Proving future damages when your client is self-employed

The dilemma posed by the self-employed client: Calculating future damages for the small-business owner can be difficult

By John M. Feder and Daniel B. Pleasant

One in five workers in today's economy is either self-employed or has started their own business. The recession is spurring even more people into these categories. When these workers are injured or killed, trial lawyers face a challenge in proving future economic losses for loss of earnings or earning capacity. A recent case handled by our office illustrates this dilemma.

Brian and Patricia Brown married in 1974. Seven years after their marriage, they started a small construction company in their hometown in Alberta, Canada. Brian Brown owned 51 percent of the company and Patricia owned 49 percent. Brian was the president, Patricia was the office manager, their two adult sons ran construction crews, and their daughter helped in the office. From humble beginnings, the Browns grew the company into a thriving, profitable business. Clients and colleagues testified that Patricia was the "backbone" of the business. She was responsible for marketing, business planning, customer service, and cost analysis.

But two years ago, the Brown family suffered a crushing loss. Brian and Patricia were motorcycle riding with friends while on vacation in Southern California. Brian was driving the motorcycle, with his wife seated behind him. A Red Company employee made a left turn in front of the motorcycle. Brian saw the car turn in front of his motorcycle and braked, but the collision was unavoidable. Brian was injured; Patricia was killed.

Red Company admitted legal responsibility for the accident but contested the extent of the family's damages. We maintained that California law provides for economic damages based on a decedent's lost earning capacity, and that such capacity can, in the case of a small-business owner, best be shown by the business's profits during the decedent's lifetime. Red Company countered that Patricia only worked four to five hours a day, that she functioned as a bookkeeper, that her husband earned the money, and that Patricia's earnings were really a profit pass-through used to take advantage of Canadian tax laws and reduce the family's taxes.

Using past profits to show reduced earning capacity

Impairment of earning capacity represents loss of earning power. It is not the same as actual, established loss of wages. (See *Handelman v. Victor Equipment Co.* (1971) 21 Cal.App.3d 902, 906.) Had Patricia been employed at a salaried position, her future lost income would have been easily calculated by multiplying her annual salary by the number of years her work life was cut short.

In contrast, if the income of a business results primarily from the skills and efforts of an owner who is disabled from pursuing the business, the past and reasonably certain future profits of the business are proper factors to consider in determining the owner's earning capacity loss. (See *Osterode v Almquist* (1948) 89 Cal.App.2d 15, 19.) Proof of a person's earning capacity varies depending on the person's occupation. The earning capacity that a decedent possessed is properly taken into consideration in determining pecuniary loss resulting from his or her death. (See *Peters v. Southern Pac. Co.* (1911) 160 Cal. 48; *Bond v. United Railroads of San Francisco* (1911) 159 Cal. 270.) In fact, in the case of the death of a spouse or parent as a result of a wrongful death, the chief element to be considered in awarding damages is the present value of the earnings such person would have contributed to the family during the period of such person's life expectancy. (See *Riley v. California Erectors, Inc.* (1973) 36 Cal.App.3d 29; *Syah v. Johnson* (1966) 247 Cal.App.2d 534.)

The general rule: Lost profits admissible to show diminution of earning capacity

So small business owners may, under the appropriate circumstances, offer evidence of lost business profits to show impaired earning capacity. The general rule is that business owners may not recover lost profits per se, but they may introduce evidence of the lost profits of their business as evidence of their lost or impaired capacity to earn. (See Annot, *Lost Profits Resulting from Tortious Injury to Business* (1994) 26 Am.Jur. Proof of Facts 3d 115, § 4, pp. 127-128.) The business owner must show that his or her own labor was the primary reason for the earning of profits, as opposed to the efforts of employees or the use of capital. (*Ibid*.; see also Annot., *Profits of Business as Factor in Determining Loss of Earnings or Earning Capacity in Action for Personal Injury or Death* (1972) 45 A.L.R.3d 345, and cases cited.) Evidence of lost profits is most appropriate when the injured person does not receive a regular salary. (Rest.2d Torts, § 924, com. c, p. 525.) "Where the profits from a business enterprise result primarily from the personal endeavors, skill, and attention of the owner, rather than from his investment of capital or from the labor of other persons, such business profits are a proper factor to consider in the determination of the business owner's lost earnings or earning capacity in personal injury and wrongful death actions." (45 A.L.R.3d 345, *supra*, at p. 353.)

