

THE DANGERS OF CONSIDERING ONLY LOST PROFITS & NOT LOST BUSINESS VALUE:

PRACTICAL TIPS RELATING TO SPECULATIVE PROJECTIONS & BV ALTERNATIVES

Presentation to the California Society of CPA's – Business Valuation Section

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Brian A. Sullivan CPA/ABV

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AGENDA

- ▶ Issues Facing Experts – Why We Are Here?
 - ▶ Definition of Value in a Loss of Business Valuation Claim
 - ▶ Considerations in Making the Claim for Lost Business or Lost Profits
 - ▶ Comparison of Lost Profits v. Lost Value of a Business
 - ▶ Can Plaintiffs Recover Both Lost Profits & Loss in Business Value?
 - ▶ Best Practice Ideas
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WHY ARE WE HERE?

- ▶ Flourine on Call Ltd v Fluorogas – 380 F 3d 849
 - ▶ Lost Profits From Breach of Contract & Lost Market Value of Contract Different
 - ▶ Evidence fails to support the correct theory of recovery

- ▶ Shonfeld v Hiliard 218 F3d 164
 - ▶ MV of an income producing asset is inherently less speculative than lost profits
 - ▶ What a willing buyer is willing to pay to earn “speculative profits” at single point in time
 - ▶ Does not mean valuation is less speculative than lost profits


- ▶ Economic Equivalency
 - ▶ Plaintiff in same position if it were not for the alleged bad act
 - ▶ Interplay between the two common damage concepts
 - ▶ Lost profits & loss in business value

