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DEFENDER

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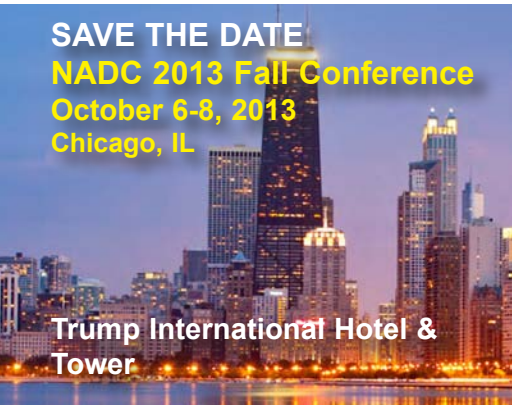

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Defending Lost Profit Claims in Vendor Contracts

By Mark A. Counts, *Bush & Ramirez, PLLC*
Gregory R. Schuelke, *Rimkus Consulting Group, Inc.*


Counts


Schuelke

Every dealership relies on the services of third party vendors. At times, these contractual relationships disintegrate and the dealership finds itself defending a vendor's breach of contract claim. If this occurs, the dealership's attorneys should focus on two aspects of the vendor's case: 1) defeating the merits of the vendor's claims; and 2) defeating the vendor's claim for lost profits. This article focuses on the general methodology that should be employed to attack a claim for lost profits under a vendor's contract.

The law surrounding the computation of lost profits is quite simple (in theory) and requires proof of lost profits to be within a reasonable degree of certainty. *Miga v. Jensen*, 96 S.W.3d 207, 213 (Tex. 2002)("lost profits are damages for the loss of net income to a business measured by reasonable certainty."); *Joerger v. Gordon Food Service, Inc.*, 568 N.W.2d 365, 369 (Mich. App. 1997); *Bemmes v. Public Emp. Retirement Bd.*, 658 N.E.2d 31 (Ohio App. 12 1995)(as to amount of damages, only "reasonable certainty" is required, which has been defined as that degree of certainty of which the nature of the case permits).[1] Thus, the fact finder cannot speculate or guess at the amount of lost profits. *Id.* Further, the amount awarded must be based on the loss of net profit, not the loss of gross profit. *Getman v. Matthews,* 335 N.W.2d 671, 673 (Mich. App. 1983). "Lost net profits" may be defined as the difference between "gross revenue" (the dollar amount which the vendor would have earned with full performance of the contract), less "avoided costs" (the dollar amount which it would have cost him to perform the contract). *See, e.g., Brodsky v. Allen Hayosh Industries, Incorporated*, 137 N.W.2d 771, 773 (Mich. App. 1965). Lost profits may be computed by using a company's established profits from prior years. *Lorenz Supply Company v. American Standard, Inc.*, 300 N.W.2d 335, 340 (Mich. App. 1981).

Generally speaking, the parties will be able to agree as to the amount of gross revenue that would have been generated under the parties' contract.[2] The real fight (and a focus of the defense's litigation strategy) should be on the costs that were avoided by the vendor's non-performance of the contract. The axiom "it is impossible to prove profits without first proving costs"[3] is quite useful in this context because without proof of costs then all revenue appears to be profit. Thus, it is critical to conduct discovery on the entire cost structure of the vendor *and* retain an expert to help present an accurate picture of this cost structure. The starting point is to propound a complete set

of discovery on the vendor requesting the following information: (1) vendor's financial data; (2) vendor's operational data; (3) vendor's marketing data, and; (4) vendor's management data.

The discovery of the vendor's financial data will allow the retained expert to develop an understanding of the vendor's cost structure, more specifically, an understanding of the costs that are affected by an increase or decrease in revenue.[4] Historical financial statements such as the annual profit and loss statements are a good starting point. Depending on the vendor and the products and/or services being provided, the vendor's profit and loss statements should be detailed to the level that "direct expenses"[5] can be verified and analyzed. Thus, if the vendor services include equipment maintenance and/or software maintenance, then the level of detail on the profit and loss statement should allow the financial expert to connect expenses to sales activities. At times, this may be nothing more than a comparison of the cost of goods sold to revenue.[6] However, more likely than not, the financial expert will have to perform further analysis on the vendor's financial statements to determine its true avoided costs.

