff lacked sufficient supporting evidence.<sup>4</sup>

In defending a case in which the plaintiff is seeking lost profits, defense counsel should be careful not to focus on liability issues to the exclusion of damages. Damages are an essential ele-

ment of breach of contract or any other cause of action that would allow a plaintiff to recover lost profits. The plaintiff's failure to meet the burden of proof on this element should result in a dismissal or defense verdict, the same as if the plaintiff failed to meet the burden on breach or any other element of the claim. Under the right circumstances, an aggressive attack on the plaintiff's damages theory and evidence can be an effective way to defeat the plaintiff's entire case. ■



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## FOOTNOTES

1. *Vogue v Shopping Ctrs, Inc (After Remand)*, 402 Mich 546, 550 n 2 (indicating that lost profits are measured by lost sales minus the cost of merchandise and direct expenses saved); *Benfield v H K Porter Co*, 1 Mich App 543; 137 NW2d 273 (1965) (holding that commission salesperson had to establish not only lost commissions but also expenses not incurred); *Lawton v Gorman Furniture Corp*, 90 Mich App 258; 282 NW2d 797 (1979) (ordering reduction of estimated gross profits not only by the cost of goods, but also by the normal overhead costs that would have been incurred).
2. *Poirier v Grand Blanc Twp*, 192 Mich App 539, 549; 481 NW2d 762 (1992).
3. *Lorenz Supply Co v Am Standard, Inc*, 100 Mich App 600, 613; 300 NW2d 335 (1980).
4. *Nugent v Muskegon Summer Celebration, Inc*, unpublished opinion per curiam of the Court of Appeals, issued October 18, 2007 (Docket Nos. 266445, 269804) (precluding the plaintiff from seeking damages for lost profits at trial when he refused to produce financial records in discovery, including tax returns and other documentation of his business revenues, after concluding that the defendant had no opportunity to evaluate or respond to the plaintiff's damages claim without access to such information); *Murray v Wolverine Pipe Line Co*, unpublished opinion per curiam of the Court of Appeals, issued December 29, 2005 (Docket No. 257121) ("[plaintiff] lacked evidence of historic profits... for use as a basis for determining lost profits..."); *Central Contracting, Inc v J R Heineman & Sons, Inc*, unpublished opinion per curiam of the Court of Appeals, issued November 18, 2004 (Docket No. 24700) (rejecting lost-profits claim when no additional evidence supported the testimony that the plaintiff earned a 25 percent profit margin on some jobs); *Welch v J Walter Thompson*, 172 Mich App 16; 431 NW2d 446 (1991) (dismissing wrongful-discharge claim following the plaintiff's failure to comply with discovery demand for past income tax returns); *Denha v Jacob*, 179 Mich App 545, 550; 446 NW2d 303 (1989) (rejecting a lost-profits claim when the only evidence offered at trial regarding lost profits was the plaintiff's relatively brief testimony).

