

I N S I D E T H E M I N D S

New Developments in Evidentiary Law in New York

*Leading Lawyers on Recent Changes to the
Evidentiary Code and the Impact of Key Decisions*



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Proving Lost Profits
Under New York Law:
High Hurdles for the
Plaintiff's Damages Expert

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In many commercial contract cases litigated in New York state and federal courts, a major, if not sole, measure of claimed damages is lost profits. New York substantive law, however, requires a high degree of certainty to prove lost profits, and the Federal Rules of Evidence add significant additional hurdles to the admissibility of expert testimony on lost profits.

New York Law on Lost Profits

Under New York law, loss of future profits as damages for breach of contract is a recoverable element of damages, *but* it “must be demonstrated with certainty that such damages have been caused by the breach and, second, the alleged loss must be capable of proof with reasonable certainty.” *Kenford Company, Inc. v. Erie County*, 67 N.Y.2d 257, 262, 493 N.E. 2d 234 (N.Y. 1986). In addition, there must be a showing that the particular damages claimed “were fairly within the contemplation of the parties to the contract at the time it was made.” *Id.* Finally, “the damages may not be merely speculative, possible or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes.” *Id.*

In *Kenford Company, Inc. v. Erie County*, plaintiffs sought to recover lost “prospective profits” after a jury found Erie County liable for breach of the parties’ contract governing construction and twenty-year operation of a domed stadium. 67 N.Y.2d at 262. The appellate division set aside the jury verdict and dismissed the action. On appeal, the Court of Appeals conceded that plaintiffs offered “massive” proof of lost profits. *Id.* (“it is difficult to conclude what additional relevant proof could have been submitted by DSI in support of its attempt to establish, with reasonable certainty, loss of prospective profits”). Nonetheless, the court held that the proof “does not satisfy the requirement that liability for loss of profits over a twenty-year period was in the contemplation of the parties at the time of the execution of the basic contract or at the time of its breach.” *Id.* It determined that the evidence—including the remedies for default in the parties’ contract—failed to demonstrate that the parties contemplated that, in the event of breach, the County would be liable for plaintiffs’ loss of profits over the length of the contract. *Id.* The court also held that despite the “massive quantity of expert proof” plaintiffs submitted to show lost profits, the experts’ ultimate conclusions were still “projections,” and those

projections were undermined by assumptions that the never-constructed dome was actually completed and that the dome was available for use and successfully operated for a number of sporting and commercial events for twenty years. *Id.* The court concluded that “the multitude of assumptions required to establish projections of profitability over the life of this contract require speculation and conjecture, making it beyond the capability of even the most sophisticated procedures to satisfy the legal requirements of proof with reasonable certainty.” *Id.*

Under *Kenford*, New York law holds the plaintiff seeking to recover lost profits to a very high standard of proof. Like the plaintiffs in *Kenford*, many (if not most) plaintiffs seek to prove lost profits through expert testimony.

Expert Testimony that Relies on Hearsay

Expert witnesses are permitted to rely on evidence that *may* not itself be admissible in reaching their opinion and providing testimony about the opinion. That does not mean, however, that the expert can rely on *any* inadmissible evidence of his and her choosing.

FED. R. EVID. 703, “Bases of Opinion Testimony by Experts,” provides that “the facts or data [on which the expert relies] need not be admissible in evidence” in order for the expert’s opinion to be admitted. This is commonly understood to mean, and the cases often hold, that experts may rely on hearsay that is not admissible as evidence. See FED R. EVID. 801, 802. For example, in *Celebrity Cruises Inc. v. Essef Corp.*, 434 F. Supp. 2d 169, 192 (S.D.N.Y. 2006), the court admitted, over plaintiffs’ objections, portions of a defense expert’s report that incorporated hearsay about the dynamics of the cruise industry. Similarly, in *Weshcler v. Hunt Health Systems, Ltd.*, 381 F. Supp. 2d 135, 145 (S.D.N.Y. 2003), the court denied defendant’s motion to preclude the testimony of plaintiff’s accounting expert, where the expert based his calculation that certain receivables were non-reimbursable on hearsay documents that had been supplied by defendants. The court held that the expert’s reliance on hearsay was reasonable. *Id.*

But that does not mean that anything is fair game for the lost profits expert. Can he or she rely upon the plaintiff's out-of-court statements that certain sales would have been made but for the defendant's breach? Can the expert rely upon the plaintiff's internal sales projections? Does FED. R. EVID. 703 permit reliance on these out-of-court "facts or data?"

