Economics Collection

Philip J. Romero and Jeffrey A. Edwards, *Editors*

Business Liability and Economic Damages

Scott D. Gilbert

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First published in 2016 by
Business Expert Press, LLC
222 East 46th Street, New York, NY 10017
www.businessexpertpress.com

ISBN-13: 978-1-60649-702-9 (paperback)
ISBN-13: 978-1-60649-703-6 (e-book)

Business Expert Press Economics Collection

Collection ISSN: 2163-761X (print)
Collection ISSN: 2163-7628 (electronic)

Cover and interior design by Exeter Premedia Services Private Ltd., Chennai, India

First edition: 2016

10 9 8 7 6 5 4 3 2 1

Printed in the United States of America.

Abstract

Businesses exist to provide goods and services to customers, and in doing so they take risks. Among these risks is the chance of losing money in lawsuits filed by customers, employees, and others negatively impacted by the business. Insurance provides some protection against these liabilities, but lawsuits still take their toll. This book covers the subject of economic damages and its role in insurance claims and lawsuits against businesses. After reading and understanding this book, the reader will be able to identify economic damages as a component of business liability, describe the business risk posed by economic damages, explain the key determinants of economic damages, and estimate economic damages and business loss in a variety of cases.

Keywords

business dispute, business liability, economic damages, economic model, insurance claim, lawsuit, personal injury, present value, risk, wrongful death

Contents

Preface

> *Let's be honest. There's not a business anywhere that is without problems. Business is complicated and imperfect. Every business everywhere is staffed with imperfect human beings and exists by providing a product or service to other imperfect human beings.*
>
> —Bob Parsons (Go Daddy founder)

Businesses exist to provide goods and services to customers, and in doing so they take risks. Among these risks is the chance of losing money in lawsuits filed by customers, employees, and others negatively impacted by the business. Insurance provides some protection against these liabilities, but lawsuits still take their toll. This book covers the subject of economic damages and its role in insurance claims and lawsuits against businesses.

Economic damages are a loss to society that can be usually valued in terms of some market equivalent. As such, economic damages are a reasonably objective and predictable component of liability risk. Business managers and students working toward a business degree can and should get a handle on economic damages as a business liability. This book shows you how, by introducing the relevant economic fundamentals and applying them to a range of lawsuit examples, including business interruption, contract disputes, wrongful employment practices, and claims of personal injury and wrongful death.

My goal is for you to be able to do the following, by the end of this book.

1. Identify economic damages as a component of business liability.
2. Describe the business risk posed by economic damages.
3. Explain the key determinants of economic damages.
4. Estimate economic damages and business loss in a variety of cases.

To accomplish these goals we apply economic principles and some understanding of financial, insurance, and labor markets. We identify roles for statistics and probability to clarify issues of economic damages. Also, the idea of economic damages is part economics and part law, so we need some understanding of legal principles and institutions. It is common these days for economists to discuss legal principles and for legal scholars to discuss economics principles, the confluence of which is the research field known as law and economics. There is even talk of having an economist serve on the U.S. Supreme Court! But I am no lawyer and nothing in this book constitutes legal advice. If you need legal advice, consult a lawyer. Also, the book discusses business decisions as they generally relate to economic damages, but does not contain advice for any specific business faced with a particular liability issue.

This book took much longer to finish than I had intended, and for their great patience and support I thank the folks at Business Expert Press, including Executive Acquisitions Editor Scott Isenberg. I also thank my family (Barbara and Sydney) for their support and forgiveness for stolen nights and weekends devoted to this project.

Afterword

If you've made it through most of the material in this book, you've encountered a fair amount of economic discussion and analysis, some description of legal procedures, and numerous examples, all targeted at understanding economic damages in business liability cases. My guess is you haven't read a similar book before, not because you aren't well-read, but because none exists. Scholars of law and economics like to write books on substantive law and its connection to economics,[1] but much of what lies in the present book concerns procedural law and the determination of economic damages in a given case. On the other hand, forensic economists like to write books on the calculation of economic damages,[2] but the focus is much more technical, with limited discussion of general economic and statistical principles.

My hope is that this book has added fruitfully to the mindset of business owners and managers who deal with business liability. If you're a lawyer or an economist curious about how economic and statistical principles play out in court settlements, I hope you've seen some familiar principles interwoven with unfamiliar ones, with a thought-provoking end result. If you have comments or questions on material in this book, I look forward to hearing from you.[3]

Despite a pretty expansive and ambitious scope, a book of this length could not possibly cover exhaustively the myriad issues that arise in the connection between business liability and economic damages. An initial plan for this book included two more chapters, one on "Economic Loss to Businesses" and one on "Economic Loss to Society." These were essentially compressed and distributed into the chapters in the present book's form, but it's worth mentioning some additional issues in these areas.