California courts have recognized the general rule

Although the California case law addressing the problem posed by the self-employed tort victim is surprisingly meager, California courts have recognized and applied the general rule. In the 1948 Court of Appeal case of *Osterode v. Almquis, supra,* 89 Cal.App.2d 15, the plaintiff, a commercial fisherman, skipper and part owner of a fishing boat, introduced evidence showing that he was getting ready to take a fishing trip just prior to being injured by the defendant. The plaintiff and his witnesses testified regarding his expected catch, the value of the fish, and his expenses. The evidence was properly admitted: "While a plaintiff in an action for personal injuries cannot ordinarily recover for loss of profits derived from a business, however, under a plea of general damages and to prove loss of earning capacity, it is permissible to show what wages, salary, or emoluments would be open to the plaintiff in a business, vocation, trade, or profession which he understands and in which he would have the right and ability to engage except for the injuries sustained, and the earning capacity of Ralph Osterode prior to the accident was a proper subject of inquiry." (*Id*. at p. 19.)

And in the 1967 case of *Sharfman v. State of California* (1967) 253 Cal.App.2d 333, 337, the Court of Appeal held that a landscape architect could establish his lost income by showing what his share of partnership income had been in the past. The Court of Appeal noted: "A sole proprietor recovers loss of profits to his business based on his personal loss of income—i.e., salary or earnings—as a result of being unable to work. Loss of profits here is really loss of earning power and clearly a recoverable element of damages." (*Ibid*.)

Cases from other states apply the rule

Courts in other states have applied the general rule in cases involving entrepreneurs and shareholders in closely held corporations:

• *Kaufman v. Tripple* (Neb. 1966) 144 N.W.2d 201, 207-209 [Jury could consider bartender's profits before and after injury on issue of reduced earning capacity, quoting with approval *Osterode, supra,* 89 Cal.App.2d 15].

• *Sezonov v. Wagner* (Ill.App. 1995) 654 N.E.2d 252, 254-255 [Jury may properly consider profits which have been derived from plaintiff's management of or activity in business when determining lost earnings of plaintiff who is self-employed; plaintiff and wife operated pet store as sole shareholders of corporation].

• *Ewing v. Esterholt* (Mo. 1984) 684 P.2d 1053, 1060 [Given nature of plaintiff's business (independent trucker) and fact that business was a Subchapter S corporation, expert testimony concerning loss of corporate profits was admissible to aid jury in determining plaintiff's lost earnings as a result of injuries sustained].

• *Rollette v. Myers* (Az.App. 1970) 474 P.2d 196, 200-201 [recognizing general rule, vis-a-vis corporate profits and individual earning capacity, that if the injured plaintiff makes a substantial showing that his own services, efforts, and initiative, rather than capital invested or labors of others, is the predominant factor producing the profits of the business, then loss of these profits can be shown, but only as an aid in determining the pecuniary value of plaintiff's services in the business, citing *Kennard v. Kaelin* (Wash. 1961) 364 P.2d 446; *Bischoff v. Dodson* (Mo.App.1966) 405 S.W.2d 514; *Greyhound Lines, Inc. v. Duhon* (Tex.Civ.App. 1968) 34 S.W.2d 406.

In a 1980 case, the Supreme Court of Iowa succinctly explained the rationale for the rule that the past financial performance of a closely held business is admissible when the heirs of one of its principals bring a wrongful-death action. (*Iowa-Des Moines Nat. Bank v. Schwerman Trucking Co.* (Iowa 1980) 288 N.W.2d

198, disagreed with on other grounds, *Weitl v. Moes* (Iowa 1981) 311 N.W.2d 259.) There, the decedents were a husband and wife who had spent 24 years building a feed-production business. The court noted that evidence of past profits was not admissible to show future profits if the injury had not occurred. But proof of the character of business the injured person has been engaged in, and the amount of yearly profits for a period before the injury, when these mainly are due to personal efforts, may be shown for some other purpose, because often, past earning capacity can be proved in no other way. "Where the party injured has worked for wages or on salary, evidence of the amount received is uniformly admitted. But plaintiff always had conducted a business of his own, attending to it personally and without any considerable assistance, and had never received wages. In such a case, how shall the financial loss due to the impairment of the earning capacity be shown?"