Expert Testimony that Relies on the Plaintiff's View of the Case

A testifying expert must rely on objective, provable facts. He cannot simply repeat hearsay evidence without applying any real expertise, and he cannot rely solely on what his client tells him. See *Arista Records LLC v. Usenet.com, Inc.*, 608 F. Supp. 2d 409, 428-29 (S.D.N.Y. 2009) (striking those portions of an expert's opinions about the capacity and capabilities of defendants' servers and software on grounds that his opinions were "merely a restatement" of defendants' views and not the product of independent analysis). Instead, the expert must form his own opinions by applying his experience and reliable methodology to the inadmissible material. See *Robinson v. Sanctuary Record Groups, Ltd.*, 542 F. Supp. 2d 284, 292 (S.D.N.Y. 2008) (ruling that an expert did not provide reliable evidence because his methodology was based on hearsay provided by the party itself, rather than "a source of first-hand, independent expert knowledge").

Applying these principles, an expert should not be permitted to rely on the plaintiff's out-of-court and obviously self-serving statements regarding lost customers, sales or profits. The plaintiff's opinions and projections, however, may provide a basis for the expert's opinion if the plaintiff's testimony or documentary projections are themselves admissible.

Expert Testimony That Relies on the Plaintiff's Internal Profit or Sales Projections

It is important to remember that not every piece of paper in a business's files or electronic record or e-mail is a "business record" under either N.Y. C.P.L.R. § 4518 (McKinney 2007) or FED. R. EVID. 803(6). The plaintiff's internal projections, though they may appear more formal than the plaintiff's anecdotal hearsay statements about lost profits, are still hearsay; they are based upon assumptions and are therefore opinions. See *Estate of*

Detwiler v. Offenbacher, 728 F. Supp. 103, 137 (S.D.N.Y. 1989) (permitting actual results to be admitted as business records, but not sales forecasts, because the “[f]orecasts represent an opinion about what may happen in the future and therefore differ from statements regarding ‘hard’ facts that are knowable at the time they are made.”). As opinion they must meet the requirements of FED. R. EVID. 701, which provides that, if the witness is not testifying as an expert, the witness’s testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness, (b) helpful to a clear understanding of the witness’s testimony or the determination of a fact in issue, and (c) not based on scientific, technical, or other specialized knowledge within the scope of Rule 702.

To the extent sales projections are admissible, courts generally admit such evidence under FED. R. EVID. 701, “Opinion Testimony by Lay Witnesses.” Following established law in other circuits, the Second Circuit took this approach in *Securitron Madnalock Corp. v. Schnabolke*, 65 F.3d 256, 265 (2d Cir. 1995), where it affirmed judgment on a defamation claim in which the plaintiff based its estimation of lost profits on testimony by its president, whom the plaintiff had proffered as a lay opinion witness under FED. R. EVID. 701. The court held that the president was entitled to prove damages through a “projection of lost profits based on evidence of record regarding decreased sales” and that his “projections provided the jury with a reasonable basis upon which to calculate lost profit damages,” because, as president of the company, he was “fully capable of examining the company’s sales over a period of years, noting a slow-down, and testifying to the estimated losses attributable to the defamatory and fraudulent activities of appellants.” *Id.* (“a president of a company . . . has “personal knowledge of his business ... sufficient to make ... [him] eligible under Rule 701 to testify as to how lost profits could be calculated.”) (citing *In re Merritt Logan, Inc.*, 901 F.2d 349, 360 (3d Cir. 1990)).

Celebrity Cruises Inc. v. Essef Corp. offers a helpful comparison of acceptable and unacceptable uses of internal company projections to prove lost profits through expert testimony. *Celebrity Cruises Inc.*, 434 F. Supp. 2d at 182-83. Celebrity Cruises sued the manufacturer of the hot tub filters on one of its ships for lost profits and loss of business value after several passengers

contracted Legionnaire's Disease on a June 1994 cruise. One of plaintiff's proffered experts calculated lost profits by projecting profits "consistent with a five-year plan formulated by Celebrity management in January 1994." *Id.* at 184. He compared the anticipated profits with profits actually realized, then made various adjustments for occurrences independent of the Legionnaire's outbreak. *Id.* The court excluded the expert, finding his opinion on lost profits "wholly unreliable" given that it was based on Celebrity's internal five-year plan. *Id.* at 186 (similarly excluding another expert who relied on the five-year plan, and also excluding a third expert who relied on budget forecasts but "failed to demonstrate the reliability of the forecasts"). However, the court refused to exclude another expert who based his lost profits calculations on the difference between expected and actual EBITDA, assuming the Legionnaire's outbreak never occurred. That expert based expected EBITDA for the period from July 1994 through December 1994—the year the outbreak occurred—on projections prepared by management in January 1994, but the court noted with approval that, unlike the other experts, he declined to use those projections to determine lost profits for fiscal years after 1994. *Id.* at 187-88.

