

Business Valuation v Economic Damages: What are the Differences?

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Agenda

- Business valuation skills used in damage assessments
- Types of damage remedies
- Lost profits and lost value
- Requirements of experts
- Reporting

Business Valuation and Damage Calculation

- Both require the ability to:
 - Forecast revenues and profits
 - Develop a discount rate
- To do this, both require an in-depth understanding of:
 - The company, including its financial position, operating history, and future outlook;
 - The factors affecting the industry in which it operates; and
 - How economic conditions are expected to affect the company.
- *Damage analyses are generally subject to a much greater level of scrutiny than a non-litigation business valuation.*

The Primary Skill Needed in Damage Analyses

- The ability to accurately forecast.
 - Because that’s what most damage calculations are—a forecast of what would have happened, “but-for” the actions of the defendant.
- Damage calculations typically require that risk primarily be reflected in the forecast,
 - As opposed to business valuations, in which risk is heavily reflected in the discount rate.
 - By taking into account of the facts and evidence as to how they would affect the forecast

How Does Business Valuation Differ From Damage Calculations?

- Business Valuation is often in the context of non-litigated matters (for example, for tax purposes or acquisitions).
 - For this purpose, you might rely in large part on what management tells you (their forecast; their view of risk).
- Damages are always in the context of a litigated matter.
 - And therefore, you should be careful when considering management told you (*because of the greater level of scrutiny*).
 - Damage analyses typically require much more focus on the *facts and evidence* (that is, the *story*).

The Cause of Action for Which We Calculate the Remedy

- Contract and Torts
- Intellectual Property Infringement
 - copyrights, trademarks, trade secrets, patents

Context for Contract or Tort Damage Calculations

- Elements of contract damages generally:
 - Breach of the contract;
 - Causation; and
 - That the plaintiff was damaged.

Damage Remedies, Contracts and Torts

- Claimant's actual damages:
 - Out of pocket;
 - Loss in value OR Lost profits
 - Possibly Indirect (may be too speculative or remote)
- Disgorgement of Defendant's Gains
- Cannot recover for losses the claimant could have taken reasonable steps to avoid (e.g., mitigation)

Damage Remedies for Intellectual Property

- Lost Profits or Lost Value
- Disgorgement of Defendant's Gains
 - “Gains” could mean profits; value; or costs avoided from use of infringed property
- Reasonable Royalty
- Cost to Develop

How Do You Decide Which Remedy?

- Selection of remedy may affect disclosure requirements of claimant and defendant
 - For example, in an I/P case, if the claimant seeks lost profits, they will have to disclose substantive information about themselves;
 - If claimant instead claims unjust enrichment, they may avoid having to disclose—at least as much (because the remedy measures the defendant’s gains, not the claimant’s).
- This is often a key consideration in the choice of remedy.

How Do You Decide Which Remedy?

- Claimant cannot “double-count” damages
 - For example, you wouldn’t claim both lost profits and out-of-pocket costs, if those out-of-pocket costs were inherently included in your lost profit calculation.
 - However, it might be good to know how much of your calculation represents lost profits, and how much represents out-of-pocket costs.
 - You wouldn’t claim both lost profits and unjust enrichment for the same time horizon,
 - At least without proof that you were not double-counting.

What is the Purpose of These Remedies?

- Lost profits, lost value, lost wages, wrongful death: to make the claimant whole.
 - Generally calculated as what would have happened, compared to what did happen.
- Unjust Enrichment: to deprive the defendant of their ill-gotten gains.
 - Calculated as the benefit to the defendant.
- “Running numbers” is the easy part;
 - Running the RIGHT numbers that match the claim and credibly tell the story of what actually happened is what takes time.

Burden of Proof, Generally

- Claimant provides evidence of the breach;
- Defendant must prove damages not caused by the breach.

- May vary by jurisdiction and type of damages
 - For example, in U.S., the claimant must prove the damages were caused by the breach.

Key Concepts—Lost Profits v. Lost Value

- Lost profits: Difference between what would have happened, and what did, but for defendant's alleged actions
- Lost value: Difference between value before and after defendant's alleged actions

Key Concepts--Methods

- The only “method” to calculate lost profits:

Incremental profit the company would have had

Minus profit the company had (or now will have)

Equals \$\$ loss

The work lies in building a forecast that is credible and convincingly supported by the evidence

Lost Value Is the Same Thing...