- ▶ Reasonable Certainty/Causation

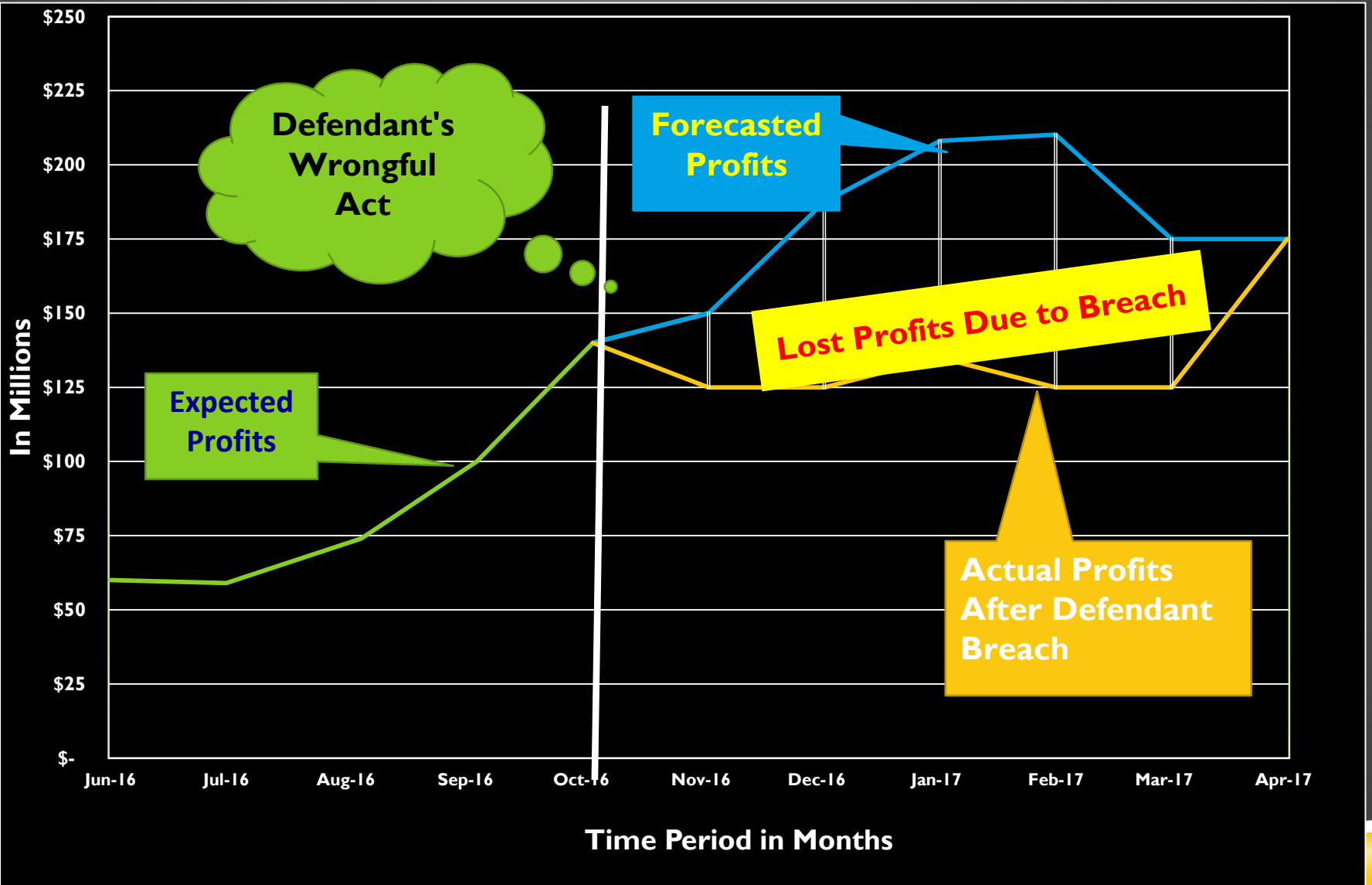
- ▶ Methods & Models to Determine Loss



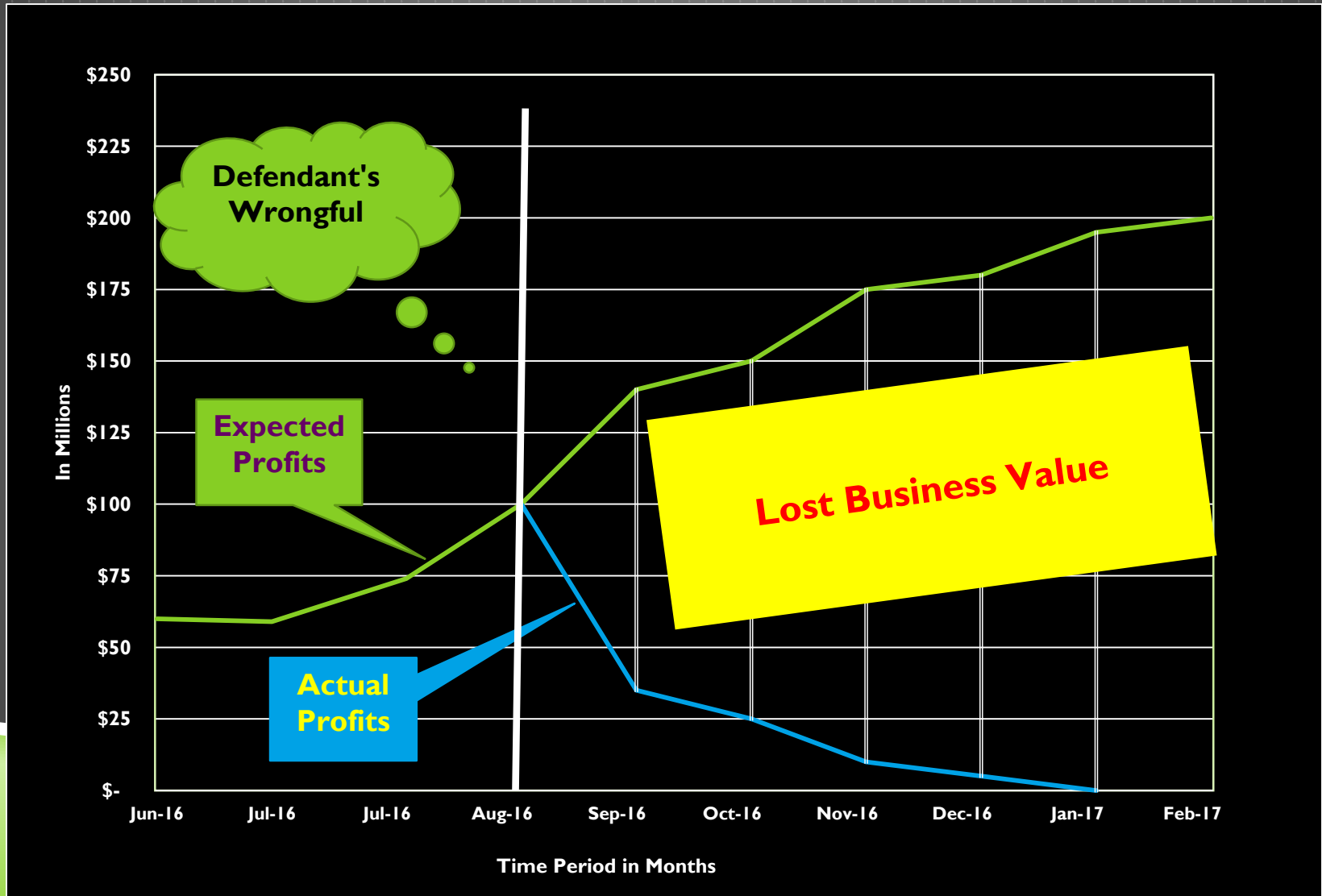
SCENARIOS TO MEASURE ECON DAMAGES

- ▶ Temporary Impairment
