LOST PROFIT CLAIMS AS SPECULATIVE DAMAGES: THE COURTS' "GATEKEEPER" ROLE

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I. Introduction

> "World history is replete with fascinating 'what ifs.' What if Alexander the Great had been killed early in his career at the Battle of the Granicus River, as he nearly was? What if the Saxon King Harold had prevailed at Hastings, and William, later called the Conqueror, had died in that battle rather than Harold? What if the series of Chinese overseas discovery expeditions that two Ming Dynasty emperors sponsored, and that reached at least the east coast of Africa by 1432, had continued rather than stopped? Many serious, and not-so-serious, historians have enjoyed speculating about these what ifs. But few, if any, claim they are considering what *would* have happened rather than what *might* have happened. Because it is inherently difficult to accurately predict the future or to accurately reconstruct a counterfactual past, it is appropriate that trial courts vigilantly exercise their gatekeeping function when deciding whether to admit testimony that purports to prove such claims."

These historical analogies, articulated by the California Supreme Court in its recent decision in *Sargon Enterprises, Inc. v. University of Southern California*,[2] are music to the ears of defendants in massive lost profit damage cases brought by companies without established track-records of similarly massive profits. *Sargon* stands for the proposition that a trial court's gatekeeper function requires it to consider not only an expert's methodology, but also the reasons for the expert's opinion, the fundamental soundness of the expert's reasoning and the evidentiary foundation for the opinion. If an expert cannot tie the lost profit analysis to a company's historical profits, to a demonstrably similar competitor or to other reliable and non-speculative evidence, litigants in cases involving an unestablished business can expect courts to exclude the expert testimony.

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[2] 55 Cal. 4th 747 (2012)

These limitations on the admissibility of expert damage testimony can be extremely significant in the defense of high exposure professional liability cases. The plaintiffs may offer the expert testimony of accountants or economists to suggest that the professional's error caused the client lost profits or market share in the millions of dollars. Whether the party being sued is an accountant who issued an audit opinion, a lawyer who performed transactional or litigation work for the client or an insurance broker who placed insurance for the client, the client may contend that the professional's breach of the standard of care caused the demise of what would otherwise have been a very successful business. *Sargon* suggests that the courts will closely scrutinize claims that new businesses, in particular, would have generated huge profits.

II. Background

In 1991, Plaintiff Sargon Enterprises, Inc. obtained a patent and FDA approval on a dental implant that it had developed. Without going into the gum-throbbing details, the implant simplified a two-surgery dental procedure into a procedure that could be completed in a single step.

In 1996, Sargon entered into a contract with the University of Southern California School of Medicine to conduct a five-year study on the use of the implant. USC's trials found initial success, but USC allegedly failed to present proper reports required by the contract. Sargon sued USC in 1999 for breach of contract. (Sargon made other allegations that were eliminated by demurrer and summary judgment.) Among other things, Sargon sought damages for lost profits in amounts ranging from $200 million to over $1 billion!

USC moved to exclude evidence of Sargon's alleged lost profits on the ground that they were not foreseeable. The trial court granted the motion. The case was tried to a jury in 2003, which found that USC breached the contract and awarded $433,000 in compensatory damages. Sargon appealed, seeking the lost profits that the trial court had excluded from evidence. The Court of Appeal reversed, holding that the trial court should not have excluded the evidence of lost profits.

On remand, USC again moved to exclude as speculative the opinion testimony of accountant James Skorheim concerning lost profits. The trial court held eight days of evidentiary hearings concerning Skorheim's proposed testimony. Skorheim's testified concerning his predictions of Sargon's share of the dental implant market based on different potential jury findings of how innovative Sargon's implant was. Skorheim explained that the market leaders must have be the most innovative companies, because otherwise they would not be the market leaders. Based on this

circular reasoning, Skorheim concluded that Sargon would become a market leader because it was innovative. Comparing Sargon to the market leaders, Skorheim claimed that Sargon lost profits ranging from about $200 million to $1.2 billion.

The trial court ruled that Skorheim's testimony was inadmissible. It expressed concern that Skorheim's projections were "wildly beyond, by degrees of magnitude, anything Sargon had ever experienced in the past." The projections were the result of comparing Sargon to established companies, which had little in common with Sargon besides the fact that "they all sell or make dental implants. In all other respects . . . such as size, history, product line, sales force, access to financing, among others, they are worlds apart from Sargon." Other characteristics that made Sargon similar to the industry leaders were present in most of the other 98 companies in the dental implant market.

The court reasoned that Skorheim's opinion "is not based on any actual historical financial results or comparisons to similar companies and, therefore, is not based on matter of a type [on which] an expert may reasonably rely." The court explained that the "fatal flaw in Mr. Skorheim's reasoning is that it starts off assuming, without foundation, its conclusion . . . [and] relies on data that in no way is analogous to Plaintiff. Mr. Skorheim deems Plaintiff's historical data, such as past business volume, 'not relevant' to his lost profits projections."