What would have happened (had valuable company)

Minus now what will happen (have worthless company)

Equals lost value

Key Concepts—Lost Profits v. Lost Value

- Lost profits are *temporary losses*, measured by the incremental profit the company would have earned until the company recovers.
- Lost value is a measure of the *permanent loss* (can be of a business, segment of a business, or reduced revenue that is never expected to be recovered).

Key Concepts—Lost Profits v. Lost Value

- Can you have both lost profits and lost value?
 - Sometimes; but they can't double-count the same time period.

Permanent v. Temporary

- Is part of the business damaged, and is it unknown if it will ever recover?
 - Could be either lost profits or lost value, but facts and circumstances would dictate.
- Is there a very long-term contract that was breached, the profits from which are irreplaceable?
 - Probably lost value.

Calculating Lost Profits—Alternately:

1. **Actual damages** for a limited number of years in the past (beginning with the date of breach, and ending at the time the company recovers from the loss);
2. Actual damages for a period of time in the past, and **anticipatory damages** for a limited number of years into the future (beginning with the date of breach, and ending at the time the company is expected to recover from the loss); or,
3. **The loss of the entire business** (as of the date of the breach, assuming the company is a total loss and is never expected to recover).

Lost Profits Damages

- A forecast of the incremental profits the claimant would have enjoyed (forecasted revenue minus saved expenses), had there been no damaging action,
- Minus the incremental profits (or loss) the claimant actually experienced, given the actions of the defendant.

How Evidence is Gathered

- “Before and After Method”:
 - Plaintiff’s Prior and/or Subsequent Experience
- “Yardstick Method”:
 - Plaintiff’s Experience at other locations
 - Comparable Experience of others
 - Industry Data
- “Sales Projection Method”:
 - Pre-litigation Profit Projections
 - Court looks unfavorably on projections *prepared contemporaneously with damage estimate*

Considerations in Projecting Lost Revenues

- Is there a pre-litigation projection?
 - How accurate are the company's projections over time?
- Consider historical trends
 - Was there a trend to begin with?
 - Was such trend likely to continue?
- Competition
 - Is it shrinking? Growing? What affect does that have on the company's ability to earn revenues?
 - Is pricing of the company's products or services stable? Or is it increasing or decreasing?
- What is the state of the company's technology?
 - Are they up-to-date? Falling behind?
- Does the company have sufficient capacity for the revenues you have forecasted?
- Are there any new regulations that might affect the company's ability to make a profit?

Deductibility of Expenses

- For lost profits, most jurisdictions require the measurement of “incremental” profits.
- This is generally interpreted as profit, after the deduction for variable costs.
 - But not all jurisdictions have the same rules!
 - For example, in the U.S., one state requires the deduction for both variable and fixed costs.

Methods for Determining Incremental Costs

- Variable versus fixed analysis,
 - With a corresponding direct assignment of costs
- Regression analysis

Understanding Cost Drivers

- Use historical cost analysis to determine what portion should be attributed to the harmful act
- Know the market and economic conditions within the industry the subject company participates

Deductibility of Expenses

- Consider incremental shifts in company size (consistent with projected growth in revenue) that lead to some (or all) fixed costs effectively becoming variable.
- For example, if you make a forecast for a loss of a product line that projects significant growth, the company may have to expand, add more space, hire customer service personnel, etc.

How is Compensation For The Business Owner Handled?

- Plaintiff sued for \$1,030,000 in lost profits, including lost wages of its anesthesiologists under terms of a contract that the anesthesiology practice had with the hospital. The trial court awarded only \$14,883, representing lost income of the practice, net of expenses saved.
- *“We therefore conclude that professional corporations must be treated like other corporations for purposes of calculating damages. **Unpaid salaries of corporate shareholders ought to be treated as saved expenses.**”*
 - *Anesthesiologists Associates of Ogden v. St. Benedict’s Hospital* 884 P.2d 1236 (Utah 1994).

Compensation

- Depending on circumstances, owner compensation could be any of:
 - Actual
 - None
 - “Normalized”
- *Different jurisdictions have handled this question differently.*

Putting it Together

- Forecast revenues the plaintiff would have had “but for” actions of defendant
- Minus incremental costs related to but-for revenues

The Basic Framework of Lost Profits Damage Calculations

Profit and Loss Line Item:	"But-For" Profit	Actual Profit	Incremental Sales and Avoided Costs
Sales Before Incremental Sales	\$ 1,000	\$ 1,000	
Incremental Sales	\$ 400		\$ 400
Total Sales	\$ 1,400		
Manufacturing Costs @ 65%	\$ (910)	\$ (650)	\$ (260)
Gross Profit	\$ 490	\$ 350	
Other Direct and Indirect Costs @ 15%	\$ (210)	\$ (150)	\$ (60)
Costs Not Impacted By Production Or Sales Levels	\$ (25)	\$ (25)	
"But-For" Pre-Tax Profit of Company	\$ 255	\$ 175	\$ 80
Lost Profit--Difference Between "But-For" and "Actual" Pre-Tax Profit		\$ 80	