The vendor's operational data should show the "mechanics" of the vendor. If the vendor provides a service then service history reports may be warranted to be discovered. If the vendor accounts internally for all services nationally then national information should be requested. This would include the number of contracts serviced. Likewise, if the information is accounted for regionally then the number of contracts should be provided by region. Ultimately, the operational data should be matched with the financial data to verify the alleged damages. An important item to remember is that the vendor may be internally using the same product(s) it sold to the dealership, *e.g.,* accounting software. If the vendor is utilizing its own products internally then the vendor should be able to provide the same level of detail on its cost structure as the dealership could provide on its cost structure.

The discovery of vendor marketing data should include the vendor's historical advertisements and approaching promotions. These documents may show the vendor changes to product lines or services on a regular or infrequent basis. Approaching promotions may show changes in the operations of vendor that may have an adverse effect on the reliability of historical financial statements. For example, a vendor which routinely fields new products and services can be expected to have higher production costs than a vendor that relies on older products/ services.

Vendor management data includes but is not limited to the minutes of company meetings, annual financial budgets,

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operational forecasts, and management reports. This information can serve many purposes. In regards to determining lost profits, the main purpose is to gain confidence that the previously requested historical data and operational data is reliable and can be used to support future cost estimates and, ultimately, the lost profits of the vendor.

If the vendor has a long standing relationship with the dealership then this discovery can be limited to a reasonable period of time prior to the alleged breach. A three-year period can be assumed to be reasonable for a vendor that is stable and not experiencing any major operational changes, *i.e.,* downsizing or rapid growth. Once this information has been discovered, it should be turned over to the financial expert retained to assist in deciphering it.[7]

After the completion of discovery, the retained expert should attempt to identify the vendor's cost structure and then classify the costs incurred as either avoidable costs, *i.e.*, those costs which can be avoided by the vendor's non-performance of the contract, or unavoidable costs, *i.e.*, those costs which cannot be avoided by performance of the contract. This classification has a direct impact on the lost profits that can be recovered under the vendor's contract, if any, as avoidable costs are *per se* non-recoverable.[8] The dealership's attorney should focus on demonstrating to the fact finder the monetary amount the vendor has saved through non-performance.[9]

The primary purpose in retaining an expert can be reduced to the segregation of the costs incurred by the vendor into two classes: avoided and unavoidable. Avoided costs "are those costs that would have been incurred in connection with the generation of lost revenues ***but were not incurred***."[10] Thus, the cost to clean uniforms under a uniform rental contract could be classified as avoided costs. Similarly, the cost to provide telephonic support for software could be classified as an avoided cost. According to the AICPA:

> "The starting point for the cost structure analysis may be the determination of fixed versus variable costs. Unless the loss period at issue is very short, however, it is unlikely that all costs will be purely fixed or variable."

In determining lost profits, the mere segregation of costs into fixed costs, *e.g.*, rent, and variable costs, *e.g.*, payroll, is insufficient because certain fixed costs may be semi-variable and certain variable costs may be semi-fixed. As a result, the retained expert must go farther to develop an explanation of why the costs incurred to provide the vendor's products or service(s) are avoidable.[11]

There are several ways to estimate the vendor's expected costs to service the dealership and achieve the ultimate goal of determining the avoided costs. Along the way, the financial expert should become familiar with some of the specific generally accepted accounting principles unique to the vendor's

industry. Familiar is the key word. The financial expert is not performing a financial audit of the financial statements. In fact, the financial expert will typically assume that the financial statements are properly stated regardless of whether the financial statements are in accordance with all generally accepted accounting principles or some other accepted reporting basis.[12]

Regardless of the basis of accounting used by the vendor, the financial expert will assume where appropriate that at least three generally accepted accounting principles[13] were followed. Those major accounting principles are as follows:

Matching - revenue and expenses are "matched" in the same accounting period.

Consistency – the method of reporting income and expenses are consistent from accounting period to accounting period

Full Disclosure – any material deviation from prior reporting periods, any material impact on the financial statements along with required disclosure in accordance with generally accepted accounting principles are properly noted.