After the Court of Appeal again reversed the trial court, USC appealed to the California Supreme Court.

III. The California Supreme Court Decision

The Supreme Court decision reinstated the trial court's ruling based on two related principles: (1) that expert testimony may not be speculative and (2) that lost profit damages may not be speculative.

a. Speculative Expert Testimony

Quoting the Court of Appeal opinion in *Lockheed Litigation Cases*,[3] the Court observed that the matter relied upon by an expert "must provide a reasonable basis for the particular opinion offered, and that an expert opinion based on speculation or conjecture is inadmissible." Accordingly, under Section 801 of the Evidence Code, "the trial court acts as a gatekeeper to exclude speculative . . . expert opinion." To enforce this goal, the court may "inquire into, not only the type of material on which an expert relies, but also whether that material actually supports the expert's

[3] 115 Cal. App. 4th 558 (2004)

reasoning."

The Court observed that Evidence Code Section 802 also permits the trial court to find the expert is precluded "by law" from using the reasons or matter as a basis for the opinion, and "law" includes constitutional, statutory and decisional law. Thus, Section 802 authorizes the court to restrict or preclude the type of opinion being offered. The trial court can therefore promulgate case law restrictions on an expert's "reasons," including that there is simply too great an analytical gap between the relevant data and the opinion proferred by the expert.

Summarizing Evidence Code sections 801 and 802, the Court concluded that in acting as gatekeepers, the trial courts may exclude expert testimony that is: (1) based on matter of a type on which an expert may not reasonably rely, (2) based on reasons unsupported by the material on which the expert relies, or (3) speculative.

This gatekeeper role requires determining "whether the matter relied on can provide a reasonable basis for the opinion or whether that opinion is based on a leap of logic or conjecture." To make this determination, the court "conducts a 'circumscribed inquiry' to 'determine whether, as a matter of logic, the studies and other information cited by experts adequately support the conclusion that the expert's general theory or technique is valid.'"[4] (.)

The Supreme Court then applied these standards to the lost profits opinions of the plaintiff's expert, Skorheim.

b. Lost Profits

The Court explained that a plaintiff must prove lost profits with reasonable certainty, both as to the certainty of their occurrence and the certainty of their amount. Critically, courts must distinguish between established and unestablished businesses. For established businesses, lost profits are generally recoverable because they may be easily ascertained based on past business volume and other ascertainable data. For unestablished businesses, lost profits are typically too uncertain, contingent and speculative to be recoverable. Only where the evidence of lost profits is not conjectural and speculative, and is of reasonable reliability, are the lost profits of an unestablished business recoverable.

[4] The opinion quotes a detailed law review article on the law concerning expert testimony: Imwinkelreid & Faigman, *Evidence Code Section 802: The Neglected Key to Rationalizing the California Law of Expert Testimony*, 42 Loyola L.A. L. Rev. 427, 449 (2009).

c. Holding

The Court discussed Skorheim's methodology in detail, its analysis tracking the trial court's analysis. The Court concluded that Skorheim's methodology was speculative and, therefore, inadmissible. The Court expressed concern that Skorheim did not base his lost profit analysis "on a market share Sargon ever actually achieved. Instead, he opined that that Sargon's market share would have increased spectacularly over time to levels far above anything it had ever reached. He based his lost profit estimates on that hypothetical increased share." Skorheim's circular reasoning concerning market share and innovation also rendered the opinion irrelevant and inadmissible under Section 802 of the Evidence Code.

Skorheim had relied upon speculative evidence on which an expert may not reasonably rely. He based his opinion on neither Sargon's historical profits nor a reasonable comparison to similar players in the market. Accordingly, the trial court properly exercised its gatekeeper function to exclude the evidence.

IV. Implications

The Court summarized the critical implications of its holding, distinguishing between "what-ifs" and "what would have happened":

> An accountant might be able to determine with reasonable precision what Sargon's profits would have been *if* it had achieved a market share comparable to one of the Big Six. The problem here, however, is that the expert's testimony provided no logical basis to infer that Sargon *would* have achieved that market share. The lack of sound methodology in the expert's testimony for determining what the future would have brought supported the trial court's ruling.

The Court's reasoning is not a prohibition on lost profits analysis for unestablished businesses. An expert could use a company's actual profits, or compare the unestablished company's profits to other, more similar companies, or use other objective evidence of lost profits. Sargon, for example, had evidence of lost profits other than its comparison to the market leaders. Had its expert relied on that evidence, the testimony may have been admissible.

Sargon stands for the proposition that a plaintiff cannot "obtain a massive verdict based on speculative projections of future spectacular success." Plaintiffs may be able to establish lost profits based on sound, empirical evidence and reasonably equivalent comparisons. More importantly, *Sargon* also stands for the proposition

that a court may exclude expert testimony not only for using improper methodology, but also based on fundamental flaws in the expert's reasoning and the foundation for his opinion.