 - ▶ Immediate Destruction of Business
 - ▶ Slow Death of a Business
 - ▶ StartUp/Emerging Businesses
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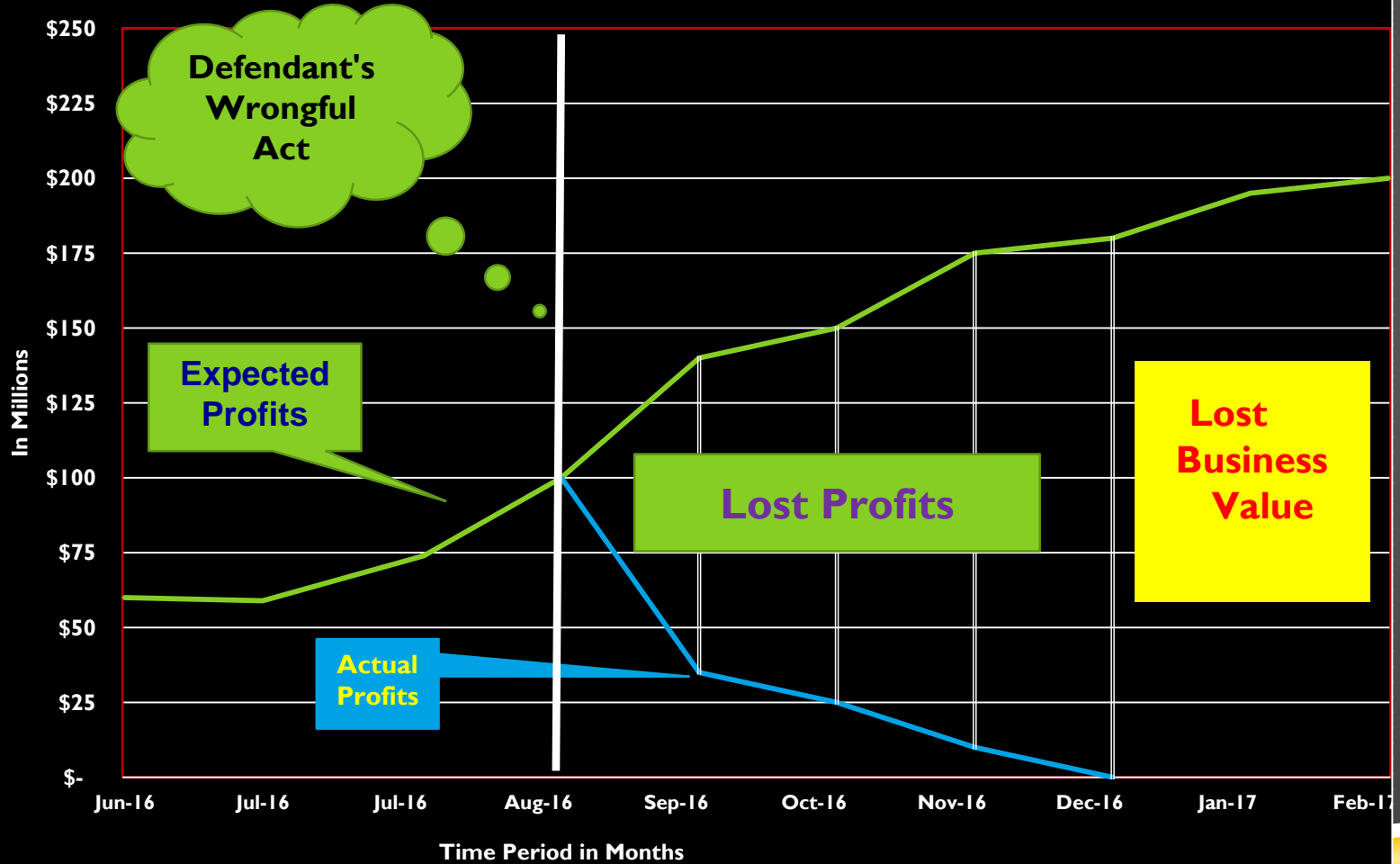
TEMPORARY IMPAIRMENT