Case Example:

- Zyco had a contract to provide steel component parts to Wyatt.
- Wyatt used Zyco's parts in the manufacture of their product, which they then sold to their customers.
- Wyatt claims they lost customers A, B, and C over the product quality issue caused by Zyco.
- Which in turn, Wyatt claims, caused them to lose revenue and profits.

Case Example:

- You get hired to calculate Wyatt's losses.
- To forecast the lost revenue, you need to delve into:
 - How much and how often did the customers historically buy?
 - At what price did they buy?
 - What was the likelihood they would have bought more? Might they have bought less?
 - What were the historical margins on A, B, and C's sales? Would the margin have changed in the future?

All that is easy enough to get. But what if you find out:

- Wyatt's sales representative sent an email telling the company president that Customer A was cutting their orders by 2/3, due to a downturn in their business—six months before the date Zyco allegedly sold them defective product.
- Customer C met with Wyatt's sales representative about a month before the date of loss, asking for price reductions of as much as 45%. Wyatt declined giving them the price reduction they asked for. The notes documenting the meeting were included in the defendant's production of documents.
- You find out in the newspaper that Company B went into bankruptcy 3 months prior.

All that is easy enough to get. But what if you find out:

- Now what is your calculation of the loss relating to Customers A, B and C?
- Does the extent to which you delve into these documents matter if you are the claimant's expert? What about if you are the defendant's expert?

Discounting Damage Calculations

- As noted, typically, the forecast of the lost revenues and profits should incorporate risk.
- Any future component of the damages are then discounted by:
 - Risk-free rate
 - Risk-adjusted rate
 - Reinvestment rate

There is no one “right” answer...very facts and circumstances driven.

Discount Rate

- Once the lost benefit stream calculations are established using the best available proof, in discounting, we further seek only to make the plaintiff “whole.”
- One way we do this is to determine what the plaintiff would have done with the funds, had he received them in due course if not for the defendant’s wrongful acts.
 - This is how I often calculate a discount rate.

Term of Damage Calculation

- “How long” to forecast losses can be one of the most difficult components of the damages calculations.
- For contracts, look to the term of the contract:
 - Are there options? Was it *already* renewed?
 - Is it terminable at will?
 - What does it obligate the parties to do?

Who Can Be an Expert

- A Specialist who is recognized as such by peers in his field
- Courts require experts to be competent, independent, impartial, and ethical, and free of conflicts of interest
- Giving false testimony can result in criminal penalties and civil liability for negligence
- Some countries have registers of experts, from which judges draw experts.
 - Which often have requirements for experience and education
 - Some are permanent, others require periodic renewal.

Standards

- The activities of judicial experts are regulated by legal standards in only 20 out of 28 European countries.

Who Appoints the Expert

- An overwhelming majority of European countries have both court-appointed experts (“technical experts”) and experts appointed by the parties (“expert witnesses”).
- Court appointed experts do not escape the adversarial process, as they may have to respond to opinions of private experts hired by the parties.
- Party experts are often used, particularly in the evaluation of damages.

Reporting Your Opinions

- Written reports are mandatory in most (but not all) European countries.
- The expert may or may not be required to attend the hearing.
- Judges may ask for oral testimony in addition to the written report.
- The parties have the opportunity to examine the experts, even if appointed by the judge

Report

1. A statement of facts (incorporating the supporting evidence on which the report is based);
2. An analysis of the points at issue;
3. A description of the approach taken by the expert;
4. The conclusion.

Supplementation is to be expected.

In Conclusion...

- Lost profits and business valuation requires similar financial skill-sets.
- At the same time, its entirely different—*mostly due to evidentiary requirements.*
- Courts demand strong evidentiary support for our conclusions
 - Without it, you risk exclusion



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Nancy is a frequent speaker both locally and nationally on the topic of business valuation and damages. She is a regular contributing author and editorial board member for several national valuation and financial expert journals, and has written and/or technically reviewed several valuation and commercial damage textbooks. In 2007 and 2008 she published two professional reference books on valuation. The third edition of her publication, *The Comprehensive Guide to Lost Profits and Other Commercial Damages* was published in February 2014. Her most recent publication, *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle*, was published in April 2015.