In contract and commercial tort contexts, lost-profits claims have the potential to exceed by a significant amount more conventional damage claims. Pleading and proving lost profits may present unique challenges, particularly in situations in which the plaintiff cannot point to specific, identifiable transactions lost due to the defendant’s conduct. Parties claiming or defending against such damages should be aware of special issues relating to the recoverability of lost profits, the burden of proof to which such claims may be subject, and the evidence required to meet that burden of proof.

Special Rules Applicable to Recovery of Lost Profits

Some states have bright-line rules barring recovery of lost profits in certain circumstances, and many states use language that appears to impose a higher burden of proof, whether in the context of existing or new businesses. Courts are not always clear on whether they are applying lost-profits rules to the admissibility of evidence or to its sufficiency (in particular in the context of motions to dismiss or for summary judgment). Consequently, these rules may operate in practice either as rules of evidence that determine what may be introduced to support lost-profits claims or as substantive rules governing which lost profits may be recoverable in a given case.

The “Reasonable Certainty” Standard

In many states, lost profits are deemed to be speculative and may be recovered as damages only where such profits can be determined to a “reasonable certainty.” Although the term is used frequently, the meaning of “reasonable certainty” (or its variants) is not subject to any concrete or consistent definition, and courts have provided little guidance as to whether and how this standard differs from generally applicable standards of admissibility or burdens of proof.

Not every state subjects lost-profits claims to the reasonable certainty standard. Some courts will allow a lost-profits claim so long as there is a “rational basis” for the calculation of such damages. In practice, courts may pay lip service to the “reasonable certainty” standard while applying that rule in a manner functionally indistinguishable from a “rational basis” analysis. In addition, some jurisdictions apply the reasonable certainty standard only to the question of causation of lost-profits damages, not to the amount of such damages. In such cases, courts may require that causation be proven to a reasonable certainty but that the amount of damages need only be supported by some evidence from which the amount can be extrapolated.

The “New Business Rule”

Some states retain a common-law doctrine known as the “new business rule” to bar certain lost-profits claims as a matter of law. In its strongest form, this rule prohibits a plaintiff from recovering any lost profits for a newly established enterprise: “[A] new business, or an existing business with a new product, cannot recover lost profits because the future profits of a new business cannot be ascertained with any degree of certainty.” The justification for the new business rule traditionally has been that the concerns regarding the speculativeness of lost-profits claims are even stronger in the context of an enterprise with no history of revenue and profits. The point at which a business ceases to be “new” appears to be an individualized, fact-specific question, but some cases make clear that an enterprise is not necessarily immunized from the new business rule merely by making its first sale.

Rule not applicable in most states. Most states either have never followed the new business rule or have abandoned that rule, and others that once followed it may be in the process of abandoning that rule. In part, this rejection of the new business rule has been fueled by courts’ view that the rule operates unfairly by punishing business owners for their failure to point to a track record of profits where the lack of such a track record is itself the result of the defendant’s conduct. Where such states have adopted some version of the reasonable certainty test, that test applies equally to lost profits for new and existing businesses.

Rule applicable with exceptions in some states. In at least one jurisdiction (Georgia), it appears that the new business rule survives in its strongest form: “[a]s a general rule, lost profits of a commercial venture are not recoverable as they are too speculative, remote, and uncertain.” In that jurisdiction, recovery of lost profits for an “established business with clearly defined business experience as to profit and loss” is treated as an exception to this strongly worded general rule, and “[l]ost profits are generally unavailable to new businesses which lack such a track record.”

However, in most states that have retained the rule, courts have carved out exceptions that may, through gradual expansion, even-
The new business rule allows recovery of lost profits where “a reasonable estimation of damages can be made based on an analysis of the profits of identical or similar businesses operating under substantially the same market conditions.”

Pennsylvania retains the general rule that “a new business with no record of profitability” generally cannot meet the reasonable certainty standard. However, Pennsylvania courts recognize an exception for “a new business that can show a ‘significant interest’ in its product or service.”