These principles are mentioned here because one of the most popular approaches to determine avoided cost is the use of a build-up factor.[14] Using a build-up factor to determine the unit cost of production or service may be a good approach if done completely and appropriately. The build-up can be based on a direct assignment of cost as a percentage to revenue or on a direct assignment of expected expenses to forecasted levels of production/service. Whether the vendor's build-up factor was developed for internal purposes or for the underlying litigation, the factor should be tested by the financial expert for reasonableness and accuracy. Please note, it is beneficial to the vendor to show a low and incomplete build-up factor because the build-up amount is offset against the expected lost revenue to determine lost profits. As a result of this potential benefit, any build up factor utilized by a vendor should be thoroughly examined.

The information provided on the financial statement should allow for the financial expert to trace the vendor's build-up through the reported profits and loss statement and verify what expenses would be avoided and which expenses would not be avoided. Most importantly, all expenses should be available to test. Vendor's reported expenses should logically mirror the build-up. If not, the differences should be investigated with the skepticism that there may be omitted varying expenses that should be treated as avoided. An example of the vendor's build-up inconsistent with the financial statements is when the build-up is represented by vendor

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to be $0.10 for each contract (revenue) dollar whereas the financial statement report $0.35 in direct cost for each contract dollar earned. Either the build-up is incomplete and needs to be adjusted to the $0.35 range, or the vendor may be erroneously reporting $0.25 of direct costs. The financial expert will consider the approach used by the vendor to estimated avoided cost but will develop his own factor and amount avoided which may differ greatly from that expressed by the vendor.

In conclusion, in order to serve your client's best interests, dealership counsel must conduct discovery focused on the identification of relevant data to assist a financial expert in analyzing the cost structure which ultimately will determine the avoided costs associated with the vendor's contract. Further, an expert must be retained to present the vendor's cost structure to the fact finder and to give an opinion on the costs the vendor avoided through non-performance. ■

References

1. The Restatement of Contracts holds that "…damages need not be calculable with mathematical accuracy and are often at be approximate. Res. (2) Contracts §352, cmt. A, 2d para. (quoting Uniform Commercial Code § 1-106, cmt. 1). Ohio courts have gone so far to state that where recovery is based in the Uniform Commercial Code ("UCC"), the requirement of certainty as to amount of damages is reduced. *See Schulke Radio Productions, Ltd. v. Midwestern Broadcasing Co.,* 453 N.E.2d 683 (1983)(consequential damages, like all remedies provided under R.C. Chapter 1302, are to be liberally administered for the purpose of placing the aggrieved party in the same position it would have been in had the contract not been breached); *Bobb Forest Products, Inc. v. Morbark Industries, Inc.,* 783 N.E.2d 560 (Ohio 2002)(because the award of consequential damages for breach of a sales contract is to be liberally administered, courts must reject any doctrine of certainty which requires exact mathematical precision).
2. The average monthly invoice multiplied by number of months remaining on the contract should equal the gross revenue.
3. *See* Hunter, *Modern Law of Contracts* §14:17.
4. At times, vendors operate under a series of related companies. If this is the case then counsel should seek to discover the financial statements of all companies that provided services to the dealership under the relevant contract. Counsel should also examine intercompany transfers of capital to determine what company absorbed the expenses associated with providing goods and services to the dealership.
5. "Direct expense" are all expenses relating to the production of goods or services which are incurred for such production. Examples include freight, wages, factory expenses, oil and fuel, factory fixed assets' depreciation and *etc.*
6. For example, if a vendor sells telephonic support then the vendor's financial statements should report the expenses tied to the operation of a telephonic support center, *i.e.,* wages paid to personnel, telephone costs, facility costs, *etc.* Importantly, the vendor's financial statement may capture these expense in the cost of goods sold. If they are captured in the cost of goods sold then the ratio of revenue to costs of goods sold *should be used as a base line model* to determine avoided costs.
7. If a vendor's financial information is involved, then the dealership's counsel should be prepared to execute a confidentiality agreement which restricts its dissemination. The retained expert may have to be a party to this agreement or acknowledge its provisions and agree to be bound by them.
8. "It has been stated that although fixed overhead expenses need not be deducted from gross income to arrive a the net profit properly recoverable as damages based on lost profits under a contract, *all applicable variable expenses should be deducted when arriving at lost profits.* Thus, for example, one court has held that in arriving at a corporation's net loss of profits, the expense of salaries paid to the corporations officer's must be deducted. … Other costs avoided as a result of a contract breach should also be subtracted from revenue when calculating lost profits. …" *Williston on Contracts,* § 64:11 (2013)(emphasis added).
9. The practitioner should realize that the prudent vendor will also retain an expert whose sole function is to minimize the avoided costs incurred under the contract. Some vendor's experts will claim that less than ten percent (10%) of all contractual revenues were expended on avoidable costs. This means that the vendor is claiming a ninety percent (90%) margin on the contract as lost profit. Please note, under the Restatement "[d]oubts are generally resolved against the party in breach." Res. (2) contracts § 352, cmt. A, 2nd para. Thus, it is imperative to present the vendor's avoided costs in a clear and compelling fashion.
10. American Institute of Certified Public Accountants ("AICPA"), Practice Aid 06-4, *Calculating Lost Profits* (2006)(emphasis added).
11. There is a common misconception that fixed and variable expenses mirror avoided and unavoided costs. This is misconception not reality. Fixed and variable expenses are interpretations gleaned from the financial statements by users of those financial statements for non-litigation purposes. In contrast, avoided and unavoided costs are determinations made for the purposes of determining lost profits using the vendor's financial information based upon the case at hand.
12. For example – income tax basis.
13. Joseph T. Wells , *Occupational Fraud and Abuse* (Obsidian Publishing Company, Inc., Austin, Texas 1997), p426-431
14. A "build up factor" is factor that is generally applied to revenue to arrive at lost profits. There are numerous methods utilized to develop build up factors. One of the most commonly utilized is for "overhead."