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[1] See for example the *Law & Economics* text cited earlier, by Cooter and Ulen.

[2] See for example the book *Determining Economic Damages* cited earlier, by Martin.

[3] The e-mail contact for author (Scott Gilbert) is gilberts@siu.edu

When a business causes a wrongful economic loss to another business, the problem of determining economic damages can become challenging simply due to the sheer scale of the businesses themselves. A case of business interruption, lost profit, or copyright infringement can involve thousands of documents, massive amounts of accounting data, and considerable thought about what economic opportunities might (or might not) have been lost due to the alleged wrongful act. There is a natural tendency for businesses to omit or obscure information in such cases, when disclosure is contrary to their interest, and an economist charged with determining economic damages due to business liability must also determine fact from fiction. Too, existing business and tax records say something about profit, earnings, risk, and so on, but not necessarily in the terms most appropriate for determining economic damages, and this often calls for careful interpretation of evidence.

When a business causes harm to society generally, the government often becomes the plaintiff in court, seeking economic damages. We mentioned oil spills earlier, but another important general context is antitrust law, with the government going after big companies like Microsoft for being monopolistic—taking too much control of an industry—to the detriment of the customer. The subject of antitrust business liability is fascinating and has attracted much attention from both legal and economics scholars.[4] When is a business too big, in a given industry? If it is too big, what is the economic loss to society? To answer the first question in detail, one must step beyond the confines of this book—which are mostly walled by the assumption of open and competitive markets, with many buyers and sellers. To answer the second question, a key fact is that big businesses typically try to maximize profit in some form, and in so doing raise prices and lower quantities supplied, relative to what they might be in a perfectly competitive market. But how much are prices jacked up, and how much are quantities cut back, in a situation of monopoly or cartel or oligopoly? Those remaining questions require some economic model of customer demand and production possibilities. At the

[4] For an example of how antitrust law and economics are commonly discussed, see the periodical *Antitrust* produced by the American Bar Association, and also relevant articles in the academic journal *The Journal of Law and Economics*.

least, an economist who estimates economic damages caused by antitrust or monopolistic activity must understand in deep terms how the company and industry in question work. Systematic coverage of these issues would fill a book different than this one, particularly if multi-period or dynamic losses are considered.[5]

[5] For the reader interested in economic damages in monopoly, cartel, and other antitrust cases, a good starting point is Chapter 7 of the book *Quantitative Techniques for Competition and Antitrust Analysis* (Princeton University Press, year 2010), by Peter Davis and Elaina Garces. Other relevant works are listed at the end of this book.

Glossary

antitrust case A lawsuit in which a business or businesses are accused of economic harm due to excessive or unfair influence on market outcomes.

arbitration Dispute resolution facilitated by a neutral binding third party.

back pay In employment law, back pay concerns the amount of labor earnings that a person could reasonably earn in the past.

bench trial A trial with a judge but no jury.

breach of contract One party's wrongful harm to another caused by failure to uphold a business contract between them, for which courts provide a remedy.

business liability Debts or other obligations owed by a business to an individual, a group, or an organization.

cause in fact In a court case, a cause in fact is the exclusive and conclusive cause of harm.

ceteris paribus All else equal.

civil law, substantive Laws concerning actions that are noncriminal yet against society's interests.

civil law, procedure The legal procedure by which a judge relies on statutes or other "black letter" instructions to decide court cases.

claims adjuster In an insurance company, claims adjusters gather evidence about loss claims and negotiate settlements with those making the claims.

claims adjuster, independent An outside, or for-hire, claims adjuster hired by an insurance company to gather evidence of liability and loss.

claims adjuster, public An outside, or for-hire, claims adjuster hired by an insurance claimant company to gather evidence of liability and loss.

class action case A lawsuit in which multiple people claim injury or harm of the same sort, and are jointly included in the legal action against the alleged wrongdoer.

common law The legal procedure by which a judge relies on past court decisions—precedent—to decide court cases.

complement In economics, if one good (call it A) is a complement for another (call it B), then A is used together with B, and so the demand for A falls when B becomes more scarce or costly.

collateral source In law, with regard to a wrongful economic loss a collateral source is some opportunity to recover from loss, available to the loss sufferer from their own resources or community, which the court refuses to consider as an offset to the amount owed by the party causing loss.

cost of capital The interest or return on investment that a business must pay in order to attract funds to pay for its business activities.

counsel In law, a lawyer acts as counsel when representing the interests of their client in negotiations or legal proceedings.

damages Court-awarded monetary transfers that compensate for economic or pecuniary loss.

deposition An interrogation of a witness by opposing counsel, while under oath, before trial.

