

Spring 2009

Lost Profits Calculations Must Include Related Costs

Catroppa v. Metal Building Supply, 2008 WL 4705605 (Mo. App.)(Oct. 28, 2008)

A music promoter paid a builder \$12,000 to provide a metal corrugated roof to protect the stage from rainstorms. Construction was completed on schedule, but due to faulty construction, during the first concert the roof leaked onto the stage and the bands refused to perform. The concert promoter sued for breach of contract, requesting damages of over \$181,000, including projected sales from the first and also future concerts. At a bench trial, the court awarded damages of \$26,620 and the builder appealed.

Evidence turns on lost profits and expenses. To prove costs incurred because of the defective roof, the promoter submitted an itemized list—including his payments for advertising, employees, equipment, etc.—that totaled \$19,120. Accordingly, there was sufficient evidence to support the trial court's award of consequential damages in that amount.

The promoter also claimed that he lost over \$36,000 in profits because he had to cancel the inaugural concert. He derived this figure from advance ticket sales (\$7,500) and three sources of estimated income: \$30,000 in door receipts (based on projected sales of 1500 tickets at \$20 per ticket), \$12,000 in expected liquor sales, and \$6,000 in food sales. The promoter relied on his 35 years of concert experience to calculate these amounts, and the court confirmed that he presented "substantial evidence" to support his claim of lost ticket sales (\$37,500) and liquor (\$12,000) with reasonable certainty.

However, the promoter had no evidence to support his claim of the lost food sales. "This court does not believe that simply placing a figure on a piece of paper transforms that figure into substantial evidence." Without more evidence, the court found inadequate support for this element of the promoter's lost profits claim.

In addition, even though the promoter provided "substantial evidence" regarding lost liquor sales, he failed to present any information regarding the costs to produce this item. Without this evidence, the trial court could not have determined any amounts for lost liquor sales.

Plaintiff can only be made whole once. Thus, the court found substantial evidence to support lost profits—but only for lost ticket sales (\$37,500). Because the promoter provided evidence of his out-of-pocket costs to produce this income (\$18,820), the court found that his lost profits equaled the difference, or \$18,680. This amount merged into the award for consequential damages of \$19,120, because "a plaintiff may not be made whole more than once," the court said. Further, because the trial court failed to allocate its \$26,620 award between the types of damages, the appellate court could only confirm the amount for which it found substantial evidence, or \$19,120.

The Court Calls Expert Statutory Fair Value 'Too Good to Be True'

Encompass Teleservices, Inc. v. Sheets, 2008 WL 5156561 (D. Or.)(Dec. 9, 2008)

A minority shareholder sued the majority owners of an S Corporation, claiming that they breached their fiduciary duties to him by: 1) diverting corporate funds to themselves or to entities in which they had a financial interest; 2) providing false, incomplete, and fraudulent information to deprive him of his shareholder rights; and 3) wrongfully withholding from him the benefits that the other shareholders enjoyed, including dividends, loans, and distributions sufficient to pay their tax liabilities on shareholder income.

The plaintiff sought reimbursement of his IRS tax liabilities, recovery for his losses due to disproportionate distributions, and payment for his 14% ownership interest in the company. When the company went bankrupt, the trustee consolidated all the claims into Chapter 7 proceedings.

At trial before the bankruptcy court, the defendants argued that the minority shareholder did not have standing to assert direct claims against them. The court found otherwise, noting that under state law, their fiduciary duties extended to both the corporation

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and other shareholders. But the court denied the plaintiff's request that they pay his tax liabilities, because he provided only circumstantial evidence that the company paid the other shareholders sufficient amounts to cover their pass-through income taxes.

To prove his economic losses, the plaintiff presented expert testimony from a CPA, who examined distributions to the other minority shareholders (in excess of their salaries). The expert concluded the plaintiff would have received \$540,000 for his 14% ownership interest, if the defendants had not diverted the company's excess earnings to themselves. The bankruptcy trustee intervened, objecting to these claims, arguing that any damages for wrongfully diverted funds belonged to the company/debtor.

