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Can a New Business Sue for Lost Profits if It Has No Profits Yet?

The answer is yes, a new business without a track record of profitability can win damage awards in court, based on evidence of the *likelihood* of future earnings. In legal terms, that likelihood must be proven "with reasonable certainty," and "without undue speculation."

Prove Liability First

In civil lawsuits, the plaintiff must first prove liability -- that is, that the defendant's conduct caused him to sustain a loss. In legalese, the defendant's wrongful conduct must be the "proximate cause" of the loss. Once this has been proven, the plaintiff must establish the amount of the damage award.

Prove Damages Second

After proximate cause, the next requirement for recovering damages is to show that the damages can be proven with "reasonable certainty." This means that the damages can be measured based on known reliable factors, without undue speculation. Mathematical precision and precise predictability are not required to prove a case.

The "reasonable certainty" rule does bar recovery of lost profits that are unduly speculative – for example, if profits depend on specific market circumstances, new and unproven technologies or products, or new business ventures with no track record. The plaintiff must establish that there are clear reasons to have expected a profit (but for the actions of the defendant). Once this is established, evidence relating to the amount of the lost profit may be admissible even if it is estimated, uncertain, and inexact.

Basis for Speculation

While older case law generally considered the lost profits of a new business to be speculative and too uncertain to be recoverable, newer law in most states allows evidence toward proving the reasonable certainty of new business profitability. Factors that could help provide reasonable certainty of profitability for a new business, where profits have never existed before, include:

- Specific profitable contracts
- Owner/manager's past performance as an employee
- Prior profitable experience in a similar business
- Success subsequent to the wrongful action
- Comparable examples of that type of business

- Plaintiff's skill and expertise together with a proven existence of a market for the service or product

In addition to the factors listed above, other items to consider include barriers to entry in the industry, reliance on new technology (and considering how proven and reliable the technology is), the quality of the business plan, cash flow projections (remember, in a new business cash flow is much more important than profitability), and general economic conditions.

Other types of evidence that can be admitted include industry averages and ratios, budgets or projections that were prepared before the loss occurred, and enforceable rights in contracts.

Mitigation in litigation

The analysis of lost profits must consider the plaintiff's ability to mitigate. Will the damage be permanent? Or will the company be able recover, and if so, to what extent? Factors that impact mitigation potential include the competitive environment, the state of the economy, and the ability of management.

Calculation

The amount of lost profits that can be recovered is generally considered to be net profit: the gross proceeds of the enterprise, minus all costs associated with realizing those proceeds. In theory, it is easy to calculate:

Earnings before the trial, had the harmful event not occurred
- Actual earnings before the trial
+ Pre-judgment interest
= *Damages Before Trial*

Projected earnings after trial, had the harmful event not occurred
- Projected earnings after trial
- Discounting to get to present value
= *Damages After Trial*

The *Damages Before Trial* plus the *Damages After Trial* equal the *Total Damages* relating to the harmful event.

Accounting disputes

Despite the simplicity of the above formulas, calculating these damages can lead to the types of disputes found in other accounting controversies. These can include:

- Segregating fixed costs from variable costs
- Determining exactly which costs were required to generate the revenues in question.

There are no general rules regarding the allocations of overhead and indirect costs when calculating the amount of lost profits. The best way to resolve accounting issues is to have a clear understanding of what wrong was committed, what the economic situation would have been without the wrong-doing, the specific harm that was caused, and the relationship between the wrongdoing and the harm that was caused.