PERSPECTIVES

How the Reasonable Certainty Standard Allows Courts to Award Lost Profits for New Business Ventures

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The material in this article was researched, compiled, and written by J.S. Held. It originally appeared in The Litigator*, published by the American Bar Association.*

INTRODUCTION

The controversy over whether new businesses can be entitled to lost profits has long been debated among courts, legal counsel, and forensic accounting analysts. In fact, until recently, many courts rejected the idea that unestablished businesses could recover lost profits. However, in the last several years the Modern New Business Rule emerged, granting new businesses potential credibility in recovering lost profits damages.

This discussion focuses on the Modern New Business Rule through several judicial decisions in which the standard of reasonable certainty is used in the measurement of lost profits damages. It also examines the view of most federal and state courts, shifting this concept from a rule of law to a rule of evidence.

One of the challenges of measuring economic damages in a case that involves a new enterprise is deriving a reasonable estimate of profits lost due to the wrongful actions of another party. Due to lack of historical performance for the new enterprises, certain state and federal courts previously abided by the former New Business Rule, which dismissed any action by a new enterprise to claim lost profits.

However, under the Modern New Business Rule, a finding of lost profits for a new business venture hinges on whether damages can be proved with "reasonable certainty."

Whether assuming a role in the plaintiff's or the defendant's damages case, it is important that the damages analyst (analyst) and the legal counsel (counsel) understand the standards by which courts assess damages and have knowledge of relevant court decisions. This discussion summarizes the following:

1. The shift in standards applied by both federal and state courts to address lost profits in damages cases involving new enterprises.

2. The application of reasonable certainty in federal and state judicial decisions.

THE FORMER "NEW BUSINESS RULE"

The New Business Rule ("NBR") has roots in 19th century American common law when courts sought to protect businesses and create an environment in which the nascent, industrializing American economy could grow.

The NBR originally held that "lost profits for a new business were not recoverable" for a new or recently formed business as future profits were too "uncertain, speculative, and contingent."[1] This view provided an opportunity for one party to potentially breach a contract before the other party began to conduct its business operations. Under the NBR, the nonbreaching party had little to no recourse against the breaching party. However, as time passed, most courts began to realize the inequities created by this interpretation and application of the NBR.

SHIFTING FROM A RULE OF LAW TO A RULE OF EVIDENCE

Recently there has been a shift in the judicial interpretation of the NBR. Most state and federal courts now reject the application of the NBR as a per se rule in favor of a new interpretation and standard. "The development of the law has been to find damages for lost profits of an unestablished business recoverable when they can be adequately proved with reasonable certainty."[2]

This distinction between absolute certainty and reasonable certainty by the court is an important element of the new interpretation that allows new businesses to claim, and in some cases recover, lost profits. "What was once a rule of law has been converted to a rule of evidence."[3]

This shift in interpretations came about gradually and eventually resulted in what is commonly known as the Modern New Business Rule (MNBR). The MNBR holds that profits of a recently formed business are in fact recoverable, so long as the amount of lost profits can be "adequately proven with reasonable certainty."[4]

[1] Robert L. Dunn, Recovery of Damages for Lost Profits (Westport, CT: Lawpress Corporation, 2005), vol. 1, 376.
[2] Ibid., 378.
[3] Ibid.
[4] Ibid.

An important distinction between the NBR and the MNBR is that the NBR is a rule of law, whereas the MNBR is an evidentiary rule.

There are several scenarios in which the MNBR may be applied:[5]

1. **Post-Breach Profits for an Injured Business.** In this situation, a damaged business may eventually return to the projected growth curve that existed prior to the alleged wrongful act. For example, if a supplier breached its contract to provide a certain product or service, the business damaged by the breach may need time to find a replacement supplier. This may ultimately lead to lost profits.

   If the injured business is able to find a replacement supplier and return to its prior level of sales, the lost profits may only apply during the time needed to find a new supplier and return to previous growth. In this instance, a comparison of projected and actual profits during the time of recuperation may be used to calculate lost profits.

