Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Calculating Contract Damages In A Volatile Market

Law360, New York (February 03, 2012, 1:57 PM ET) -- With the volatility that markets have experienced in the past few years — including markets for real estate, stocks and other assets — litigation increasingly involves disputes over the relevant time period for measuring damages in contract breach actions. The difference between measuring damages when market conditions are strong and when they are weak could result in dramatic changes in the ultimate calculation of damages.

The general rule of thumb is that “damages are measured as of the time of breach.” But that is not always the case. For example, when the plaintiff seeks damages based on profits that would have accrued over time, many courts have held that the calculation should be based on the best available information available at time of trial. Courts have had to wrestle with this issue many times over the past few years, and their rulings have not always been consistent. Counsel must engage this issue early in the case to put their clients on the best footing.

Lost Profits Damages May Change When the Market Does

The broad rule of thumb is that contract damages are measured from the time of breach. And in many cases, that straightforward assertion holds. When the plaintiff seeks “general” or “market” damages — that is, compensation for the fair market value of that “very thing to which the plaintiff is entitled” courts are in apparent uniformity that the damages should be calculated as of the time of breach.[1] Thus, the time-of-breach assessment is the well-known norm in cases that involve the market value of stocks[2], real estate, a business entity or other property — even if the value of that item has increased or declined in the interim before trial.[3]

But when a plaintiff seeks instead to recover forward-looking damages that would have accrued over time from ownership — i.e., lost profits — the at-breach time of calculation may not hold. As "Dobbs The Law of Remedies" explains, these “consequential” or “special” damages differ from “general” damages in that they remedy “not the very thing the plaintiff was entitled to but income it can produce or losses it can avoid.”[4]

Dobbs offers an example of the difference. If a seller breaches an agreement to sell a horse worth $30,000 on the open market, a plaintiff who contracted to purchase the horse for $25,000 would have a general damages loss of $5,000. But the plaintiff may also claim that as a consequence of not getting the horse, he lost earnings the horse could have produced for him. These lost profits are consequential damages, “not based on the asset value of the horse but on its income production.”[5]

In many jurisdictions, courts have held that the latter form of damages — consequential "lost profit" — should be calculated using the best information available at the time of trial, rather than projections calculated from the time of breach. As the Federal Circuit recently explained, such post-breach evidence may better serve the goal of putting the non-breaching party "in as good a position as he would have been had the contract been performed."[6]

Or as U.S. Supreme Court Justice Benjamin N. Cardozo once put it, "[I]f years have gone by before the evidence is offered[,] [e]xperience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect."[7] Thus, courts have endorsed the use of post-breach evidence to calculate contract damages in a variety of cases that involve forward-looking damages.[8]

The Rule Varies Significantly Between Jurisdictions

But the case law on lost profits calculation in a changing market is far from uniform, and the distinction in approaches becomes particularly challenging where damages are claimed relating to income-producing properties. The future income from the property can either be treated as a component of calculating a "market valuation" for the property at time of breach, or as lost consequential damages that occur over time.

A trio of recent decisions illustrates the unsettled state of the law on this point. In CR-RSC Tower I LLC v. RSC Tower I LLC, the Maryland Court of Special Appeals recently affirmed a damages award that calculated future lost profits from the expected 2012 sale of an apartment complex using "at breach" projections as of the December 2006 breach — disregarding the real estate market crash that we now know followed shortly thereafter.[9]

The court acknowledged cases such as Anchor Savings Bank and Sinclair Refining that set forth the contrary rationale, and even noted two prior Maryland cases that could be read as sanctioning the use of post-breach data to more accurately assess future lost profits. Even so, the court held fast to the "general principle" that "breach of contract damages are measured at the time of breach."[10]

The Maryland decision arrives on the heels of a federal court ruling in the neighboring District of Columbia that (applying D.C. law) came out the other way on the question just over a year before. In Capitol Justice LLC v. Wachovia Bank NA, the court rejected plaintiff's claim that the lost profits that would have accrued from its ownership of a commercial building should be calculated based on predictions at the time of the 2007 breach.[11]

In that case, plaintiffs' preferred at-breach calculation would have increased damages by over $20 million, while ignoring both the general downturn in the real estate leasing market, and evidence that it had taken far longer to lease vacant space than anticipated as of 2007. Siding with defendant on this issue, the court held that damages must be calculated at the time of trial.[12]

A third recent case, Epicenter Partners LLC v. Northeast Phoenix Partners, takes yet another approach to the matter.[13] Like the Maryland case, Epicenter considers a planned apartment complex project that plaintiff was forced to abandon before the 2007 real estate crash. Plaintiff argued that lost profits from the project should be calculated using estimates from the time of the 2006 breach; not surprisingly, defendant argued that the damages should reflect post-breach market changes. In this case, the court declined to rule as a matter of law, instead turning the question over to the jury (which sided with the plaintiff).[14]

These three cases are not easily reconciled. The Maryland and D.C. cases treat the question as one for the court, but arrive at different answers, whereas the Arizona court leaves it entirely to the preference of the jury. Moreover, proponents on both sides muster compelling policy arguments.

Those favoring a time-of-breach measurement argue that it promotes foreseeability and protection of the parties' economic expectations, while avoiding the prospect of never-ending updates to the parties' expert reports each time the market shifts. Under the at-breach rule, neither party can gain an undeserved windfall based on unanticipated market fluctuations. On the other hand, those who favor a time-of-trial measurement argue that it is indefensible to overlook concrete proof that the profits (or some portion of them) would never have materialized.[15]

Counsel Must Prepare for Uncertain Outcomes

In short, the jurisprudence on this point is decidedly mixed, and may continue to generate unpredictable outcomes. Thus, counsel may well face an open question on this issue — or worse, find in midstream that their prior assumptions on the matter are not borne out in the case law.