IMMEDIATE DESTRUCTION OF BUSINESS



SLOW DEATH OF BUSINESS



START-UP...EMERGING BUSINESSES



ISSUES WE FACE AS EXPERTS – GATEKEEPER FOR THE COURT

▶ RELEVANCY

- ▶ Does testimony assist the trier of fact

▶ RELIABILITY

- ▶ Is the underlying analysis reliable and based on reliable assumptions & methodologies
- ▶ Are the estimates of damages supported by reasonable certainty

▶ ACCEPTED METHODOLOGY

- ▶ Are acceptable & commonly used valuation & lost profits methods used

▶ SPECIALIZED KNOWLEDGE

- ▶ Does the expert have the specialized skill to support his/her opinion
- ▶ Financial Damages Expert generally not competent to comment on causation

CAUSATION & ELEMENTS OF PROOF

- ▶ Plaintiff must establish defendant under a legal duty to perform
- ▶ Plaintiff must demonstrate that the defendant breached its duty by failing to perform
- ▶ Plaintiff must prove he/she suffered injury or loss as a direct result of the defendant's breach
- ▶ **Burden of Proof**
 - ▶ Credible lost profits include economic damages that are natural, proximate, probable or a direct consequence of an act
 - ▶ Must establish LP to a reasonable degree of certainty
 - ▶ Calculations cannot be speculative, vague, contingent or unreasonable
 - ▶ Damages for LP are recoverable only if plaintiff establishes legally sufficient proof that the financial expert's economic damages are reasonable and that reliable factors were utilized
 - ▶ Refer to *Coyne's & Co Inc v Enesco LLC* 2010 WL 3268877

REASONABLE CERTAINTY

- ▶ In *Texas Instruments, Inc. v. Teletron Energy Mgmt., Inc.*, 877 S.W.2d 276 (Tex. 1994), the court noted that the “requirement of ‘reasonable certainty’ in the proof of lost profits is intended to be flexible enough to accommodate the myriad circumstances in which claims for lost profits arise.” *Id.* at 279. It confirmed that the test should focus on the commercial activity allegedly damaged rather than on the age of the business. The fact that the business was new is one consideration. A mere hope for success of an untried enterprise is not enough. But when there are good reasons to expect a profit, damages are not prohibited just because the business is new. The focus is on the experience of the persons involved in the enterprise, the nature of the business activity, and the relevant market.
- ▶ The court set clear parameters on the application of the reasonable certainty standard:
- ▶ Profits which are largely speculative, as from an activity dependent on uncertain or changing market conditions, or on chancy business opportunities, or on promotion of untested products or entry into unknown or unviable markets, or on the success of a new and unproven enterprise, cannot be recovered. Factors like these and others which make a business venture risky in prospect preclude recovery of lost profits in retrospect.