The court agreed. In essence, the plaintiff's claim amounted to one for the excess compensation that the company paid to the other minority shareholders, and these funds were assets of the debtor's estate. "If he is entitled to anything on this claim," the court said, "he must pursue it in the bankruptcy proceeding."

The court took an interesting view on valuation of ownership interest. To support his statutory fair value reimbursement, the plaintiff's expert valued his 14.3% ownership interest at \$2.4 million. In reaching this conclusion, he rejected the cost approach and weighted the income approach 75% versus the market approach, finding the former more reliable.

The court, however, found this weighting "too good to be true," in particular because the ultimate values under the two approaches differed by only 1%. It also found that under his income approach, the expert failed to consider the "fragility" of the company's relationship with a major client/contractor (who was also romantically involved with the majority owner) and did not account for the substantial costs (over \$500,000) caused by the owner's fraud and

unlawful divergence of distributions to himself. These factors and others created a "disquieting picture of a company that was not well managed and doomed to early failure on the path it had chosen," the court said. Yet notwithstanding these financial troubles, the plaintiff's expert projected 7% to 12% growth over five consecutive years followed by a period of stabilization.

In the end, the court viewed the entire record and valued the plaintiff's 14.3% stake at \$900,000. But it did not make specific findings or state the specific evidence on which it relied to reach this value, which could make the decision vulnerable on appeal.

Inexperienced, Unprepared Expert Caught in Deposition

Unleashed Magazine, Inc. v. Orange Co., Fla., 2008 WL 4304883 (M.D. Fla.)(Sept. 16, 2008)

As lawyers and litigation experts know, depositions can sometimes prove to be a real battleground. In this case, a poor pre-trial performance led directly to a *Daubert* motion that pitted the experience of the expert witness against the reliability of his opinion.

The plaintiff hires an expert with little expertise. The plaintiff registered the trademark "Unleashed" in connection with efforts to develop pet-related publishing and television programming, including a magazine called *Orlando Unleashed*. When the city of Orlando began broadcasting a public TV program called *Pet Pals Unleashed*, the plaintiff sued for trademark infringement. To support a damages claim, the plaintiff retained a former entertainment executive turned consultant, who had spent twenty years developing media licensing. The expert had never authored any articles or received any formal accounting training other than a master's degree in business administration. He lectured frequently on licensing and once belonged to a professional licensing association, but never received any formal peer review or credentialing. His fee was \$100 per hour and he worked twelve hours on his four-page report.

The first sections of his report covered the licensing industry and in particular, the value of licensing a magazine's brand to television programs. The second section found that trademark dilution could exist in this case, and concluded that an annual royalty of \$7,500 would be a "reasonable fee" for the rights to use the magazine's trademark in the city's television show.

In considering the defendant's *Daubert* motion, the



U.S. District Court excerpted several pages from the expert's deposition, in which the attorney tried to pinpoint the expert's experience with calculating hypothetical royalty rates. (Because the standard rule for calculating royalties, if no actual rate exists in the relevant market, is to project a hypothetical, arm's-length licensing agreement between the patent holder and infringer at the time of the alleged infringement, most often based on the fifteen factors established by the leading 2nd Circuit case, *Georgia-Pacific Corp. v. U.S. Plywood Corp.*, 318 F. Supp. 1116 (S.D.N.Y. 1970)). Still, when the attorney asked the expert if he knew the *Georgia-Pacific* factors, he answered, "No I do not." Instead, he maintained that because his consulting work for actual clients involved telling them what they might negotiate for a licensing of their trademark—this experience constituted rendering an opinion regarding a "hypothetical" situation.

To calculate royalty income from a *specific* licensing agreement, the expert said all he needed was an "established market" for the trademark, without relying on any financial statements. But when asked how this differed from "rank speculation," the expert conceded that he had not consulted or conducted any formal surveys to show that the plaintiff's magazine had an established market. *For example:*

Question: What is the source of [your] information?

Answer: My opinion.

