

Recovering Lost Video Game Profits In The Age Of COVID-19

By **Bruce Isaacs** (June 24, 2020, 5:41 PM EDT)

Assume you have a client who has developed and produced a new video or mobile phone game that doesn't go to market because of an alleged breach of a contract. Is your client entitled to recover its lost profits? Or, will your client's lost profits be precluded either (1) by virtue of a "limitation of damages" provision set forth in the contract; or (2) because the lost profits are speculative damages and therefore the damages model is inadmissible?

Has the pandemic actually or artificially increased the dollar amounts set forth in the plaintiff's damages models? According to the Washington Post, the video game industry has seen a significant increase in revenues and profits related to COVID-19 by virtue of stay-at-home orders and no sports to watch on television. Will this rise in revenues and profits continue once our country's economy reopens?



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As further explained below, a plaintiff is entitled to recover its lost profits if it can establish the occurrence and extent of its damages with "reasonable certainty." If a plaintiff can make such a showing, the plaintiff does not have to prove the amount of its damages with absolute precision. However, before the plaintiff can even grapple with the issue of reasonable certainty versus speculative damages, it first must address, and overcome, the limitation of damages provision set forth in the contract itself.

The Limitation of Damages Provision

Many contracts contain a waiver provision by which the parties to the contract expressly waive the right to recover "consequential damages," which almost always includes an express waiver of the right to recover lost profits, known as a limitation of damages provision. Is such a provision enforceable? Not necessarily.

In *Coremetrics Inc. v. Atomic Park.com LLC*, the U.S. District Court for the Northern District of California, in construing California and New York law, concluded that although a limitation of damages provision is valid so as to preclude the recovery of indirect damages, such a provision does not effectuate a waiver of the right to recover direct damages and, importantly, direct damages includes the recovery of lost profits.

In short, because lost profits are a form of direct damages that a party is entitled to recover under

California Civil Code Section 3300, a plaintiff is thus entitled to recover lost profits even if the contract contains a limitation of damages provision.

This leads to the next hurdle over which a plaintiff must climb: Does the plaintiff's damages model establish lost profits with reasonable certainty, in which case it will be admissible, or is it merely speculative damages, and therefore inadmissible (and subject to a potentially successful motion for summary judgment or motion in limine following a Section 402 hearing)?

The Case Law Before and After the 2012 Sargon Decision, and the Line Between Reasonable Certainty and Speculative Damages

In *Grupe v. Glick*, the California Supreme Court addressed the issue of lost profits as damages and concluded that an established business, with historical financials and a proven track record, can recover lost profits, while an unestablished business cannot do so. However, the rule for unestablished businesses was relaxed somewhat, and in an important way, in *Kids' Universe v. In2Labs*.

The California Court of Appeal's Second Appellate District, relying on Section 352 of the Restatement of Contracts, reasoned that a new or speculative business could indeed establish lost profits by making use of "expert testimony, economic and financial data, market surveys and analyses, business records of similar enterprises, and the like."

In *Parlour Enterprises Inc. v. The Kirin Group*, the defendant allegedly terminated, without cause, a franchise agreement relating to Ferrell's ice-cream parlors. The plaintiff built a damages model for lost profits by comparing Ferrell's ice cream to another business — Friendly's, a national chain that sold ice cream and food.

The California Court of Appeal's Fourth Appellate District held, however, that the damages model was too speculative and not admissible. The court reasoned that Friendly's was not a true comparable to Ferrell's and stated a more specific rule that in order for a plaintiff to establish an admissible lost profits damages model based on another business, that other business must be "sufficiently similar" to the business seeking the lost profits.

Enter the California Supreme Court in *Sargon Enterprises Inc. v. University of Southern California*. In *Sargon*, the California Supreme Court ruled that the plaintiff's expert's damages model, based on a market share approach was, in that instance, based on too many assumptions about the innovativeness of the new product and was also based on a speculative (and shockingly high) market share. The court found that the damages model was dependent on too many "what ifs" and ruled that the lost profits analysis should have been excluded.