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President's Message

Oren Tasini
Haile, Shaw & Pfaffenberger, P.A.
NADC President

Our Fall Conference is fast approaching. We will meet at our usual place, the fabulous Trump International Hotel & Tower in Chicago, October 6 - 8. This year, due to high demand, we have extended the program by a half day, making the total education program 1 and ½ days. There is just so much to talk about, and one day was not enough. The conference schedule is as follows:

Register NOW! CLICK HERE.

Sunday, October 6

3:00 – 5:00 pm	Board Meeting
6:00 – 7:30 pm	Reception

Monday, October 7

7:30 – 8:30 am	Breakfast
8:30 – 8:45 am	Opening Remarks
8:45 – 9:45 am	Session 1: **Getting Ready for 2015–Offering Health Care Coverage to Employees: Who, What, How, and When?** James Harbert, *Hinshaw & Culbertson*
9:45 – 10:00 am	Break
10:00 – 11:00 am	Session 2: **Understanding Your Dealership Insurance Program** Steven Gibson, *Dealer Risk Services, Inc.* Richard Minor, *AmWins*
11:00 – 11:15 am	Break
11:15 – 12:15 pm	Session 3: **Service Department Legal Issues: Loaner Contracts and Repair Orders** Michael Dommermuth, *Fairfield and Woods* Jami Farris, *Parker Poe Adams & Bernstein*
12:15 – 1:30pm	Lunch
1:30 – 2:30 pm	Session 4: **Arbitration Update: What You Can do to Protect Your Dealer Clients** Thomas Hudson, *Hudson Cook, LLP* Christian J. Scali, *The Scali Law Firm*
2:30 – 3:30 pm	Session 5: **Current Buy/Sell Market** Erin Kerrigan, *Presidio Automotive* Alan Haig, *Presidio Automotive*
3:30 – 3:45 pm	Break
3:45 – 5:00 pm	Session 6: **Open Mic – The Listserv "In Person": Hot Topics and Questions You've Always Wanted to Ask** Moderator: Oren Tasini, *Haile, Shaw & Pfaffenberger, P.A.*
5:00 – 6:30 pm	Reception

Tuesday, October 8

7:30 – 8:30 am	Breakfast
8:30 – 9:30 am	Session 7: **NADA Update** Paul Metrey, *Chief Regulatory Counsel, NADA*
9:30 – 9:45 am	Break
9:45 – 11:15 am	Session 8: **Sales and Finance Litigation Update** Geoff Chackel, *Higgs Fletcher & Mack, LLP* Rob Cohen, *Auto Advisory Services, Inc.* Patty Covington, *Hudson Cook, LLP*
11:15 – 11:30 am	Break
11:30 – 12:30 pm	Session 9: **Estate Planning Vehicles–Model Year 2013** Mitchell Drossman, *U.S. Trust*
12:30 – 12:45 pm	Closing Remarks
12:45 – 1:30 pm	Lunch

Please register now so you will not miss out on this great opportunity to stay abreast of the latest developments and get a chance to network and make new friends and connections. CLE credit is available for the 570 minutes of education program. Checkout the NADC website, www.dealercounsel.com for a detailed agenda, conference brochure and to Register.