Question: Other than just...your opinion, are you able to document any source that will prove *Orlando Unleashed* has a recognition factor in the market from a base of paid and/or non paid subscribers and advertisers?

Answer: Are you asking do I have a formal survey?

Question: Do you have any proof that backs you up?

Answer: No.

The expert also admitted that he did not know whether anybody actually read the magazine. He had found no evidence of readership and had never read it himself. He had no specific "matrix" for the potential TV market and consulted no data on potential viewership.

Plaintiff's counsel conceded that the expert 'did not do well' in deposition, and prior to trial agreed that he was not qualified to render an opinion whether there was any infringement, consumer confusion, and/or trademark dilution in the case. The court was left to decide only whether his testimony and report were admissible regarding his \$7,500 calculation as a reasonable royalty for the alleged infringement.

Under the *Daubert* standard, the court focused primarily on the expert's experience. In this case:

[The expert's] deposition clearly established that he developed no data, such as a survey, he reviewed no data, he made no measurable calculations, and has no more than a nonprofessional's knowledge of what the size of the market, program type, and potential viewership is of *Pet Pals Unleashed*. Furthermore... [he] acknowledged that he had no evidence indicating that *Unleashed Magazine* has a recognition factor in the market place.

"The Court cannot simply take [his] word for it," it concluded, and struck the expert's report.

Buyer's Projections Used to Value Asset from the Seller's Perspective

***Nano-Proprietary Inc. v. Canon*, 2008 WL 2854816 (5th Cir.) (July 25, 2008)**

Canon paid nearly \$5.5 million for a perpetual, irrevocable license of the plaintiff's patented flat-screen television technology in 1998. The parties' agreement precluded Canon from sublicensing the patents, but less than a year later, it entered a joint venture with Toshiba, each contributing \$83 million to the deal. The plaintiff terminated the licensing agreement, kept the \$5.5 million, and sued Canon for loss of the prospective license.

The district court doubts prospective damages.

On the plaintiff's summary judgment motion, the U.S. District Court (W.D. Tex.) found the defendant liable for the breach, and permitted the plaintiff to keep the \$5.5 million. Although the court "did not see how there were provable consequential damages," it allowed the plaintiff to try nonetheless.

At trial, plaintiff's expert witness intended to present a hybrid model that measured the value of the lost license from three perspectives: **1)** the buyer (the defendant, its joint venture partner, and/or the joint venture); **2)** the seller (plaintiff); and **3)** the market, determined by tracking fluctuations in the plaintiff's stock prices.

But in describing how he calculated the value of the lost license from the seller's (plaintiff's) perspective, the expert said that he relied on the buyer's (defendant's) internal document, which projected future sales for its joint venture with Toshiba. The district court precluded the expert from testifying on this basis, because the plaintiff had no knowledge

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or access to these confidential projections. The court permitted the expert to rely on the document to present the buyer's perspective, however, and to testify regarding fluctuations in the plaintiff's stock price during the relevant period, but he could not offer the purported relationship between stock volatility and value of the lost license because the evidence was too speculative. Within these evidentiary limits, the jury considered the damages claim found that the plaintiff had not suffered any compensable harm beyond its \$5.5 million payment.

The plaintiff appealed, arguing that it should have been able to present all evidence based on the defendant's projections. Under the "willing buyer, willing seller" fair market value standard, it said, the parties are presumed to have reasonable knowledge of the relevant facts—and in this case, knowledge of the defendant's internal projections would fall within this scope. The court disagreed, however. At a "realistic bargaining table," it said, the plaintiff

would not have access to the defendant's confidential memorandum. "It cannot be the case that having 'reasonable knowledge of relevant facts' requires knowledge of all the opposing parties' secrets," the court held, in confirming the preclusion of the expert's testimony. It also upheld the exclusion of his market testimony, finding any correlation between fluctuations in the plaintiff's stock price and the lost license as too speculative.

The court additionally agreed with the district court that the plaintiff could not measure the value of its lost license by the \$83 million joint venture price. "The \$83 million...could have merely reflected the amount Toshiba paid into the joint venture," the court said, "and was not tied to the value of the license."

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