Finally, even in states that appear to retain the new business rule, courts may find creative ways to avoid imposing it. For instance, in one recent case, the Virginia Supreme Court, after appearing to reaffirm the applicability of the new business rule, found that because the claimant was engaged in the relevant industry in other jurisdictions, its thwarted entry into the Virginia market did not constitute a new business. In addition, a New Jersey court, after having reluctantly found that the new business rule continues to apply in that jurisdiction, held that, for purposes of the new business rule, a center that drew blood to be tested by third-party laboratories was not establishing a new business in attempting to in-source blood-testing services to a newly formed related entity.

Reasonable Certainty Plus
Some jurisdictions reject the new business rule, but employ a standard that can best be described as “reasonable certainty plus.” Under this standard, courts appear to employ the reasonable certainty standard, applicable generally to lost-profits claims, but observe that this standard is particularly hard to satisfy in the context of new businesses.

Established businesses have a track record of revenue, costs, and profits, and more easily fit within the model of proving lost profits by inferences from known data. New businesses face the additional hurdles of (a) obtaining appropriate data from which to calculate lost profits and (b) drawing inferences from the data that are appropriate and justified given the facts known about the new business itself.

Depending on the jurisdiction and the facts of the case, the standards applicable to lost-profits claims may be relevant to complaints and motions to dismiss, motions for summary judgment, motions in limine to exclude evidence, and to motions for judgment as a matter of law.

Courts appear reluctant to grant motions to dismiss lost-profits claims at the pleading stage. In jurisdictions that follow the new
A Sampling of State Definitions of “Reasonable Certainty”

Alaska: “The evidence must afford sufficient data from which the court or jury may properly estimate the amount of damages, which data shall be established by facts rather than by mere conclusions of witnesses” (City of Whittier v. Whittier Fuel & Marine Corp., 577 P.2d 216, 223 (Alaska 1978)).

Connecticut: “In order to recover lost profits . . . the plaintiff must present sufficiently accurate and complete evidence for the trier of fact to be able to estimate those profits with reasonable certainty” (Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicoff & Kotkin, 247 Conn. 48, 271 A.2d 724 (Conn. 1998)).

Florida: In order to recover lost profits, claimant must prove that “1) the defendant’s action caused the damage and 2) there is some standard by which the amount of damages may be adequately determined” (W.W. Gay Mech. Contractor, Inc. v. Wharfside Two, Ltd., 545 So. 2d 1348, 1350–51 (Fla. 1989)).

Illinois: Evidence supporting lost-profits claims “must with a fair degree of probability tend to establish a basis for the assessment of damages for lost profits” (Tri-G, Inc. v. Burke, Bosselman & Weaver, 222 Ill. 2d 218, 248, 856 N.E.2d 389, 407 (Ill. 2006)).

Minnesota: “[T]he plaintiff must prove the reasonable certainty of future damages by a fair preponderance of the evidence” (Pietrzak v. Eggen, 295 N.W.2d 504, 507 (Minn. 1980)).

Missouri: Lost profits may be recovered only when they can be “made reasonably certain by proof of actual facts, with present data for a rational estimate of their amount” (Indep. Bus. Forms, Inc. v. A-M Graphics, Inc., 127 F.3d 698, 703 (8th Cir. 1997)).

New York: Lost profits may be recovered only when they are “capable of measurement based upon known reliable factors without undue speculation” (Schonfeld v. Hilliard, 218 F.3d 164, 172 (2d Cir. 2000) (N.Y.)).

Ohio: In lost-profits analysis, a “fact is ‘reasonably certain’ if it is probable or more likely than not” (Bobb Forest Prod., Inc. v. Morbark Indus., Inc., 151 Ohio App. 3d 63, 88, 783 N.E.2d 560, 579 (Ohio App. Ct. 2002)).


South Carolina: Proof of lost profits “must consist of actual facts from which a reasonably accurate conclusion regarding the cause and the amount of the loss can be logically and rationally drawn” (Drews Co. v. Ledwith-Wolfe Assoc., 296 S.C. 207, 210, 371 S.E.2d 532, 534 (1988)).