Plaintiffs' counsel can manage this issue by working with experts to develop the damages calculation that will be most favorable in the prevailing market conditions. In many cases, particularly those involving income-generating assets, a plaintiff may have the opportunity to choose whether to seek general or collateral damages. For example, a plaintiff who loses the opportunity to acquire a business may be able to seek compensation based on the business' market valuation at the time of breach (general damages), or instead to seek profits that would have accrued from ownership (collateral damages).[16]

If no firm precedent controls, plaintiffs' counsel must be aware in choosing to seek collateral lost profits that the claim may be affected by a post-breach downturn. If significant time passes before trial, a seemingly lucrative lost profits claim may evaporate. Thus, if conditions at the time of breach were more favorable, counsel should explore whether the damages claim can be crafted as a "market" valuation. If, on the other hand, conditions are improving as time passes, a lost profits claim may allow plaintiff to reap the rewards of that improving market, whereas a general damages claim would lock in the less favorable at-breach conditions.

Defense counsel, for its part, should work to establish clarity as to whether plaintiff is indeed seeking market damages or lost profits. The difference is not always apparent. A current market "valuation" is often calculated based on a projection of future profits[17], while a "lost profits" calculation must be reduced to a lump-sum present value.

Thus, the two calculations may appear quite similar. Counsel should question plaintiff's expert closely on the nature of his or her calculations, and whether they are meant to reflect a fair market value or profits over time. An early motion (such as a Daubert filing or motion for partial summary judgment) may also bring clarity to the issue and lock in plaintiff's choices.

--By Reginald R. Goeke and Joanne Savage, Mayer Brown LLP

Reginald Goeke is a partner in the litigation department in Mayer Brown's Washington, D.C., office. Joanne Savage is an associate in the D.C. office.

Mayer Brown represented Wachovia Bank in Capitol Justice LLC v. Wachovia Bank NA, a case discussed in this piece.

[1] Dan B. Dobbs, The Law of Remedies § 3.3(4) (2d ed. 1993).

[2] See, e.g., Gen. Universal Sys. v. Lee, 379 F.3d 131, 154 (5th Cir. 2004) (rejecting plaintiff's claim that its damages should have been calculated as of the time of trial, rather than breach). The Fifth Circuit explained that courts have rejected attempts to recover for later increases in the stock's value under the guise of "lost profits", because such "profits" are in reality "the market gain, to which [plaintiff is] not entitled." Id.

[3] See, e.g., Rhue v. Dawson, 841 P.2d 215, 225 (Ariz. Ct. App. 1992) (value of dissolved partnership); Logan Motors v. Lenders, 125 A.2d 511, 511-12 (D.C. Mun. Ct. App. 1956) (value of automobile lien).

[4] Dobbs, supra note 1.

[5] Id.

[6] Anchor Sav. Bank, FSB v. United States, 597 F.3d 1356, 1368-71 (Fed. Cir. 2010).

[7] Sinclair Ref. v. Jenkins Petroleum Process Co., 289 U.S. 689, 697-98 (1933).

[8] See, e.g, Advent Sys. Ltd. v. Unisys Corp., 925 F.2d 670, 682 (3d Cir. 1991) (joint business collaboration marketing hardware and software); Consumers United Ins. Co. v. Smith, 644 A.2d 1328, 1341 (D.C. 1994) (lost leasing income); accord Celebrity Cruises, Inc. v. Essef Corp., 434 F. Supp. 2d 169, 183 (S.D.N.Y. 2006) (rejecting lost enterprise value calculation in part because ex ante budget projections relied upon by the expert were shown to be unreliable when they diverged from actual post-breach market performance).

[9] CR-RSC Tower I LLC v. RSC Tower I LLC, 32 A.3d 456 (Md. Ct. Spec. App. 2011).

[10] Id. at 478.

[11] See Michael D. Kibler and Benjamin A. Gold, Lost profits should be determined as of the time of the breach, NAT'L L. J., May 24, 2011.

[12] See id.

[13] Epicenter Partners LLC v. Northeast Phoenix Partners, No. LC2007-000011 (Maricopa Co., Ariz., Super. Ct. March 9, 2010) (order denying in part defendants' motion for summary judgment).

[14] See Kibler & Gold, supra note 11.

[15] Further, a time-of-trial measurement comports with the "heightened certainty requirements" that apply to damages calculations that are "based on estimates of future lost income." See Dan B. Dobbs, Law of Remedies § 3.4 (2d ed. 1993).

[16] While many jurisdictions allow the plaintiff to choose its remedy, some hold that if the market value of an income-producing asset can be ascertained, a plaintiff will be held to that measure and may not seek lost profits. See, e.g., Sharma v. Skaarup Ship Mgmt. Corp., 916 F.2d 820, 825-27 (2d Cir. 1990).

[17] As the Federal Circuit has explained it, “[t]he market value of income-generating property reflects the market’s estimate of the present value of the chance to earn future income, discounted by the market’s view of the lower future value of the income and the uncertainty of the occurrence and amount of any future property.” First Fed. Lincoln Bank v. United States, 518 F.3d 1308, 1317 (Fed. Cir. 2008). Thus, “the market value of the lost property [at the time of breach] reflects the then-prevailing market expectation as to the future income potential of the property.” Id.