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Advisory Alert: Business damages measurement: Lost profits or business valuation?

Introduction

In business litigation matters, financial experts are often asked to provide an opinion on the quantification of economic damages suffered by an injured party. Business valuation and lost profits are two common damages estimation approaches used by financial experts. These two approaches share many similar economic and financial principles; however, some dissimilarity between these approaches can lead to very different outcomes. Therefore, consideration must be given as to which damages method is allowed and whether one method will make the injured party whole and the other not. Other questions arise: Can one apply both methods to the same damages calculation? Can lost profits exceed business value? Is one method more certain, or does it provide a better estimate, than the other? Do certain circumstances indicate that one method must be used?

Business valuation

Although each case is unique, there are circumstances in which the business valuation method almost always prevails over the lost profits method. Business valuation is applied almost exclusively in entire business destruction, shareholder oppression, dissenting shareholder, family law and tax court matters. In addition, permanent business value impairment (diminution in value) cases often rely on business valuation as an appropriate measure. These types of cases include M&A disputes, defamation, slander and intentional business destruction, among other matters. A damages measurement in this type of case may be based on the difference between the value of the business in the but-for world and its actual value.

Lost profits

There are some cases, however, that apply lost profits rather than business valuation as the measure of damages, including breach of contract and intellectual property infringement. There are other circumstances in which it may be appropriate to apply either the lost profits method or the business valuation method. While the selection of a particular methodology is based on facts and circumstances, the lost profits method can be an appropriate measure of damages when the injury is for a specific period of time (and not into perpetuity as with a business valuation), or when the injury can be related to a separately identifiable cash flow.

Lost profits are commonly calculated based on the difference between the expected profits assuming the harmful event did not occur and the actual profits received (or if there will be future damages, what profits are estimated to be received).

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March 16, 2015

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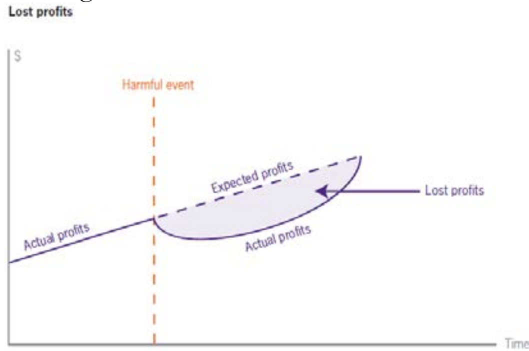
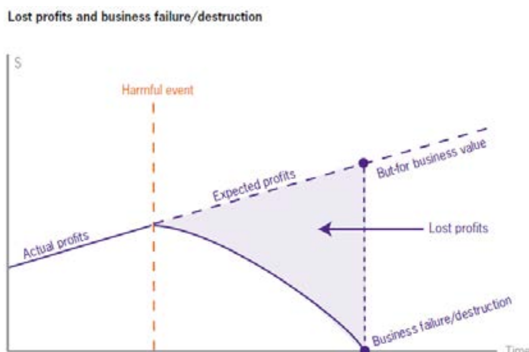
The lost profits model can be depicted as in the diagram below.



Business valuation and lost profits

If a lost profits analysis is performed, can a business valuation analysis also be performed to measure the total damages owed? It can, as long as doing so will not cause duplicative damages. This damages measure can be calculated as the difference between the but-for expected profits and the actual profits received from the date of the harmful event to the date the business ceased operations, plus the loss of the but-for business value on the date operations ceased, less any salvage value. One might depict this damages method to a trier of fact as in the diagram below.



In making the plaintiff whole, one must consider whether it's plausible that a measurement of damages using lost profits could exceed one using a business valuation. Some say that lost profits cannot exceed business value, whereas others disagree. As with many things, the answer is that it depends. One can certainly come up with facts and circumstances that cause lost profits to exceed business value. Robert L. Dunn may have summarized it best in his book *Recovery of Damages for Lost Profits* when he said 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."[1] The measurement date and the discount rate are two items that cause differences in business valuation and lost profits damages measurements.

	Ex-ante	Ex-post
Measurement date	Date of harm	Date of calculation/trial
Information considered	Information known or knowable at the date of harm, exclusive of subsequent information	All information available
Discounting	Discount all cash flows to the date of harm using an appropriate risk-adjusted discount rate, and apply a prejudgment interest to the date of calculation/trial to bring cash flows to their present value	Discount only future losses to the date of calculation/trial, and apply prejudgment interest to past losses to bring them to their present value

I. Measurement date and the book of wisdom

Background

Business valuation standards outside litigation employ a known-or-knowable concept, requiring a valuation professional to consider only information that is known or knowable as of the valuation date. However, a damages expert may very well consider subsequent information when estimating damages.
For example, what are the damages for a stolen $1 winning lottery ticket if it was stolen after the purchase but before the winning ticket was drawn? Is it worth $1? Or is it worth the $100 million prize? This is commonly referred to as the ex-ante versus ex-post debate.

Any one of the differences between the ex-ante and ex-post methods can cause a

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[1] Dunn, Robert L., Recovery of Damages for Lost Profi ts, 6th ed. (Lawpress Corporation, Westport, Conn.), 2005.

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significant difference in the damages calculated. Although case law and opinions differ, an expert will generally have an easier time supporting the use of the ex-ante method when a business valuation approach is applied. In light of a Supreme Court opinion commonly referred to as the book of wisdom, an expert will generally find it simpler to support the use of the ex-post method when taking a lost profits approach.

II. Discount rate

Background

The discount rate used in a business valuation involves the overall risks of a company's invested capital (debt and equity), whereas the discount rate in a lost profits calculation may apply only to specific risks. Therefore, discount rates can be, and often are, different for a business valuation than a lost profits damages calculation. High technology and R&D are good examples.

Whether you consider computers or biopharmaceuticals, a stand-alone R&D project will likely have more risk than a portfolio of R&D projects at the same phase of development, all other things being equal. The opposite can be true too. Assume a manufacturing company has multiple clients, many of which have decreasing orders in a declining market and do not have long-term contracts, and one is a client with a long-term contract and increasing purchases. This certainly imposes the likelihood that the long-term contract with the stable client has a lower level of risk than the company overall. Interestingly, though, in a case in the Second Circuit (Schonfeld v. Hilliard, 218 F.3d 164 [2nd Cir. 2000]), the court held that "[t]he market value of an income-producing asset is inherently less speculative than lost profits because it is determined at a single point in time.

It represents what a buyer is willing to pay for the chance to earn the speculative profits."

This general statement does not mean that valuation is less speculative than lost profits from an economic perspective in all situations. Clearly, facts and circumstances play a critical role. While there isn't a one-size-fits all standard for litigation purposes, some common practices are used in determining a risk-adjusted discount rate for a lost profits case. The methods or combination of methods, that could be used include:

- the weighted-average cost of capital (WACC);
- equity discount rates;
- debt discount rates;
- lease rates;
- the cost of debt;
- internal rates of return;
- returns on investments of similar businesses or lost profits; and
- conservative, or risk-free, investment returns

However, when one uses business valuation to measure damages, this list becomes shorter, and a traditional discount rate derivation such as the WACC is commonly applied. Each discount rate application may have a theory behind it that applies to a particular set of facts and circumstances, and this theory may lead the expert to select one discount rate over the other.

The bottom line

There are several other differences between business valuation and lost profits damages calculation methods, including the consideration of expenses and taxes. This article did not attempt to articulate them all; rather, it focused on providing a foundation for understanding some of the primary differences between business valuation and lost profits as measurements of economic damages.

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