Advocate'sEDGE

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Calculating lost profits

Do post-breach conditions matter?

Recently, some breach of contract defendants have argued that poor market conditions subsequent to the alleged breach undermine plaintiffs' claims for lost profits. The defendant in a Maryland case, *CR-RSC Tower I, LLC v. RSC Tower I, LLC,* learned the hard way that courts don't always agree.

PROMISING PLANS

CR-RSC owns a 53-acre tract of land in Maryland. It entered into two 90-year ground leases with RSC, which is partially owned and controlled by a real estate development company, for a total of about five acres. The parties expected RSC to develop the portion of the land not subject to the ground leases.

The ground leases provided that RSC would construct two apartment buildings — Towers I and II — that it would sell after construction and initial rental. Construction on Tower II was projected to begin about two years after construction of Tower I. The leases obligated the parties to cooperate with each other in the development of the apartment buildings and the rest of the tract.

THE PROJECT COLLAPSES

After executing the leases, in late 2004 and early 2005 the parties modified their agreements to permit development of condominium buildings, a hotel and a spa, rather than apartments. They executed several agreements in furtherance of this project, but in September 2006 the parties abandoned it and entered into a termination agreement. RSC then obtained county approval to revert to the original plan to build apartments and arranged financing with Northwestern Mutual Life Insurance Company to construct Tower I.

CR-RSC, however, failed to provide estoppel certificates required to secure the financing; the leases required RSC to provide such certificates. It also initiated proceedings to challenge the county's approval of RSC's site plans and building permits.

RSC sued CR-RSC in November 2006, alleging breach of contract and seeking declaratory and injunctive relief that would require appellants to perform their obligations under the leases. In early 2007, the trial court issued a preliminary injunction ordering CR-RSC to deliver executed estoppel certificates.

CR-RSC delivered the certificates, but RSC claimed that they didn't comply with the terms of the leases, and no one — including lenders — could or would rely on them. It subsequently alleged that CR-RSC's continued refusal to execute proper estoppel certificates and its efforts to hinder governmental approval of the apartment project constituted continuing or successive breaches of the leases.

COURT CONSIDERS COLLATERAL DAMAGE

The court in *CR-RSC Tower I, LLC v. RSC Tower I, LLC* (see main article) was asked to consider the distinction between direct lost profits and collateral lost profits. The former are the "immediate result of the broken contract's performance." The latter, which were at issue here, result from the loss of "other contracts collateral to the one broken," to which the defendant wasn't a party.

CR-RSC argued that, even if evidence of post-market conditions was properly excluded, the 2006 projections were insufficient to prove collateral lost profits damages with reasonable certainty. After all, CR-RSC asserted, it was pure speculation that Tower I would be constructed, leased and sold.

The court found that RSC proved collateral lost profits damages with reasonable certainty. The accountant expert witness used a "stabilized pro forma" model to project profits for the Tower I building in 2010, the first year it was expected to be fully leased. His findings were corroborated by a real estate expert, as well as by a representative of Northwestern Mutual Life Insurance Company who authorized a financing commitment to the project on the basis of the same pro forma projections. Further, RSC's parent company was a successful real estate development company that had, in the past 20 years, constructed a variety of buildings in the area.

RSC sought about $28 million in lost profits, claiming that the real estate and credit markets had deteriorated after April 4, so it could no longer obtain financing for the apartment project. It also alleged that the county no longer considered its prior approvals of the project to be valid. After various new complaints, amended complaints and motions were filed, the jury found for RSC and awarded it about $36 million. CR-RSC appealed.

TRADITIONAL RULE APPLIES

RSC based its lost profits claim on market projections at the time of the initial breach in December 2006. CR-RSC argued that, at that time, the Towers weren't projected to be fully leased until 2010 and 2012. Therefore, the actual market conditions in that time frame were relevant. Under those conditions, it contended, RSC wouldn't have profited. The trial court, however, had excluded evidence of post-breach actual market conditions.

The Maryland Court of Special Appeals began its analysis by noting the "traditional rule" that lost profits damages are measured at the time of the breach. It noted that later events, such as post-breach fluctuations in value, frequently are "irrelevant for damage determinations."

The Court of Special Appeals cited courts in other jurisdictions — including the District of Columbia and Arizona — that have come to the same conclusion about the irrelevance of post-breach events in construction cases. Other courts, however, have considered such evidence. Nonetheless, the court held that, under Maryland law, the traditional rule was appropriate based on the specific facts and circumstances of this case. Therefore, the trial court didn't err in barring evidence of post-breach market conditions.

CONSTRUCTING YOUR CASE

Regardless of the law on post-breach conditions in your jurisdiction, calculating lost profits can be a complicated process. Work closely with a damages expert to help ensure an accurate computation.

When the cupboard's bare …

How fraud experts prove inventory theft

Inventory fraud is notoriously difficult to find and document. So if a client suspects an employee of stealing inventory, it's important to get a fraud expert involved as quickly as possible. The expert may discover that goods have simply been misplaced. However, if the theft is real, you'll need a professional to properly assemble evidence — and possibly present it in court.