See you in Chicago! ■

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Reservations must be made directly with the Trump International Hotel & Tower by calling **877-45-TRUMP.** Please reference the **NADC Fall Conference** to receive our discounted rate of $299. A deposit equal to one night's stay is required to hold each individual's reservation. A valid American Express, Visa, MasterCard, Diner's Club Card, or Carte Blanche card number and expiration date are acceptable. The rates are subject to a 16.4% tax per room per night. These rates are subject to change by law.

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Thoughts from the Editor

Help Your Client to Avoid Being Deened

Feature Article

By Michael Charapp, *Charapp & Weiss, LLP*

Most lawyers have followed the troubles of Paula Deen. Some have suggested that it is a case of bad depo prep. I think that we have to look a bit deeper. Any lawyer who has ever prepared a witness for a deposition knows that the ability to control events diminishes markedly once the witness is sworn in. So what lesson should lawyers take from this?

Let us start by looking at some of the background. Before this year, Ms. Deen was an American success story. Starting in Savannah, Georgia in a restaurant famous for its fried chicken, Ms. Deen built a comfort food conglomerate that Forbes magazine estimated earned $17 million last year on total revenues of nearly $100 million. She was a food star – until news about her deposition in a lawsuit brought by an employee of a restaurant Ms. Deen co-owns with her brother. The suit alleged harassment and inappropriate workplace behavior, including a pervasive "racially discriminatory attitude".

Most Americans knew nothing of the lawsuit until a report on the deposition of Ms. Deen. The attention-grabbing part of the story was Ms. Deen's admission that she had used the "n-word". Critics seized on other testimony that they said portrayed a less than enlightened attitude on racial issues. Her description of her dream restaurant where the "whole entire wait staff was middle-aged black men, and they had on beautiful white jackets with the black bow tie," did not help. Nor did her puzzlement at whether jokes using the "n-word" are hurtful – "I can't, myself, determine what offends another person."

The judge in the case recently dismissed the counts based on race, finding that the plaintiff lacked standing. However, once the story broke nationally, the damage was done. The fallout from the coverage was devastating,

ranging from loss of Ms. Deen's cable TV show to cancellation of endorsements. The high flying Ms. Deen has been brought down, and she will have to work hard to rebuild her empire and her reputation.

That brings us to the lessons that dealer lawyers should learn. If a case gets to the stage where the client's business depends on careful and complete control of a deposition you are defending, you are in a very dangerous position. Some witnesses stop thinking in the deposition, and their thoughtless remarks can be trouble. Others cannot control their emotions, and they blurt out damaging statements, regardless of the truth. The worst are the witnesses who want to be confrontational, since a skilled lawyer taking a deposition lives for that.

Dealers generally have a high profile in their communities. Like what happened to Ms. Deen, things can go downhill quickly for a dealer who becomes the target for media humiliation and the butt of jokes. Ms. Deen went from successful advocate for fried foods to a vilified racist almost overnight.

What can happen if your client's dealership winds up in the media thumping barrel? The client may dismiss the possibility of being labeled a racist because of enlightened attitudes in the dealership. However, what if a salesperson's complaint about a thoughtless remark in a sales meeting ("Make sure you convince the husband or boyfriend since women are less decisive than men.") leads to the dealership being labeled as sexist? Or what if some silly statement in training ("Luxury buyers demand more so we have to treat them better than other buyers") gets the store's practices branded as arrogant and unsympathetic to regular customers? Or what if some stupid jokes among employees about customers gets the dealership tagged as uncaring about consumers? By the way, these situations are not hypothetical. They all come from cases I have been involved in over the years.