Expert Testimony Must Be Based on "Sufficient" Facts or Data

FED. R. EVID. 703 also must be read in tandem with Rule 702, "Testimony by Experts," which provides that "a witness qualified as an expert may testify. . . in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data that is the product of reliable principles and methods. . ." FED. R. EVID. 702(1).

What data or facts are "sufficient" to support an expert's opinion? That is up to the discretion of the trial court in fulfilling its "gatekeeper" function. FED. R. EVID. 104(a); *see Kumbo Tire Co. v. Carmichael*, 526 U.S. 137, 150 (1999) (holding that the trial court's "gatekeeping obligation" applies to evaluating the reliability of all experts, not just scientific experts).

First, the facts themselves must be accurate and reliable. Thus, in *Compania Embotelladora Del Pacifico, S.A. v. Pepsi Cola Co.*, 650 F. Supp. 2d 314 (S.D.N.Y. Sept. 8, 2009), the court rejected plaintiff's experts' damages calculations, which the experts themselves conceded were based on unreliable and inaccurate data. There, both of plaintiff's proposed experts

based their estimated damages figures from the alleged breach of a bottling and distribution agreement on admitted inaccurate figures obtained from a market research firm. They then extrapolated data from the market research report to make their estimates of lost profits. *Id.* at 319-20. The court determined there was no reliable basis for the opinions, which were “built upon one baseless, flawed assumption after another.” *Id.* at 321.

Second, the Supreme Court has held that a court may refuse to admit expert opinion when there is simply too great an analytical gap between the data and the opinion proffered. *General Electric Co. v. Joiner*, 522 U.S. 136, 146 (1997). When assessing the “facts” that purport to support a lost profits calculation, proffered experts must also take into account real-world events that are material to the determination. For instance, in *Point Prods. A.G. v. Sony Music Entertainment, Inc.*, No. 93Civ.4001(NRB), 2004 WL 345551, at *7 (S.D.N.Y. Feb. 23, 2004), the expert Point Productions retained to calculate lost profits resulting from Sony’s cancellation of the parties’ licensing agreement assumed that Point Productions would have marketed the same number of artists for the duration of the license, that the artists’ sales would have remained constant, and that the sales would have continued to increase 15 percent per annum. The court rejected the expert’s methodology, in part because he failed to account for the fact that Point Productions encountered significant problems within the industry in the year leading up to and following Sony’s cancellation of its license that were wholly independent of Sony’s actions. *Id.* at *6-7.

Conclusion

New York’s strict standard of proof in lost profits cases requires the trial court to test rigorously the sufficiency of the facts or data relied upon by plaintiff’s lost profits damages expert.

For defense lawyers, this means carefully monitoring the admissibility and reliability of the data on which the expert has relied. Indeed, plaintiff’s failure to put the supporting evidence of his lost profits in evidence before his expert takes the stand can be fatal to his damages case. If the expert intends to rely on inadmissible (or just not admitted) evidence, counsel should test the “sufficiency” of the data or facts against New

York's high standard of proof for lost damages with an objection under FED. R. EVID. 702 to preclude the expert's testimony.

It is dangerous for the plaintiff to put too much reliance on a damages expert in a complex commercial case. The party offering the expert's testimony should lay a careful and complete trial record on the evidentiary bases for the claimed damages before offering the expert testimony. The expert cannot be used to overcome an evidentiary weakness in the plaintiff's damages case.

Damages experts can also fall prey to careful cross-examination on the factual bases for the opinion. Exposing unjustified reliance on the plaintiff's out-of-court assumptions and projections can not only undermine the expert's credibility but even threaten the admissibility of the opinion.

Brian S. Fraser represents clients in a wide variety of complex commercial and financial matters. He routinely represents participants in the equity, debt, structured finance, CDO, derivatives and insurance markets. In commercial and intellectual property litigation, Mr. Fraser has extensive experience representing clients in breach of contract, antitrust, trademark and trade secrets cases. He has successfully represented plaintiffs and defendants, in state and federal courts across the country and in arbitrations and mediations.

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