

## **A SMOKING GUN, PERHAPS?**

### **Background of the Case:**

According to the complaint filed by the Plaintiffs, the Defendant committed to purchasing in excess of 50,000 pieces weekly of seasonal clothing from the Plaintiff, based upon an alleged oral contract. The Plaintiff hired an expert who prepared a report alleging damages of approximately \$2,000,000 over the alleged terms of the contract. I was provided a copy of the expert report prepared and produced by the Plaintiffs. The case was in Federal Court and accordingly, the report was supposed to conform to Federal Rule 26 regarding such reports. The Plaintiff's Expert Report was titled "Interim Report and his exhibits were captioned "Preliminary for Discussion Only". I was informed that the Plaintiff made a settlement demand in the amount of \$2,000,000 based upon this expert report.

### **My Assignment:**

In discussions with the Defendant's attorney and the Defendant, I soon learned that the Plaintiff was delivering many items late, not delivering items at all, and delivering items with much higher rates of unacceptable defects. The Defendants were selling the seasonal clothing to many large retailers with very specific delivery deadlines. In many cases, a 10-day or so delay in delivery allowed the retailer the right to cancel the entire order. This is because the season to sell the goods is often short and once the window to sell the clothing is open, it can close very rapidly.

As a result of both late delivery by the Plaintiff and an abnormally high rate of defects in the clothing items manufactured by the Plaintiff, several retailers cancelled orders and in some cases allowed a late order to go forward, but at a significantly discounted price and sometimes reduced quantities. Accordingly, after discussions with the client and the attorney, I was asked not only to review the computations and basis of the Plaintiff's Expert Report, but to also develop a counterclaim for lost sales orders and sales orders sold at reduced quantities and discounted sales price. The Defendant had no interest in pursuing such a claim against the Plaintiff until the Plaintiff filed suit.

### **My Review of the Plaintiff's Lost Profits:**

I reviewed the Plaintiff's lost profits analysis and found several flaws. First, he assumed a gross profit margin of just under 15%. This was allegedly based upon a schedule that quite frankly made no sense to me. The schedule was supposed to be fixed versus variable costs analysis. However it lacked sufficient detail to allow me to completely review it.

I reviewed the Plaintiff's historical audited financial statements for three years before the alleged lost profits which showed an average gross profit margin of almost 2% less. While a difference of 2% may not seem significant at first thought, when applied to alleged lost sales of

approximately \$12,900,000 this would result in an adjustment to this computation of lost profits in the amount of approximately \$250,000. In addition, I noted that other operating costs declined approximately \$134,000 one year after the alleged lost profits. Using the 21-month contract period alleged by the Plaintiff's Expert, this would have resulted in a savings of approximately \$231,000. In total, I estimated that the Plaintiff' Expert damage computation was overstated by no less than approximately \$481,000. I say no less than because the Plaintiff's expert report was very vague, lacking in significant details. As a result, I was unable to perform a complete review, a fact I made clear in my rebuttal report.

### **The Plaintiff's Expert Review of Purchase Orders:**

In his report, the Plaintiff's Expert opined that in 19% of the purchase orders there was a revision that was dated after the original delivery date. The 19% represented 27 purchase orders. I also reviewed these purchase orders and found of the 27 purchase orders identified by the Plaintiff's Expert, several contained only minor changes correcting typographical errors such as the year was typed incorrectly. On others, there was a request to increase the quantity of the order, mostly in insignificant amounts. In all cases, when a change (other than correcting a typographical error) were requested, the delivery date was changed to provide more time for the Plaintiff to fill the purchase order.

It appeared that the Plaintiff was planning to use the expert opinion contained in his report to argue a justification for the Plaintiff's repeated late shipping and delivery of the orders. However, the expert did not deal with the fact that in all cases when a change of substance was made in a purchase order, the delivery date was modified. I therefore concluded that his analysis was flawed and not useful in determining if the Plaintiff's failure to meet deadlines was justified.