Texas: “Profits are not required to be exactly calculated; it is sufficient that there be data from which they may be ascertained with a reasonable degree of certainty and exactness” (Ramco Oil & Gas Ltd. v. Anglo-Dutch (Tenge) LLC, 207 S.W.3d 801, 808 (Tex. App. Ct. 2006) (citing Tex. Instruments, Inc. v. Teletron Energy Mgm’t, Inc., 877 S.W.2d 276, 279 (Tex. 1994))).

Utah: Reasonable certainty means “sufficient certainty that reasonable minds might believe from a preponderance of the evidence that the damages were actually suffered” (Cook Assoc., Inc. v. Warnick, 664 P.2d 1161, 1165 (Utah 1983)).
Prior to Daubert, the standard for admissibility of expert testimony was the Frye test, which required the principles on which the opinion was based to have gained “general acceptance” in the scientific community.

Admissibility and Sufficiency of Evidence. In addition to, and closely related to, the question of what rules govern lost-profits claims is the issue of how to prove such claims. Cases in which a plaintiff can point to specific unconsummated transactions do not present significant evidentiary problems. However, establishing the level of profits in the absence of such concrete evidence requires some degree of speculation or opinion. Under Federal Rule of Evidence 702, a plaintiff can attempt to introduce expert opinion testimony. In addition, under Rule 701, a lay witness (often a business owner or other insider) may be able to testify regarding lost profits. Both approaches raise specific issues in the lost-profits context.

Expert Witnesses
In many ways, the Daubert standard can be seen as the functional equivalent of the reasonable certainty standard discussed above. Under the reasonable certainty standard, lost profits are deemed to be speculative in nature and may be recovered only where such profits can be determined to a reasonable certainty. Under Daubert and Rule 702, the court focuses primarily on the reliability of the expert’s methodology but also makes sure the testimony relates to the specific facts at issue. These principles can be seen as a more formulaic attempt to ensure that the expert’s testimony is not speculative.

Admissibility under Daubert and Rule 702. In many cases, parties attempt to prove lost profits through expert testimony. Expert testimony is admissible if it is both relevant (e.g., it will assist the trier of fact) and reliable, or as the Daubert opinion puts it, “[g]rounded in the methods and procedures of science.” Expert testimony will be excluded if the opinion does not fit the facts of the case or if the reasoning or methodology underlying the opinion is scientifically invalid. The Supreme Court in Daubert listed several factors that should generally be considered, including whether the theories and techniques employed by the expert have been tested, have been subjected to peer review and publication, have a known error rate, are subject to standards governing their application, and enjoy widespread acceptance. In addition, the admissibility inquiry focuses “solely” on the expert’s “principles and methodology,” and “not on the conclusions that they generate.”

Federal Rule of Evidence 702 was amended in 2000 to codify Daubert and its progeny, but to some extent the amendments to Rule 702 actually elaborated on the rules and interpretations set forth in the Supreme Court cases. Whereas Daubert merely sets forth the proposition that courts may exclude unreliable testimony, Rule 702, as amended, states that courts must exclude testimony if an expert witness’s methodology is not reliable. This creates a slight disconnect between Daubert and the subsequent amendment to Rule 702 and is sometimes confused by courts.

Reference Manual on Scientific Evidence. Lost profits are generally not recoverable when they are speculative or dependent on multiple variables where there is no evidence from which such variables may be reliably estimated. The Reference Manual on Scientific Evidence published by the Federal Judicial Center lists reference guides that include reliable methods approved by some courts, such as multivariate regression analysis. At least one circuit emphatically endorsed the methods outlined in the Reference Manual: the Seventh Circuit has, on at least one occasion, admonished a party for relying on an expert’s “intuition” without explaining why the party failed to use multivariate regression analysis or another econometric means specifically approved by the Reference Manual. Other courts, however, do not appear to share the Seventh Circuit’s rigid adherence to the Reference Manual’s enumerated methodologies.

The Reference Manual devotes an entire chapter to multivariate regression as a tool to isolate the effects of multiple variables in a statistical (here, damages) analysis. The guide addresses a number of procedural and methodological issues that are relevant in considering the admissibility of, and weight to be accorded to, the findings of multiple regression analyses. It also suggests
some standards of reporting and analysis that an expert presenting multiple regression analyses might be expected to meet. But multiple regression is only one type of statistical analysis involving several variables. Other types mentioned in the Reference Manual include matching analysis, stratification, analysis of variance, probit analysis, logit analysis, discriminant analysis, and factor analysis.