Sargon is interesting because the California Supreme Court was careful to try to strike a balance. On the one hand, the court directed lower courts to exercise their gate-keeping function and to make sure that speculative damages models are excluded from evidence. On the other hand, the court made it clear that lower courts cannot be too strict on the admissibility of damages models or else they would essentially "eviscerate the possibility of recovering lost profits by too broadly defining what is speculative."

Although the plaintiff's damages model was precluded in *Sargon*, the line between reasonable certainty and speculation is hardly clear.

In *Asahi Kasei Pharma Corp. v. Actelion Ltd.*, a post-Sargon case, the plaintiff developed a promising hypertension drug that had not yet obtained U.S. Food and Drug Administration approval. The defendant, a foreign competitor, engaged in conduct designed to snuff out competition to its own market-leading hypertension drug.

The trial judge did not exclude the plaintiff's allegedly speculative damages model and the jury rendered a verdict of \$546 million (later reduced by the trial judge). On appeal, the appellate court ruled that the damages model was not too speculative even though the drug was contingent upon FDA approval and the variables of price, market share and timeline to market were based entirely on assumptions.

Even If Admissible, Is the Damages Model Persuasive? What Is an Appropriate Comparable?

As the case law referred to above demonstrates, it is extremely hard to predict what a trial judge will do when considering a damages model relating to a new, unestablished business or product. When the unestablished business or product is compared to another business or product with a historical track record, the more substantially similar the businesses or product, the greater the chances that the damages model will be received into evidence. (And, if the defendant itself prepared prelitigation projections especially given the popularity of video and mobile phone games in this coronavirus era, those rosy projections are typically received into evidence as well.)

What if the new business or new product is based on a new (or newish) technology? By way of example, suppose a mobile phone game developer fails to deliver a new, augmented reality mobile phone game based on the characters and plotlines of a very successful comic book and television show. Suppose that the nondelivered game has no track record, no actuals, and no historical profit and loss statements. What, then, is an appropriate comparable to render the damages model both admissible and persuasive?

There are a variety of approaches on how to construct the damages model relating to this hypothetical set of facts, such as a damages model consisting of comparables based on:

- Other games distributed by the plaintiff;
- Other games created, developed and delivered by the defendant;
- Other games that made use of the television intellectual property (assuming the damages model includes both the successful games and the unsuccessful games, i.e., no cherry-picking of just the "winners");
- Other augmented reality games in general (Should the damages model include or exclude an exceptional outlier like Pokémon Go, an augmented reality game that generated revenues in excess of \$3 billion?); or
- A combination of "substantially similar" products, if any.

Or, are all of these "comparables" inappropriate because the damages model needs to conform to the precise definition of the "game" as set forth in the contract? If so, does that mean that only games that are (1) augmented reality; (2) created for the mobile phone; and (3) which make use of the television IP would be worthy comparables? But what if there are no such comparables? Furthermore, as the damages models extrapolate profits based on the usually high revenues and profits flowing from the pandemic, are such damages models persuasive?

Conclusions

There are no clear answers. As the case law makes clear, however, the better the comparables, the better and more persuasive the damages model.

This area of the law is extremely dangerous for litigants because a damages model with enormous dollar amounts (which is often the case) may indeed find its way to the jury, giving the case a significant settlement value. At the same time, a damages model based on enormous dollar amounts may be shut down entirely by the trial judge as speculative damages, giving the case huge downside and little settlement value.

In short, huge stakes are riding on the integrity and persuasiveness of the damages model. Persuasiveness will turn on the quality of the comparables and the reasonableness of the baseline projections.

Given all these uncertainties about the damages model and because of the large potential swings in the valuation of the case and the potential unreliability of damages models based on coronavirus-inflated projections, the parties may want to consider a meaningful mediation as a sensible alternative to trial (perhaps while a motion for summary judgment or a motion in limine is pending) due to the volatility and unpredictability of these crucial damages questions.

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