REASONABLE CERTAINTY

- ▶ “At a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits can be ascertained.”
 - ▶ *Holt Atherton Indus., Inc. v. Heine*, 835 S.W.2d 80, 84 (Tex. 1992).
- ▶ Reasonably certain evidence of lost profits is a fact-intensive determination.
- ▶ Profits which are largely speculative, as from an activity dependent on uncertain or changing market conditions, or on chancy business opportunities, or on promotion of untested products or entry into unknown or unviable markets, or on the success of a new and unproven enterprise, cannot be recovered.

PLANNING THE ENGAGEMENT

- ▶ Review and understand recent Daubert Challenges
- ▶ Know opposing parties level of experience
- ▶ Trier of Fact history & experience
- ▶ Regular communication with counsel
 - ▶ Set Expectations & Due Dates
 - ▶ Consultant v Expert (discovery)

DAMAGE ANALYSIS

- ▶ Without v With Alleged Actions
- ▶ But For/Projected Analyses v Actual/Projected Analyses
- ▶ Lost Profits Analysis = (But For Revenues minus Costs) – (Actual Revenues – Costs) + Mitigating/Incremental Costs
- ▶ Duration of damages period left to processes of the trier of fact informed by the presentation of conflicting evidence – Consider preparing multiple damage periods

ESTIMATING BUT FOR REVENUES

- ▶ 4 Commonly Used Models
 - ▶ Before & After Method (Historical)
 - ▶ Yardstick Method (Industry & Guidelines)
 - ▶ Sales Projection Method
 - ▶ Market Model
- ▶ Causation requires the need to differentiate between the legal/factual requirements & proof of damage amount.
- ▶ Reasonable Certainty applies to the entire economic damages period
- ▶ Prove the defendant caused the damages (significant & material – not sole cause)

YARDSTICK METHOD

- ▶ Utilizes company specific forecasts for certain items
 - ▶ Prepared in ordinary normal course of business
 - ▶ Other than for litigation
- ▶ Expert should conduct additional independent analysis of mgmt projections/business plan to determine reliability and consistent with industry, guideline companies et al
- ▶ Do not hope for the best....Daubert Challenge


SALES PROJECTION METHOD

- ▶ Go to BV Professional Standards
- ▶ Do independent analysis
- ▶ Check for reasonableness & reliability


MARKET MODEL METHOD

- ▶ Expert considers plaintiff's market share prior to bad act to determine loss of revenues
- ▶ This method not used as often as Yardstick & But For Models
- ▶ Used in Patent Infringement Cases
- ▶ Expert must define appropriate market and analyze the subject company historical sales as well as those of its competitors.

OTHER METHODS TO PROJECT REVENUE

- ▶ Regression analysis
 - ▶ High/Low Method
 - ▶ Incremental Method
 - ▶ Terms of contract
 - ▶ Accounting of the defendant's profits
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ESTIMATING COST – METHODS & DRIVERS

- ▶ Understand company's methodology to track costs
 - ▶ Statistical methods
 - ▶ Non-statistical methods
 - ▶ Market & Economic conditions
 - ▶ Distinguish & Understand: Fixed Variable and Semi-Variable Costs
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COMPARATIVE SUMMARY OF LOST PROFITS V LOSS OF VALUE

| Attribute | Lost Profits | Business Valuation |
|--|--|---|
| Income Stream | Incr income stream net of avoided cost | Typically net after tax inc |
| Income Stream | B4 Income Tax | Typically after tax inc |
| Income Stream | Typically limited life | Perpetuity |
| Valuation Methods | PV post trial lost incr inc stream added to pre-trial lost incr inc + interest | Discounted Net Inc or net cash flow supported by other bv methodologies |
| Discount Rate | Risk adjusted risk free or plaintiffs use of funds | Risk adjusted risk assessment |
| Pre-Judgment/Post-Judgment Interest | Considered | Considered |
| Use of Hindsight | Typically considered | Seek Guidance |
| <p>“The Comprehensive Guide to Los Profits Damages” 2015, pg 340, Business Valuation Resources</p> | | |