descriptive statistic For a data set consisting of number values, a descriptive statistic serves to summarize or describe the information in the number values.

discovery Evidence gathering.

duty of care In tort law, duty of care is a responsibility held by a party toward others, to reasonably prevent harm. A failure to perform a duty of care may imply negligence.

earnings capacity In law, earnings capacity is the ability to do work and receive wages.

earnings stream A sequence of earnings, or payments, over time.

econometrics The application of statistics to economics. See **economics**.

economics The social science dealing with the production, distribution, and consumption of goods and services.

economic damages In tort and contract law, economic damages are wrongful economic costs imposed by one party (the defendant) on the other party (the plaintiff).

economic expansion A period of time in which the national economy is producing output at a rate that is significantly above its optimal level, given its resources and institutions.

economic loss The destruction of economic opportunity. See **economic opportunity**.

economic opportunity A means of deriving utility from goods consumption now or in the future. See **utility**.

economic recession A period of time in which the national economy is producing output at a rate that is significantly below its optimal level, given its resources and institutions.

economic risk Uncertainty about future economic outcomes.

egalitarianism A political philosophy in which people should be treated as equals, or receive the same opportunities.

evidentiary standard At trial, an evidentiary standard is a standard or criterion for the admissibility of evidence.

externality, negative Costs to people not involved in an activity.

externality, positive Benefits to people not involved in an activity.

first fundamental welfare theorem An economic theory in which markets provide a socially optimal way of allocating society's resources and distributing its goods to people, except in special circumstances.

forensic economist An economist who serves as a consultant or expert in disputes involving economic loss, he or she is qualified to see, produce, or interpret evidence in a way that may clarify its meaning to the parties in a dispute.

front pay In employment law, front pay concerns the amount of labor earnings that a person could reasonably earn in the future.

good faith Honesty or sincerity of intention.

goods Anything satisfying human needs and wants, providing utility, including life-enhancing experiences and vehicles thereof.

hypothesis test In statistics, a hypothesis test uses a data sample to weigh evidence on two or more competing hypotheses about what is happening in the population from which the sample was drawn.

implicit rate of return For a future earnings stream, with a known price for the stream and given values of expected future earnings, the implicit rate of return equates price with the (time-discounted) present value of expected earnings.

insurance A contract in which one party meets the obligations of another, under specific conditions.

insurance, first party Insurance owned by one party that covers losses incurred by that party.

insurance, third party Insurance owned by one party that covers losses incurred by another party.

intentional tort In law, an intentional tort is a civil wrong or harm that is intentionally caused by the offending party—or tortfeasor.

liability, business (legal) Situations, identified by the law, where a business is found to bear obligation to an individual, a group, or an organization.

liability, legal Situations, identified by the law, where an individual, a group, or an organization is found to bear obligation to another.

liability, strict In law, strict liability is the responsibility for causing harm, regardless of intent or disposition.

liability, joint and several In law, joint and several liability is a responsibility for causing harm, shared by two or more parties.

life care plan For a person who has suffered a permanent injury or disability, a life care plan is a scheduled set of medical and health-related services and goods, designed to restore the injured person to a state of health and function as good as the person had before the injury, or as near as possible to that state.

life expectancy The number of future years during which a person can be expected to live.

life expectancy, healthy The number of future years during which a person can be expected to live and remain healthy.

lump sum An amount of money paid all at once.

mean For a random variable, the mean value is a measure of central tendency, describing the middle of the probability distribution.

mediation Dispute resolution facilitated by a neutral nonbinding third party.

moral hazard An excessive shift of risk from one party to another, due to risk avoidance.

motion in limine A request made by one party of a legal dispute for the court to suppress evidence presented by another party.

negligence, tort A tort, or harm to society, arising from lack of due care.

nuisance, tort In civil law, nuisance is a tort in which one party wrongfully controls another's property.

opportunity cost The difference in value between a given opportunity and the next best available opportunity.

option, financial The right to buy or sell a financial asset, at a given price—called the strike price—within a specific time period.

option, real Options available to businesses, to pursue future earnings opportunities.