### **My Computation of Lost Sales and Corresponding Lost Profits:**

According to interviews I conducted with the Defendant's operational staff, I was informed that the Defendant suffered lost sales as a result of the Plaintiff's actions. In some cases, the delivery of items was late and the Defendant's customers canceled orders. In other cases, the Defendant's customers agreed to accept the order late, but at reduced quantities and reduced prices. To verify what I was told, I reviewed documents such as purchase orders, work in process reports, cancellation reports, reports summarizing actual sales by the Defendant, invoices from the Plaintiff, receiving reports, inspection reports, prepaid freight bills and other information contained in the Defendant's computer system. From some of this information I was able to determine that many orders were cancelled by the Defendant's customer due to the inability of the Defendant to deliver the merchandise timely or not at all. Because of the seasonal nature of the clothing, the retail purchaser had the right to cancel the order if not delivered timely.

The result of my analysis showed that cancelled orders, reduced orders and required reduced prices resulted in lost sales by the Defendant of approximately \$6,300,000. To mitigate its damages, In some cases, the Defendant sold the merchandise to its customers at reduced prices and or quantities. In other cases, the goods were sold through large discounters. In total,

these reduced sales amounted to approximately \$3,300,000 resulting in net lost sales of approximately \$3,000,000. Based upon a review of the Defendant's historical operating cost structure I determined it was able to avoid additional costs of approximately \$1,154,000 including cost of goods sold avoided on non-delivered goods and certain other variable costs. After taking into account the cost savings, the net profits were approximately \$1,846,000. This loss did not take into account the bad will it may have created with certain customers for the Defendant's failure to meet the terms of orders, especially with large retailers. Accordingly, my computation was conservative.

### **The Smoking Gun:**

In my experience, one rarely sees a smoking gun in litigation. I am not sure if this qualifies or not. You can be the judge. In my discussions with the client's operational employees, I wanted to know why they stopped using the Plaintiff to manufacture clothing. They told me that the quality of the clothing did not meet their standards and delivery was not timely or not at all. I had them go through the process so I could understand from order to receipt what steps were done.

During the description of the process, I learned that the Defendant engaged a private individual to inspect the goods before shipment by the Plaintiff. Upon further inquiry, I learned that the significant defects were not always noted by the inspector. With the permission of my client (Defendant) I arranged for an interview with the inspector. Since he did not reside in the US, it was to be conducted by phone. In preparation for the interview, I reviewed the inspection reports and noted that for many of them, photocopies were provided instead of originals. Upon further inspection, it appeared to me that the photocopied inspection reports had the inspectors signature in exactly the same place on a line on the reports. I accordingly became suspicious that these inspection reports were falsely created by the Plaintiff and that the inspector never performed the inspections. In further preparation for the upcoming phone interview, I had these inspection reports faxed to the inspector for his review. I also sent him copies of some original inspection reports that seemed to be in order.

The interview confirmed my suspicions. The inspector clearly informed me that he had not conducted inspections on any of the goods reflected on the photocopied inspection reports. While the photocopied inspection reports included a signature that looked like his, he did not sign the inspection reports in question and did not inspect the goods. He told me that according to his passport, he was not in the country where the manufacturing facility was located on many of the dates of the alleged inspections. I asked for it and he graciously agreed to send me a copy of his passport. Once received, I was able to confirm that his passport established he was not present in the country that the manufacturing facility was located in 64% of the dates of the inspection reports in question. In some cases, he could have been in that country at other facilities unrelated to the Defendant. In some cases, it was unclear from his passport if he was or was not in the same country. What was clear is that I located 126 photocopied inspection reports that the inspector told me he never signed because he never inspected the goods.

I completed my report which was provided to the Plaintiff. Within a few days, the Plaintiff's lawyer called the Defendant's lawyer and lowered his \$2,000,000 demand to \$75,000. After discussions with the client, the Defendants countered with \$60,000 which was accepted. The attorney who hired me called and told me the client was thrilled and to fax over a bill. I prepared a bill, faxed it over and within a day or two was paid in full. It would have cost far more to go to trial than the \$60,000 paid to settle the matter. I can't be sure what the Plaintiff was concerned about. They intended to go to court claiming millions of dollars of damages based upon an alleged oral contract. I do believe it would be difficult to convince a jury that they are entitled to damages based upon their performance, especially when they had been caught altering inspection reports and forging signatures.