Every dealer should understand the importance of not getting Deened. When negative publicity starts, the online sarcastic comments will fill webpages and the jokes will start. The situation can get out of control quickly.

Any lawyer who represents dealers knows how difficult it can be to sometimes get a dealer to settle and put a bad case in the rear view mirror. It is not just the dealer's pride at stake. Often it is the managers and employees involved who must feel vindicated because … well, gosh darn it, they are RIGHT! Regardless of the feelings, however, if bad things develop and become public, there may be little one can do to handle the fall out. Here are some things to discuss with your dealer clients.

A dealer must control the atmosphere in the dealership. It is easy for jokes in a sales

meeting or statements made while bantering on the floor to be misconstrued. Jokes or comments targeting a specific group or customers are no laughing matter. The best way to protect against claims of a hateful and discriminatory environment is to prevent it. Everyone wants to work in a friendly place, but banter and jokes at the expense of a group of people or customers are contrary to that goal. Train all managers to stop this kind of behavior when they see it or hear of it. Train employees in the importance of a professional atmosphere. Good personnel policies, training, monitoring compliance, and action when behavior deviates from the requirements are the first layer of protection.

A dealer who receives a complaint must investigate it thoroughly and handle it. Problems will usually bubble up as complaints before becoming public lawsuits. A complaint provides the opportunity to find out what is going on and to solve the problem. Too often, complaints are ignored or decisions on handling complaints are made from incomplete knowledge or the insistence of personnel that they are right. Complaints that are not well handled may turn into lawsuits. Then, as facts develop and the wisdom of settling is apparent, you may find positions hardened to the point where settlement is difficult. A dealer must do an early and thorough investigation of every complaint, whether from an employee or a customer. This is the second layer of protection if done correctly. If there is a problem or the allegations may to lead to embarrassing disclosures, the dealer should try to settle the case. An early settlement is usually the cheapest solution.

If your client is sued, that is generally when you are brought into it. Every dealer lawyer has experienced the dealership that just does not want the attorney to spend too much time investigating. After all, it is all nonsense, and any attorney worth his or her salt should just make it go away – and do so quickly and inexpensively. Every lawyer knows that there is little magic in the world. A lawyer must know all the facts – good and bad – so that an effective defense strategy can be developed. Dealer personnel tend to be excellent salespeople, and they often approach lawyers with the idea that they can sell them on the validity of the dealership's position by emphasizing the positive. An attorney must be in a position to make a balanced decision based on an open and full presentation of the facts – not just the positive ones. If there are bad facts, a lawyer must determine at this stage to advise the client to settle the case for business reasons.

Don't think that arbitration provisions will completely solve the problem of negative publicity. Yes, arbitrations are private. That is why a plaintiff attorney with a case that he or she thinks is hot will file a lawsuit and challenge the pre-dispute arbitration provision. The strategy will be to throw around as many embarrassing and damaging facts as possible in a hearing on whether arbitration should be compelled to try to convince the judge that pre-dispute arbitration is unconscionable in the case. The attorney may even try to get media coverage of the facts if they are sufficiently embarrassing for the dealership.

Prepare witnesses thoroughly for depositions and testimony. Every lawyer knows the importance of this, but clients think that they can handle any questions a lawyer will throw at them. It is important for witnesses to understand that thorough preparation will give them the opportunity to hear how testimony will sound. As important, it will allow the attorney to understand where there may be vulnerabilities and an opportunity to get in front of problems.

Always consider the public relations aspects of the case. If a dealership is sued, its legal vulnerability is not the only issue. Many dealers think that negative publicity can be controlled because they advertise, and the folks at the newspaper and the local TV and radio stations will not want to alienate them. However, the news folks in the media take pride in ignoring the business folks, and they will run with a hot (and embarrassing) story if they think it will get them an audience. A dealer must be aware of this, and must understand the importance of a quiet settlement that can help avoid a public airing of potentially damaging matters. If the attorney cannot negotiate a settlement, the dealer may want to consider hiring a PR professional. Many dealers think that they are PR experts because they advertise, but PR and marketing are really two different skill sets.

Ms. Deen's fall was staggering in its swiftness and severity. However, no businessperson today – with the internet spreading stories internationally in minutes – can feel immune from such treatment. It is more important than ever for a dealer to be proactive to protect the dealership. ■

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