Pareto optimal A Pareto optimal outcome is a socially best outcome in which no one person can be made better off without making someone else worse off.

pecuniary loss A loss of money, assets, or the opportunity to earn money. Financial losses that can be precisely measured. See also **economic loss** and **economic damages**.

personal consumption The amount of goods consumed by an individual that are not jointly consumed by others.

plaintiff In civil law, a plaintiff is the party bringing suit via a complaint to the court.

precedent In law, a precedent is one court's ruling on a legal case that is relied upon by other courts facing similar cases.

probability For an event, its probability is the chance that the event will occur.

probative value The ability of proffered evidence to prove something important in a trial.

procedural law Laws that specify how litigants may present their cases before the court, separate from substantive law—laws that specify how courts may reach a decision on a case, based on the evidence.

property Anything, tangible or intangible, that is owned by a person or entity. Also, the right to possess, keep, hold, use, enjoy, and dispose of what is owned.

proximate cause In a court case, a proximate cause is an event sufficiently related to the harm or injury in question to be held as its cause.

public good A good which a market cannot provide adequately, either because nonbuyers cannot be excluded from its use, or, similarly, because a single unit of the good can be enjoyed by more than one person at a time.

random variable A variable whose value is random and not perfectly predictable.

regression model A statistical model of the expected value of one variable, given some other variables.

return For a financial investment, the investment's return is the amount of money it produces, often expressed as a ratio of money received to money invested (*gross return*) or as the ratio of profit to money invested (*net return*).

return, excess The financial return earned by a risky asset minus the interest rate or yield on a riskless bond.

risk-averse preference An attitude that views risky economic opportunities as less desirable than riskless opportunities having the same expected rewards.

risk-neutral preference An attitude that views risky economic opportunities as perfect substitutes for opportunities having the same expected rewards.

settlement hearing In a tort trial, a settlement hearing is a private meeting between the plaintiff, defendant, their lawyers, and the judge, with the aim of reaching a settlement before trial.

Sharpe ratio A measure of the attractiveness of a financial investment or portfolio of such investments, the Sharpe ratio is the investment's excess return divided by the standard deviation of return.

social contract An idea or framework that serves to define and limit the rights and responsibilities of society's members.

social welfare function Society's collective or aggregate utility associated with consumption by its members. See also **utility**.

special damages In tort law, special damages refer to relatively concrete, tangible, or readily monetized losses.

speculation In law, speculation is opinion lacking foundation in fact or evidence.

standard deviation A measure of spread or dispersion among the possible values of a random variable, equal to the square root of variance. See also **variance**.

statistical model A mathematical model of some pattern, tendency, or relationship in a data set. Statistical models are applied to a data sample and are often used to better understand a larger population.

substantive laws Laws that specify how courts may reach a decision on a case, based on the evidence.

substitute In economics, if one good (call it A) is a substitute for another (call it B), then A can be used in place of B, and so the demand for A rises when B becomes more scarce or costly.

substitute, perfect In economics, one good is a perfect substitute for another if the first can be used in place of the other, with no loss of utility.

state of nature A possible situation or outcome.

statute A written law passed by a legislative body.

structured settlement An amount of money paid over time.

taking In law, a taking is the act of laying hold upon something.

tort One party's wrongful harm to another, notwithstanding any business contract between them, for which courts provide a remedy.

tortfeasor In civil law, a tortfeasor is one who commits a wrongful (tort) act.

transfer In economics, a transfer—or transfer payment—is a redistribution of goods, income, or resources within society.

trespass, tort In civil law, trespass is a tort in which one party wrongfully occupies another's property.

trier of fact The person or persons responsible for determining facts from evidence in a dispute.

utility In economics, utility is usefulness, the ability to satisfy needs or wants.

variable A quantity that can take on different values in different situations.

value of a statistical life For a person facing an opportunity to take on increased chance of death in exchange for some money, the value of a statistical life is the dollar price per unit of death probability.

variance A measure of spread or dispersion among the possible values of a random variable, equal to the mean squared deviation of the variable from its mean. See also **standard deviation**.

worklife expectancy The number of future years during which a person can be expected to work. See also **life expectancy**.

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Business Liability and Economic Damages

Scott D. Gilbert

Businesses exist to provide goods and services to customers and in so doing they take risks. Among these risks is the chance of losing money in lawsuits filed by customers, employees, and others negatively impacted by the business. Insurance provides some protection against these liabilities, but lawsuits still take their toll.

This book covers the subject of economic damages and its role in insurance claims and lawsuits against businesses. After reading and understanding this book, the reader will be able to identify economic damages as a component of business liability, describe the business risk posed by economic damages, explain the key determinants of economic damages, and estimate economic damages and business loss in a variety of cases.

Scott Gilbert, PhD, is an economist who is currently an associate professor of economics at Southern Illinois University Carbondale, and has been director of graduate and undergraduate economic studies there. He teaches courses in economic and business statistics, econometrics, macroeconomics, microeconomics, financial economics, and monetary economics. He is a research economist and statistician whose research has been published in excellent academic journals, including the *Journal of the American Statistical Association*, the *Journal of Multivariate Analysis*, the *Journal of Futures Markets*, and *Economics Letters*. He received his PhD in economics from the University of California, San Diego, and his bachelor's degree in economics from the University of California, Berkeley. He also provides consulting and expert witness services in insurance and court cases involving economic damages.

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ISBN: 978-1-60649-702-9
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