Not all states have adopted the Daubert analysis. Prior to Daubert, the standard for admissibility of expert testimony was the Frye test, which required the principles on which the opinion was based to have gained “general acceptance” in the scientific community. Many states still apply the Frye test, while others have adopted Daubert. Some states even substitute their own standards for Daubert and Frye. Ultimately, whichever standards are applied, the focus of a court’s admissibility determination tends to be whether the methodology and data used by the expert result in a conclusion meeting some minimum level of reliability.

Expert admissibility in particular cases. Although courts have excluded testimony of experts based on insufficient expertise, reliability is generally the key question in a Daubert analysis. Courts routinely reject testimony for inappropriate or misapplied methodology. For example, the Seventh Circuit has affirmed the exclusion of an expert’s lost-profits testimony because he failed to separate damages cause by the alleged conduct from decreased profits resulting from a powerful competitor’s entry into the marketplace. Similarly, the Eighth Circuit rejected lost-profits testimony in an antitrust case between a boat manufacturer and an engine-drivem manufacturer because the expert had performed a market-share analysis without considering all the relevant facts in the relevant market.

Choosing the wrong method for calculating damages can sometimes be fatal. District and appellate courts alike have rejected an approach to calculating damages that presumes the plaintiff’s revenues would have grown strongly and would have leveled off only eventually. In excluding an expert’s lost-profits testimony, the Tenth Circuit concluded that this “S-curve” method was “capable of manipulation to achieve virtually any desired result.” This analysis is not absolute, however, as illustrated in a Second Circuit opinion affirming the admissibility of plaintiff’s expert testimony showing losses in a suit against a competitor for false advertising. That court found that in the absence of enough data to conduct a regression analysis, the expert’s method of determining “residual impact” of competitor’s advertising when two products were in oligopolistic competition was sufficient for a jury to evaluate a lost-profits award. One district court found an expert’s opinion regarding the absorption rate for identical park property in the local real estate market valid because the underlying multiple regression methodology was scientifically valid.

Business Owner Testimony

Lay witnesses, such as a business owner “not testifying as an expert,” may only offer opinions “rationally based on the perception of the witness.” Courts may allow business owners with special knowledge of the business and its operations to testify as to the facts of the business that underlie lost-profits calculations under Rule 701 without qualifying as experts.

A business owner generally can testify to past profits as long as they are based on the witness’s personal knowledge. Under Rule 701, the business owner must have sufficient personal knowledge of his or her business and of the factors relied upon to estimate lost profits or offer valuations based on straightforward, commonsense calculations. Apart from these straightforward calculations, courts do not allow business owners testifying under Rule 701 to make inferences from the data; business owners may only testify as to the underlying facts known to them. In a Seventh Circuit case, the plaintiff sought to prove lost profits relating to projected increased sales of certain pay television services by introducing the plaintiff’s own internal projections regarding its ability to increase sales. The court excluded plaintiff’s own internal lost-profits projections, which rest on plaintiff’s say-so rather than a statistical analysis. Like many other internal projections, these represent hopes rather than the results of scientific analysis. . . . Rule 701, which allows managers to offer the facts underlying such projections without the need to qualify as an expert . . . does not assist plaintiff, because its claimed losses depend on the inferences to be drawn from the raw data, rather than these data (or their internal appreciation) themselves. Reliable inferences depend on more than say-so, whether the person doing the saying is a corporate manager or a putative expert.

Personal knowledge or experience in the relevant market is not a guarantee that the testimony will be admitted. For instance, Maine courts have stricken as speculative estimates of lost profits in the following instances: where evidence of lost profits was based only upon the plaintiff’s own opinion and one year’s past performance as reflected on his income tax statements, where the business owner made only a bare guess as to his future earnings, and where the estimate of lost profits consisted of the business owner’s speculation combined with general information from real estate agents. However, where expert or statistical information corroborates the business owner’s testimony, Maine
In 2000, Federal Rule of Evidence 701 was amended to “eliminate the risk that the reliability requirements set forth in Rule 702 will be evaded through the simple expedient of proffering an expert in lay witness clothing.” Many of the cases admitting business owner testimony as to lost profits can be distinguished as predating this change to Rule 701. But the amendment has not unilaterally affected the admissibility of lost-profits testimony from business owners. Courts continue to allow business owners to offer lay opinion on lost profits based on their experience in the relevant market.