2. **Post-Breach Profits by Successor Business.** In some instances, a wrongful act may cause the injured business to vacate its location, and a competitor business may take its place. Provided all other market factors remain the same, the profits generated by the successor business may be used as a substitute for calculating the lost profits of the damaged business.

3. **Business Enterprise Ceases.** In some situations, the damaged business may cease all operations. In such a case, to meet the reasonable certainty standard, the elements that are necessary for the success of a particular business must be identified. These critical success factors are business-specific and should be determined by the nature, industry, and market of each enterprise.

4. **Short-Term Pre-Breach Operations.** It is possible for a new business to have only operated for a short period of time before being affected by an alleged wrongful act. "Even if the business operated for less than one year, sufficient information may exist to extrapolate lost profits as a result of the breach."[6]

   Data gathered for even a few months may be comparable to industry statistics. A new business may demonstrate reasonable certainty by comparing its data with similar new business trends.

Although courts have started to acknowledge scenarios in which unestablished businesses may recover lost profits, the requirement of reasonable certainty is often strictly followed.

REASONABLE CERTAINTY: A MORE PRECISE EVIDENTIARY BASED STANDARD

In determining the validity of a calculation of lost profits, courts consider the establishment of reasonable certainty in an analyst's measurement of lost profits.

Schwartz v. Menas

In a 2022 decision, *Schwartz v. Menas*, the Supreme Court of New Jersey, the state's highest court, ruled against a per se ban on lost profits damages by a new business. The decision placed New Jersey with a view held by most other jurisdictions. "We concur with the majority of courts that reject a per se rule barring any new business's claim for lost profits damages, and decline to follow the new business rule," the court stated in its opinion. "We reaffirm that a trial judge must conduct a case-specific inquiry when deciding a motion to admit or bar a category of evidence."[7]

In this case, plaintiff Larry Schwartz formed NJ 322, LLC to build an affordable housing complex with a developer on a property in Monroe Township. Schwartz and his company sued two real estate developers and their former legal counsel contending that they arranged to have the property rezoned so that only affordable housing could be built on it, at which time the developer withdrew and Schwartz had no alternative but to sell the property. Schwartz

[5] Mark Gauthier, "Recovering Lost Profits for StartUp Companies," Business Law Today (December 14, 2017), found at https://businesslawtoday.org/2017/12/recovering-lost-profits-for-start-upcompanies/.
[6] Ibid.
[7] Supreme Court of New Jersey. Schwartz v. Means. A-54/55 25. 085184 (2022).

conceded that he had no experience with or knowledge of the requirements imposed on developers of affordable housing but asserts that he intended to act as the property's developer.

Schwartz's damages expert prepared a report and presented two lost profits damages models for the Monroe Township development. First, there was the profit Schwartz would have achieved if the development had proceeded as originally planned, and second, the profit Schwartz would have achieved if his company constructed the affordable housing project. However, the report did not acknowledge Schwartz's lack of experience in residential housing development.

The two lower courts imposed the former NBR and barred the testimony of Schwartz's expert. Schwartz appealed. In the 2022 opinion reversing the lower courts, New Jersey's highest court said: "We concur with the trial court and the Appellate Division that the development projects that give rise to both cases constituted new business. Nonetheless, so that these matters can be decided under the correct standard, we reverse the Appellate Division's decision and remand these matters to the trial court for consideration of defendants' motions to bar plaintiffs' proofs of lost profits damages and for summary judgement."[8]

Morris Concrete v. Warrick

In another case decided in 2003, *Morris Concrete, Inc. v. Warrick*, the Court of Civil Appeals of Alabama concluded that Warrick's presented testimony failed to meet the "reasonable certainty" test for seeking lost profits. In the opinion, the court describes reasonable certainty as follows: "In order that it may be a recoverable element of damage, the loss of profits must be the natural and proximate, or direct, result of the breach complained of and they must also be capable of ascertainment with reasonable, or sufficient, certainty . . . absolute certainty is not called for or required."[9]