DEFINITION OF VALUE



- ▶ “Value” can mean different things depending on the contract.
- ▶ Lost Profits has no widely accepted of standard of value definition
 - ▶ Purpose of compensatory damages to put injured party in the same position as it would have been had there been no injury
- ▶ Loss of Business Value
 - ▶ FMV or FV – it matters
 - ▶ Specific valuation methods and procedures
 - ▶ Subsequent Events DNA
 - ▶ Shareholder Dissent Action – Check state jurisdictions
 - ▶ Some courts consider post merger activity to determine value at date of merger
- ▶ Varying Court definitions of “VALUE” complicates the process
 - ▶ Know your jurisdiction
 - ▶ Know the trier of fact ruling history

REMEDIES TO RECOVER DAMAGES

▶ Dependent on type of Claim Asserted

▶ TORT CLAIM

- ▶ RELIANCE DAMAGES is the measure of compensation given to a person who suffered an economic harm for acting in **reliance** on a party who failed to fulfill their obligation.
- ▶ RESTITUTION is an equitable remedy when the money or property wrongfully in the possession of defendant is traceable (i.e., can be tied to "particular funds or property").

▶ BREACH OF CONTRACT

- ▶ EXPECTATION DAMAGES is compensation that tries to place the harmed party in the position he would have been in had the breach not occurred

▶ Financial Expert will consider same factors irrespective of the type of claim.

- ▶ Assumption as to one party prevails on liability
- ▶ Plaintiff must consider: proximate cause, reasonable certainty and a damages measurement that puts plaintiff in an economically equivalent position
- ▶ Can affect the calculation but also claimants

SUBTLETIES OF LOST PROFIT DAMAGES...

- ▶ Economic Damages caused by the wrongful acts of another by two alternative methods
 - ▶ The going concern value, or:
 - ▶ Lost future profits
- ▶ Courts Allow plaintiff to recover
 - ▶ PV of lost future earnings or
 - ▶ Present Market Value of the lost business,
 - ▶ But not both
- ▶ Going Concern Value Defined
 - ▶ Price a willing buyer would pay and a willing seller would accept in a free marketplace for the business. It measures damages by awarding the difference between the going concern value and the price actually received by the plaintiff upon sale of the business
 - ▶ *Protectors Insurance Service Inc v. US Fidelity & Guaranty Co* 132 F3d 612 (10th Circuit

MORE ON DEFINITION OF DAMAGES....

- ▶ Cooper Distributing Co v Amana Refrigeration Inc
 - ▶ 180 F3d 542 (3rd Circuit)
 - ▶ Court did not define “Market Value”

- ▶ Action Marine Inc v. Continental Carbon
 - ▶ 481 F3d 1302 (11th Circuit)
 - ▶ Purpose of compensatory damages for “lost business value” is to place an injured party in the same position as it would have been, had there been no injury...that is to compensate for the injury actually sustained.

- ▶ Sierra Wine and Liquor Co Heublein, Inc
 - ▶ 626 F2nd 12 (9th Circuit)
 - ▶ This is no different than the purpose of compensatory damages for lost profits: the amount necessary to “make the defendant whole” and “place it in the same position it would have been but for the defendant’s’ breach...”

CAN LOST PROFITS = VALUE OF LOST BUSINESS

- ▶ Maybe???
- ▶ “...One might say that if all other things are equal, using the same methodology should produce the same results for lost business value and lost profits. But all other things are rarely equal...”
 - ▶ Robert L. Dunn, Recovery of Damages for Lost Profits, 6th Edition
- ▶ Does this mean we could reconcile and quantify differences?

DAMAGE ANALYSIS MUST BE BASED...

