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Working With Your Expert in Determining Lost Profits From a Vendor Contract

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We were recently involved in a case in which the plaintiff, a wholesale distributor, brought an action against a manufacturer for breach of a vendor contract. The complaint alleged the manufacturer breached the contract by canceling it, causing significant lost profits to the wholesale distributor. Although this type of legal action is fairly common and straightforward, we encountered certain interesting issues during our evaluation of plaintiff's damage claims.

These issues are summarized as follows:

• How does an expert predict sales when there is no consistent historical trend?
• In this case, the manufacturer was a U.S. based company and the wholesaler distributed into a foreign market with heightened inflation. How do these facts impact the damages?
• When sales and administrative costs are difficult to reduce immediately how does an expert predict the amount and timing of future reductions of costs?

Projecting 'But For' Sales

The product was introduced to the plaintiff's market in 2006. Sales rose quickly between 2006 and 2008. Concurrent with the recession, sales fell in both 2009 and 2010. Sales recovered in 2011 and 2012 and, in 2013, declined. The contract was terminated in early 2014.

Plaintiff's expert calculated the average annual rate of growth in sales for 2006-2013, and averaged those growth rates to estimate average annual growth in the years following the alleged breach. While conceptually simple, the calculated average looked suspiciously high given the rapid growth in the first years of the product's introduction into the market and the decline in the most recent year. Further, the projected growth was greater than the expected growth (in volume) of the particular product's consumption in the distributor's country based on industry data.

We concluded that it was improper for plaintiff to use the average annual sales increase for the full eight year period. We did observe, however, that 2011 to 2013 reflected a heightened level of sales apart from 2006 to 2010, and that those years may be most indicative of future sales. One approach we considered was to measure the linear trend for only those years and use that trend for predicting future sales. Another approach was to assume no change in future periods except for inflation (i.e. future sales equal to 2013 plus inflation). A third approach was to measure the linear trend for only 2012 to 2013, and due to the decline in 2013, to project a continuing decline in sales.

Our further investigation of 2013 sales led to the conclusion that the sales decline in 2013 was due to significant returns from the prior year's sales. The idea that sales would continue to decline in the future was thus rejected. Industry forecasts of volume consumption in the distributor's country were between 5 and 10 percent per year, so just increasing for inflation seemed unreasonably low. Ultimately, we concluded that the linear trend for the three years prior to the breach was a reasonable predictor of future growth.

TIP: Question your expert's sales forecast. What prior years did they use and why? What prior years did they exclude and why? Did the expert give the more current years the most weight and, if not, why not?

Adjusting for Inflation

Inflation in the distributor's country was higher than in the U.S. Plaintiff's expert's calculations of lost profits were calculated in the currency of the foreign market and were converted to U.S. dollars at the current exchange rate.

Interestingly, the plaintiff's expert added an inflation adjustment to the calculated sales growth rate that already had inflation imbedded in it. The calculated growth rate used by plaintiff's expert was based on real, not inflation-adjusted (or nominal) sales figures. This had the effect of double counting growth due to inflation. The linear trend we used for predicting future sales was based on real sales observations and, thus, an additional adjustment for inflation was not necessary.

TIP: Question all of your expert's adjustments. Why are they making an adjustment? If the adjustment was not made, why would the forecast or calculation be wrong?

Estimating Unavoidable Costs

As in many damages cases, calculating lost profits involves estimating profits in the "but for" world and comparing those profits to what actually occurred. In this instance, the distributor experienced extremely low profits during the periods that the vendor contract was in place. Further, we observed that the defendant's products likely had no net profits after all costs were considered since the avoidable costs relating to such sales were roughly equal to the margins on those products.

Accordingly, in the "but for" world where the contract would have continued, our contention was that the net profits were essentially zero. The remaining question, from a damage point of view, was "What costs did the plaintiff continue to incur because the contract terminated?" These costs would be Selling, General & Administrative costs that could not be quickly reduced when the contract terminated.

In estimating SG&A costs that would continue to occur in the post-contract period, plaintiff's expert analyzed the level of those costs for the one year period following the alleged breach. The expert compared the costs in the year following the breach to the one year period prior to the breach, and then calculated the percentage reduction. The assumption was that this reduction represented all of the costs that would be avoided due to the alleged breach.

Our analysis reflected that SG&A costs continued to decrease as a percentage of sales throughout and following the one year period subsequent to the alleged breach. Thus, using the one year period was not capturing all avoided costs, particularly since cost reductions are frequently hard to rapidly achieve following a loss of sales (in other words, they are "sticky"). Our approach to determining the amount of avoidable costs not captured in plaintiff expert's analysis was to determine if a model could be developed to predict costs that were "fixed" and costs that were "variable" based on sales volume.

SG&A costs are, for most businesses, a fairly constant percentage of revenue over time. This phenomenon exists because most costs vary with revenue volume and even costs considered to be “fixed” can be reduced in response to revenue reductions given sufficient time. For example, unused warehouse space leased under a long-term agreement can be sub-leased.

We performed an analysis of historical data for the plaintiff to determine if a reliable model could be developed to predict fixed and variable costs (where variable costs would rise or decline as revenues rose or declined). Indeed, a very strong statistical relationship existed between revenues and SG&A costs based on an analysis of 2006 (the year the product was introduced) through 2013 historical financial data. What we discovered was a linear relationship where each dollar of revenue predicted 40 cents of SG&A costs. This relationship held true even when sales declined, as they did in 2009 and 2010 due to the recession.

Accordingly, we were able to determine that SG&A costs (representing approximately 40 percent of sales) varied with sales volume and, therefore, were subject to control by plaintiff. Based on this knowledge we analyzed the periods subsequent to the alleged breach. Our observation from this data was that plaintiff was able to reduce its sales and administrative costs to amounts below 40 percent of sales in 2015, the year following the alleged breach. So, by 2015, plaintiff was no longer paying for “sticky” SG&A costs associated with sales of defendant’s products.

TIP: Question why future unavoidable costs will be static. What else could a plaintiff do to mitigate future unavoidable costs? How long should it reasonably take for plaintiff to fully reduce unavoidable costs?

Conclusion

The lesson learned from our analysis of plaintiff’s claims was that one cannot always blindly rely upon past results in predicting the future. The expert must consider the appropriate time period on which to base future projections, and when predicting lost profits into the future must consider the plaintiff’s ability to mitigate losses through a reduction in costs. Even costs considered on their face to be fixed may be subject to reduction within a reasonable time.

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