While there is no law or single measure for reasonable certainty, section 352 of the Restatement (Second) of Contracts states: "Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."[10]

Although federal and state courts provide varying case-specific decisions, they generally agree on certain guidelines:

1. The conduct of the defendant upon which the claim is based directly caused the damages to the plaintiff.

2. The plaintiff can estimate the amount of damages, and the estimation employs a reliable method of measurement.

3. The length of the damage period is reasonable.

4. The plaintiff based its assumptions upon the best available evidence, and both internal and external factors were considered within the measurement of damages.

For well-established companies, damages measurements should acknowledge past performance as reliable predictors of the future. For a new or speculative business, parties may measure damages with reasonable certainty by the use of expert testimony, business records, economic and financial data, and other verifiable data. However, new businesses face significant challenges in proving lost profits due to the lack or limited historical record of performance.

Some of those challenges include the following:[11]

1. Reliability of expected profits projections.

2. Selection of guideline companies to apply a yardstick method.[12]

3. Determination of the length of the damages period.

4. Demonstration of specific business risk, cost of capital, and discount rates as applicable to future lost profits.

5. Verification of existence of a market and probable acceptance of the product/service.

[8] Id. 27
[9] Morris Concrete, Inc. v. Warrick, 868 So. 2d 429, 440 (Ala. Civ. App. 2003).
[10] Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, Litigation Services Handbook, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), 4.9.
[11] Scott A. Barnes, "Lost Profits and Lost Value in Litigation Involving Startups, New Ventures, Emerging Companies and New Technologies" found at (https://docplayer.net/90185629-Lostprofits-and-lost-value-in-litigation-involvingstartups-new-ventures-emerging-companies-andnew-technologies.html).
[12] "The yardstick method involves using a benchmark to estimate what would have occurred if the damages event had not taken place. Common benchmarks used in a yardstick method damages analysis include other companies in the same or a similar industry as the owner/operator or industry data for the industry that the owner/operator participates in." Source: Robert F. Reilly and Robert P. Schweihs, Guide to Intangible Asset Valuation (New York: American Institute of Certified Public Accountants, 2014), 200.

6. Capacity to scale operations and meet expected projections.

7. Confirmation of management expertise.

The inherent challenges of proving lost profits in a damages case where the plaintiff is a new business result in increased scrutiny by both federal and state courts as evidenced by the judicial decisions summarized below.

***Energy Capital Corp. v. United States*[13]**

In *Energy Capital Corp. v. United States (Energy)*, Energy Capital Corporation (Energy Capital) brought a breach of contract action against the Department of Housing and Urban Development (HUD) in the Court of Federal Claims (the Claims Court) and was awarded lost profit damages. This judicial decision was subsequently appealed by the U.S. government.

Upon review, the United States Court of Appeals for the Federal Circuit (Appeals Court), affirmed the decision by the Claims Court to award Energy Capital lost profits.

Formed in 1994, Energy Capital Corp. was established to provide financing that would allow institutions and businesses to optimize their energy consumption. One opportunity that Energy Capital identified was the affordability and lack of financing available for energy improvements in HUD housing.

A major hurdle to the development of an affordable financing program was the regulatory restrictions on HUD housing already in place. Mortgages for HUD housing were provided mainly by the Federal National Mortgage Association (Fannie Mae) and were insured by the Federal Housing Authority (FHA). The restrictions imposed by Fannie Mae and the FHA would not allow the homeowners of HUD housing to place additional mortgages on their properties.

Over time, Energy Capital was able to come to an agreement with HUD and eliminate the financing restrictions put on HUD housing. This agreement was known as the Affordable Housing Energy Loan Program (AHELP). The AHELP agreement allowed Energy Capital to originate $200 million in loans to owners of HUD properties over three years.