- ▶ Sound Principles
- ▶ Relevant Facts
- ▶ Reasonable Assumptions
- ▶ Facts & Circumstances specific
 - ▶ Will yield a quantification focused on putting the injured party in an economically equivalent position

DEDUCTIBILITY OF BUSINESS EXPENSES

EXPENSES

- ▶ Net Income After Tax v Modified Cash Flow
- ▶ Business Valuation
 - ▶ Net Income after deduction of all business expenses
- ▶ Lost Profits
 - ▶ Incremental expenses associated with generating lost gross profits
 - ▶ Variable & semi-variable expenses deducted
- ▶ Capital Expenditures/Overhead & Depreciation

EFFECT OF INCOME TAXES- LOST PROFITS

- ▶ LP damages typically considered taxable to the recipient
- ▶ Hanover Shoe v United Shoe Manufacturing Corp 392 US 481, 503 (1968)
- ▶ Since Shoe Decision the CA Court of Appeals has listed several reasons why courts should not consider tax consequences as a mitigating factor in compensatory damages calculations in breach of contract actions
 - ▶ Tax Benefit Rule
 - ▶ Evaluating Tax Consequences Speculative
 - ▶ Lost Profits can exceed loss of business value

LOSS RECOVERY PERIOD

- ▶ Lost Profits – specific or limited period
- ▶ BV (when entire business destroyed) – perpetuity
- ▶ Practice Point
 - ▶ Demonstrate how the PV of the lost income is equivalent to lost business value

APPLICABLE DISCOUNT RATES

- ▶ Discount rate often times different in LP or L BV scenario
- ▶ Discount rates can vary tremendously depending on the facts and circumstances
 - ▶ Risk free rate v risk adjusted discount rate

POST BREACH EVENTS

- ▶ Significant difference between lost profits and loss in business value analysis
 - ▶ Ex Ante v Ex Post
 - ▶ Known or Knowable Concept
- ▶ Differing opinion and case law
 - ▶ California Federal Bank FSB v. United States 245 F3d 1342 (Fed Cir 2001)
 - ▶ Fifth Third Bank of Western Ohio v United States 55 Fed Cl 223 (Fed Cl. 2003)
- ▶ Ex-Ante used when using a business valuation to calculate damages
- ▶ Ex-post is used in a lost profits calculation

MITIGATION SHOULD BE CONSIDERED

- ▶ Injured Party obligated to undertake reasonable effort to mitigate
 - ▶ Find replacement parts
 - ▶ Consider costs expended to mitigate damages
 - ▶ Actual Expense Incurred + Future Expenses to mitigate damages
 - ▶ Defamation – costs to rebuild reputation
 - ▶ In LP context
 - ▶ Damages = actual costs expended + LP
 - ▶ In BV context
 - ▶ Identify Mitigation factors & adjust valuation
 - ▶ TTM actual expenditures may not be reflective of future expenditures (inclusion of mitigation costs)...

CAN PLAINTIFFS RECOVER LOST PROFITS & LOST BUSINESS VALUE

- ▶ No double counting
 - ▶ Applies where plaintiff attempts to recover LP and LV for the same time period
- ▶ Facts & Circumstances dictate results & will drive approach to provide trier of fact with a credible damages estimate
- ▶ Montage Group Ltd v Athle-Tech Computer Systems Inc 889 So 2d 180 at 191
 - ▶ *“...Generally, one cannot recover as damages both diminution in value of a business as well as loss of future profits because future profit potential is a factor utilized in calculating market value and, as such, is compensated for in the diminution of value award. However, loss of profits prior to cessation of a damaged business is properly allowable as an element of damages in addition to an allowance for a market value diminution because the interim profit losses experienced prior to liquidation of the business are not reflected or compensated for in the market value determination...”*

PRACTICE IDEAS

- ▶ Pre-Planning
- ▶ Determining the Appropriate Damages Period
- ▶ Estimating Lost Revenue & Costs
- ▶ Sufficient Reliable Data
- ▶ Model Approaches
- ▶ Cross Checking Conclusions
- ▶ Reasonableness Check