Third-Party Testimony
Some courts have allowed other third-party lay witnesses to testify as to lost profits where the witness has direct knowledge of the business accounts underlying the profit calculation. For example, courts in the Third Circuit have allowed the plaintiff’s accountant, bookkeeper, and even principal shareholder to testify concerning their company’s lost profits. The Second Circuit has allowed Rule 701 testimony by the president of a company alleging lost profits. In an Illinois case, a plaintiff was able to quantify lost profits from a real estate development by presenting the testimony of the developer who took over the development from the plaintiff. As with business owner testimony, the key requirement appears to be personal, firsthand knowledge of the business.

Conclusion
Questions regarding whether lost profits are recoverable, and how to prove such profits, may present themselves in many contract and business tort cases. Careful attention to lost-profits and evidentiary rules can ensure that a plaintiff’s claims are not barred. Conversely, forcing a plaintiff to adhere to such rules can prevent a defendant from being held liable for speculative damages.

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Endnotes
1. See, e.g., Computer Sys. Eng’g, Inc. v. Qantel Corp., 740 F.2d 59 (1st Cir. 1984) (interpreting federal and Massachusetts law).
7. See, e.g., TK-7 Corp. v. Estate of Barbouti, 993 F.2d 722, 726 (10th Cir. 1993); Beverly Hills Concepts, 717 A.2d at 733.
9. Id.
14. Tri-G, Inc. v. Burke, Bosselman & Weaver, 222 Ill. 2d 218, 856 N.E.2d 389 (Ill. 2006) (holding that lost profits were not impermissibly speculative based on testimony concerning the experience of an existing company in selling goods indistinct from those planned by the new business).
16. Id. at 798.
22. See, e.g., Tipton v. Mill Creek Gravel, Inc., 373 F.3d 913, 918 (8th Cir. 2004) (applying Missouri law); Indep. Bus. Forms, Inc. v. A-M
Graphics, Inc., 127 F.3d 698, 703 (8th Cir. 1997) (same).


28. State rules of evidence vary; however, some states have adopted the Federal Rules of Evidence, and many states have adopted the Uniform Rules of Evidence, which now contain a modified Frye test that incorporates the Daubert reliability test. See Unif. R. Evid. 702; Rhoda B. Billings, Expert Testimony to Accommodate the Frye, Daubert and Kumho Tire Standard of Admissibility, 54 Okla. L. Rev. 613 (2001).

31. See, e.g., Seahorse Marine Supplies, Inc. v. P.R. Sun Oil Co., 295 F.3d 68 (1st Cir. 2002).


34. Daubert, 509 U.S. at 592–93.


37. Id.

38. See Marvin Lumber & Cedar Co. v. PPG Indus. Inc., 401 F.3d 901, 915–16 (8th Cir. 2005).


40. Id.

41. Id.

42. Frye v. United States, 293 F. 1013 (D.C. Cir. 1923).

43. States that continue to apply Frye include Alaska, Arizona, California, Colorado, Florida, Kansas, Maryland, Michigan, Nebraska, New York, Pennsylvania, and Washington.

44. States that accept Daubert include Connecticut, Georgia, Indiana, Kentucky, Louisiana, Massachusetts, Missouri, New Mexico, Oklahoma, South Dakota, Texas, and West Virginia.

45. States that have their own tests or apply a Frye-plus analysis include Arkansas, Delaware, Iowa, Illinois, Minnesotta, Montana, North Carolina, Oregon, Utah, Vermont, and Wyoming.


50. Lifewise Master Funding, 374 F.3d at 929–30.


52. Id.


55. Id., notes of advisory committee on 2000 amendments.


57. Lifewise Master Funding v. Telebank, 374 F.3d 917, 929–30 (10th Cir. 2004).


59. Id. at 420 (citations omitted).


64. Fed. R. Evid. 701.