These loans would include provisions referred to as a “spring subordinated lien” and a “cross-default provision.” This means that if a property owner defaulted on the energy efficiency loan originated under AHELP, the first mortgage on the property would also go into default.

At the same time, the energy efficiency loan would “spring” into the senior mortgage position. In turn, Energy Capital would structure the loans so that the anticipated savings of the energy improvements would be 110% of the loan payments annually. These loans would bear an interest rate of 3.87% above the Treasury rate.

Fannie Mae would fund the loan and be paid back at an interest rate equal to the Treasury rate plus 1.87%—Energy Capital would keep the other 2%. As part of its agreement to fund up to $200 million in loans, Fannie Mae agreed to buy back the loans from Energy Capital in the future.

On February 7, 1997, an article in the Wall Street Journal stated that Energy Capital had received the AHELP contract in exchange for fundraising for President Clinton. HUD terminated the AHELP agreement on February 10, 1997.

The Claims Court started from the premise that in order to demonstrate entitlement to lost profits, Energy Capital was required to establish 1) causation, 2) foreseeability, and 3) reasonable certainty.[14]

In addition, the court took the position that because AHELP was a new venture, Energy Capital would have a difficult burden establishing that its claim for lost profits was reasonably certain.

During the appeals process, the government argued that because the agreement with Energy Capital was a new venture, the court should adopt a per se rule that lost profits may never be recovered from a new business venture that was not performed.

The Appeals Court declined to adopt this rule for the following reasons, among others:

- The benefits that were expected from the contract, “expectancy damages,” are often equated with lost profits, although they can include other damage elements as well.[16]

[13] Energy Capital Corp. v. U.S., 302 F.3d 1314, 1317 (Fed. Cir. 2002).
[14] Id. at 1320.
[15] Id. at 1324.
[16] Id.

- To recover lost profits for the breach of contract, the plaintiff should establish by a preponderance of evidence that 1) the loss was the proximate result of the breach, 2) the loss of profits caused by the breach was within the contemplation of the parties because the loss was foreseeable or because the defaulting party had knowledge of special circumstances at the time of contracting, and 3) a sufficient basis existed for measuring the amount of lost profits with reasonable certainty.[17]

In addition, the Appeals Court did not agree with the government's argument that because AHELP was a new venture, there was no evidence of a track record, and it would be impossible to measure lost profits.

Ultimately, the Appeals Court upheld the opinion of the Claims Court that, "while the evidentiary hurdles to recovering lost profits for a new venture are high, such profits may be recovered if the hurdles are overcome."[18]

In *Energy Capital Corp. v. United States*, the Claims Court and the Appeals Court rejected the per se NBR that lost profits cannot be determined for a new business or venture because future profits are too speculative and uncertain. Instead, both courts expressed support for the MNBR and applied the standard of reasonable certainty.

In Energy, the court was provided a business plan and the fees that were agreed to by all parties involved. The capital to finance the project was also in place. The only matter that was left to speculation was the extent to which Energy Capital could execute on the $200 million loan program.

The Appeals Court addressed this in its opinion by commenting that the Claims Court "drew reasonable inferences based upon the evidence" and that this "was not a case in which the trial court engaged in unsupported speculation."[19]

Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P.[20]

In contrast, the following case shows how "reasonable certainty" can result in a court not awarding lost profit damages.

In *Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P.*, and Christopher Wyatt (Youtoo), the plaintiff, Al-Saud, brought a breach of contract claim against Youtoo Media, L.P. (Youtoo Media) and its chief executive officer Christopher Wyatt (collectively, the defendants). The breach of contract claim was related to a failure by the defendants to reimburse Al-Saud.

The defendants filed counterclaims. The U.S. Court for the Northern District of Texas (the District Court) granted Al-Saud's motion for entry of judgment on jury verdict in his favor.

The District Court also rejected the defendants' counterclaims on the basis that the testimony of the Youtoo Media damages expert was too speculative. The parties appealed to the U.S. Court of Appeals for the Fifth Circuit (the Fifth Circuit Court).