THEFT OR OVERSIGHT?

Before assuming theft, a fraud expert determines whether the items were really stolen or were simply misplaced. In many cases, employees keep sloppy records or fail to follow proper procedures, resulting in "missing" inventory. For example, a company without a location assignment for each item, an effective method of keeping tabs on overflow stock and a well-run returns system might have misplaced inventory.

If there's no innocent explanation for missing inventory, the expert looks for signs that the environment is conducive to fraud. For example, a company with poor controls over purchasing, receiving and cash disbursement is at high risk of inventory theft. In addition, one person performing multiple duties can easily commit and conceal fraud.

If the expert believes inventory could have been stolen, he or she combs the records for clues. Anything that doesn't follow established inventory procedures could be a red flag — such as odd journal entries posted to inventory, large gross margin decreases or sudden problems with out-of-stock inventory.

LOOKING FOR ANOMALIES

Next, the expert works to prove the fraud. Inventory fraud may leave a paper (or electronic) trail, so forensic accountants typically review journal entries for unusual patterns. An entry recording a physical count adjustment made during a period when no count was taken obviously warrants investigation. The expert follows up by tracing unusual entries to supporting documents.

Vendor lists also may show suspicious patterns, such as post office box addresses substituting for street addresses, vendors with several addresses, and names closely resembling those of known vendors. Even if they've found no evidence of nonexistent vendors, fraud experts look at vendor invoices and purchase orders for anomalies such as unusually large invoices or alleged purchases that don't involve delivery of goods.

Discrepancies between the amounts due per invoice, the purchase order and the amount actually paid warrant investigation. Finally, experts familiarize themselves with the cost, timing and purpose of routine purchases and flag any that deviate from the norm.

DOWN FOR THE COUNT

It's important to confirm physical inventory as well. Although a count performed by employees may disrupt normal business routines, it's an effective way to learn exactly what merchandise may be missing — and could lead directly to the thief. Fraud experts sometimes recommend hiring an outside inventory firm to perform the count and value the inventory.

Anything that doesn't follow established inventory procedures could be a red flag.

Whether employees or inventory specialists perform the job, a fraud expert carefully observes warehouse activity once employees realize a count is imminent. Thieves may attempt to shift inventory from another location to substitute for missing items they know will be discovered.

Inventory at remote locations also can disappear, so fraud experts often will confirm quantities with the storage facility or go with the client to inspect them personally. Whenever possible, it's best to perform a count in person rather than delegate the job to someone who may not be trustworthy.

EXPERTISE IS ESSENTIAL

Some companies fail to limit access to inventory and allow poor recordkeeping. They may use haphazard counting methods or perform a complete inventory only once a year. Unfortunately, such practices make them particularly vulnerable to inventory fraud.

If this sounds like your client's company, don't despair. Make sure the company stops investigating the possible fraud on its own and hands the investigation over to an experienced fraud expert. He or she can help find the perpetrator, assemble evidence, testify in court and work with the company to prevent inventory fraud from happening again.

Copyright infringement damages: Doing the math

Technological leaps and bounds made in the past decade have opened up a virtual playground for copyright infringers. Materials that previously were difficult to duplicate or use are now often available with the click of a mouse. But copyright infringers may find themselves liable for significant damages down the road.

STATUTORY DAMAGES

The Copyright Act and the Digital Millennium Copyright Act (DMCA) provide for statutory damages that are generally subject to caps of $30,000 per work under the Copyright Act and $2,500 per violation under Section 1201 of the DMCA. If the infringement was committed *willfully*, courts in some cases may increase the award to a sum of up to $150,000.

Courts may also reduce a statutory damages award. If the infringer wasn't aware — and had no reason to believe — that his or her acts constituted an infringement of copyright, some courts may reduce the award to a sum not less than $200.

ACTUAL DAMAGES

Many plaintiffs elect to pursue actual damages, which are commonly measured by lost profits. Courts have applied several different approaches to compute such losses, including:

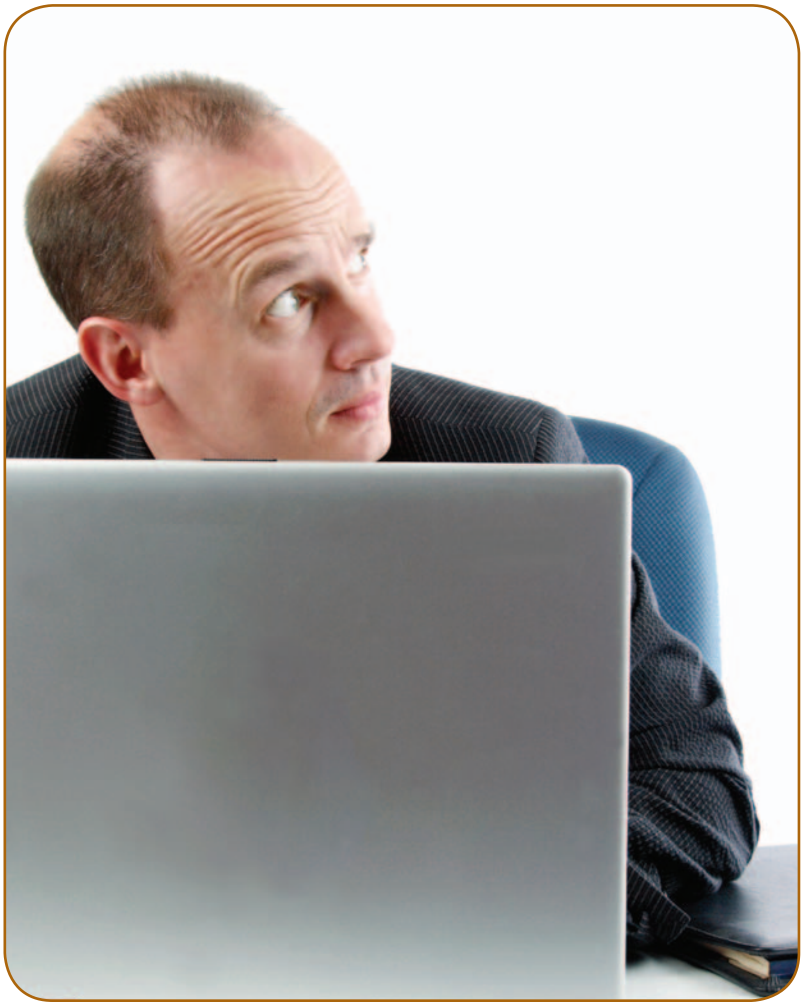
The infringer's sales. The copyright holder may allege that, if not for the infringement, its sales of the protected work would have grown in an amount equal to the infringer's sales. The plaintiff must show that the infringer's products are comparable to its own in terms of price, customers, distribution, packaging and advertising.

Diverted sales. A plaintiff could claim that it lost customers to the infringer and, if not for the infringer, those customers might have purchased from the plaintiff again. Courts consider comparability, especially in the customer base, as well as other factors affecting the customers' decisions.

Courts might consider changes in market size, sales of alternative products and related market trends.

Sales projections. If the plaintiff has records of its projected and actual sales from previous financial periods, it could establish a historical correlation between the figures that would support the use of sales projections to measure lost sales.

Product mix. Sales of different products also can reflect lost sales. The sales of these products during periods of both infringement and noninfringement could establish benchmarks for projecting the mix relationships in the absence of the infringement.



Courts might also consider changes in market size, sales of alternative products and related market trends. By offering multiple approaches that produce similar results, a plaintiff can increase the likelihood of recovering appropriate damages.

Other factors may affect the final amount of actual damages. For example, the Copyright Act allows recovery of the infringer's profits that were attributable to the infringement but not already taken into account in the actual damages formula.

ABOVE AND BEYOND DAMAGES

Of course, copyright holders aren't limited to damages as a remedy. They can also seek equitable relief, including injunctions and impoundment of infringing items. A qualified financial expert can help you decide the best route for your client, depending on the circumstances of the case.

Unreliable data could doom your next divorce case

Can you count on your financial expert's testimony? Not if the expert isn't basing that testimony on reliable data. A recent divorce dispute, *In re Marriage of Rodenback,* illustrates how unreliable data can undermine an expert's estimate.

ISSUES IN DISPUTE

When Mark and Susan Rodenback ended up in divorce court, one of the primary issues was Susan's marital share of Mark's interest in a software company. Mark co-owned the business with his brother Gary, and the parties agreed that Susan was entitled to half of Mark's interest — but they didn't agree on the company's value.

At trial, Gary was asked to speculate on the amount of income the company would earn over the next year. He responded that he wasn't an expert at forecasting but guessed the business would earn $1.2 million to $1.5 million in net income.

Mark's financial expert testified on three separate occasions, providing a different value for Mark's interest each time as he took into account new information. The expert's final testimony, which relied on calculations he'd performed that day based on Gary's forecast, determined the value of Mark's interest to be about $2.3 million. But the expert testified that, up until the afternoon of his testimony, he had valued the interest at about $3.5 million, based solely on the most recent information on the company's sales and operations.

FAULTY FORECAST?

The trial court didn't adopt any of Mark's expert's values and instead made its own determination of value. It forecast the next year's income at $1.5 million and set the value of Mark's interest at about $2.6 million, making Susan's share about $1.3 million. The court, however, adjusted her share to reflect the fact that Mark planned to pay her from taxable income. It allocated the tax liability equally, reducing Susan's share to about $1 million.

On appeal, the Oregon Court of Appeals concluded that the most persuasive valuation of Mark's interest was the $3.5 million figure. It wasn't convinced that a valuation "based on an off-the-cuff forecast by a nonexpert [Gary]" provided a more accurate value than that generated exclusively from historical figures. The court also found it was "not just and proper" to reduce Susan's share for taxes.

COSTLY LESSON

In the end, the appellate court increased Susan's share of the software business by more than $700,000. This result provides a costly reminder of the importance of using experts who rely on strong supporting data.