The court answered its own query with the common-sense solution: "Quite naturally, as was done in the case at bar, by proving the character of the business, the amount of time given to it, what the returns had been, and from these, in connection with the capital invested, a fair idea of the party's earning power at the time of the accident may be inferred." The court ruled that such evidence indicated the character and value of the services the party was capable of rendering immediately before the injury, just as proof of employment at some occupation at a salary would have done in a case involving an injured employee. The court noted that the fact that capital is made use of was an "important consideration" that had to be taken into account in determining the injured person's earning power. But on the other hand, the "recognized fact" that the earning capacity of a man operating his own business ordinarily is greater than that of an employee in the same line of service was not to be overlooked. "The object of such evidence is to show the capacity to earn values, and for this purpose it is quite as pertinent to the issue, even though not as definite as proof of wages or salary." (*Id*. at pp. 201-202, quoting *Mitchell v. Chicago, Rock Island & Pacific Railway* (Iowa 1908) 114 N.W. 622, 625.)

Accordingly, the Iowa Supreme Court held that in view of evidence of decedents' full-time efforts and success in making a volatile corporate business prosper and grow over a 24-year period, it was within the trial court's discretion to permit lay and expert testimony relating to that growth and the past profits of the operation as bearing on the decedents' earning ability. Even though earnings left in the business may have paid employees and generated capital which enhanced profits, where the decedents were supervising daily the capital and employees and the evidence tended to prove frugality, tendency to save money, drive, business acumen, managerial ability, and the size and contours of the operation, the case was removed from the general rule that loss of profits are not admissible to show damages in a wrongful-death action. (*Ibid*.)

Tactical tips

As you can see, lawyers representing the self-employed must prepare these cases with care. W-2s, and maybe a vocational rehabilitation evaluation, might be sufficient evidence of future economic losses for the traditionally employed client. But when proving losses for people in business for themselves, it may be necessary to depose the business's employees, clients, vendors, and even competitors. Accounting and forensic economics experts are essential.

Help can be found in the unlikeliest places. For example, in the Brown case, we interviewed one of their chief competitors in Canada. He spoke highly of them, and made many complimentary statements about Patricia and her role in the company. He was even willing to travel to California to testify because he thought it was the right thing to do. Our experts were able to rely on his statements in forming their opinions about the family business and its prospects.

We also delved deeply to uncover information about the history of the business. Brian told us the day after he and Patricia were married, he was at the jobsite at 6:00 a.m. ready to work. When we learned that the business's profits had dramatically increased in the years before Patricia's death, we framed that information as the story of the hard work of two individuals finally paying off.

An industry expert who was familiar with the locale of the business was also crucial. He was able to link the business to specific prospective contracts and projects, buttressing our claim that the business would have continued to be profitable. When defendant filed a mandatory settlement conference statement comparing Patricia to, among other things, an accounting clerk, and speculating that Patricia would soon retire because that was the norm among Canadian women, we turned to forensic economist Robert W. Johnson. He was very skilled in responding to the subtle sexism of the defense contentions by showing that Patricia was much more than a clerk; she was the cofounder of a successful business.

And we interviewed blue collar, dirt-under-the-fingernails workers at the company about Patricia's contributions. At trial, these witnesses would have presented a more complete picture of the company than would be the case if only

executives and accountants testified. In addition, by presenting a broader spectrum of witnesses, we would have increased our chances of having the testimony resonate with the jurors.

Using these techniques, John M. Feder and Miles B. Cooper were able to obtain an $8.75 million settlement on the night before trial was to open in Riverside County. As our jury focus group had revealed the tremendous economic adversity facing residents of that county, we believed it was imperative to introduce into evidence the hard work and sacrifice made by the wife and husband to succeed in a business when they started from virtually nothing. They were not white collar executives; they built their business from their own blood, sweat, and tears.

More and more, plaintiffs' lawyers are going to represent the self-employed. When doing so, it is insufficient to gather W-2s and multiply to calculate future wage loss. Only by focusing on lost earning capacity, and digging deep to correlate past profits to that lost capacity, can plaintiffs' lawyers best represent their clients and maximize recovery.

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