The case arose out of Al-Saud's investment of $3 million in the form of a reimbursable down payment to Youtoo Media while he contemplated whether to purchase an interest in it. Youtoo Media was a technology company that combined elements of social media and television in a way that allowed viewers to participate in broadcasts through their mobile device by sending pictures, videos, or texts.

The ultimate goal of Youtoo Media was to have its platform purchased by American broadcasters. To reach this goal, Youtoo Media believed it should demonstrate success in other markets. Youtoo Media felt that capital would be required to enable it to reach those markets. The search for additional funding brought Al-Saud and Youtoo Media together and led the parties to enter a letter of intent in 2013.

However, Youtoo Media encountered financial difficulty and was forced by a lender to sell its intellectual property and assets to pay outstanding obligations. After learning of the Youtoo Media troubles, Al-Saud requested that Youtoo Media reimburse the $3 million down payment. Youtoo Media refused, and Al-Saud sued Youtoo Media for breach of contract. Youtoo Media filed a counterclaim for breach of fiduciary duty to seek lost profits attributable to the actions of Al-Saud.

[17] Id. at 1325.
[18] Id. at 1328.
[19] Id. at 1329.
[20] Mansour Bin Abdullah Al-Saud v. Youtoo Media, L.P., 754 Fed.Appx. 246 (5th Cir. 2018).

The District Court rejected the Youtoo Media counterclaims on the premise that the testimony of the Youtoo Media damages expert was too speculative. The Fifth Circuit Court upheld the District Court ruling for the following reasons, among others:

- Youtoo Media lacked a history of profitability.
- Youtoo Media had few signed agreements with potential customers. Therefore, the defendants' expert relied largely on "hoped for" partnerships and the earnings those partnerships might create.

Both the District Court and the Fifth Circuit Court considered the fact that Youtoo Media was a newly established business and determined that this status did not preclude a reliable lost profits number. However, upon hearing and analyzing the testimony of the defendants' damages expert, both courts determined that the measurement of lost profits was too speculative to be deemed reliable.

Although the courts involved in the Youtoo decision reached a different conclusion than the courts involved in the previously mentioned ones, the decisions were premised on the idea that a newly formed business or enterprise may be entitled to damages for lost profits if it can prove with reasonable certainty that such profits would have been earned but-for the breach.

CONCLUSION

Although new businesses face significant challenges in validating a claim of lost profits, the MNBR allows recently formed businesses and ventures to recover economic damages as long as the business provides adequate reasonable certainty.

In the New Jersey case as well as in the Energy and Youtoo decisions, the courts did not dismiss the cases based on the new nature of the involved ventures. Instead, the courts determined a verdict founded upon the reliability of evidence as a basis to measure lost profits.

Energy Capital provided thorough documents such as its business plan and contracted fees of all parties involved, which left little for the court to speculate, and, as a result, received a favorable court decision.

While also a new venture, Youtoo Media lacked a history of profitability and could not supply objective confirmation of future profit which resulted in the rejection of their counterclaims. In reviewing cases such as these, analysts may better understand the role of reasonable certainty in supporting lost profits claims.

The court in Schwartz vs. Means remanded the matter to the trial court to determine if the plaintiffs' lost profits evidence is sufficient to establish a claim for damages with reasonable certainty despite their inexperience in developing housing.

New businesses can now contest inequities caused by harmful conduct against them; however, the responsibility lies with analysts and counsel to thoroughly understand the implications of reasonable certainty.

An understanding of these judicial decisions can assist an analyst in better understanding the judicial application of reasonable certainty in light of the shift toward the modern new business rule, identify the hurdles in proving reasonable certainty in a lost profits analysis involving a new business or venture, and recognize justifiable scenarios where federal and state courts have awarded lost profit damages.

ACKNOWLEDGMENTS

We would like to thank our colleague Brandon McFarland for providing insights and expertise that greatly assisted this research.

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