

BDG Business Valuation Insight



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Economic bust,
litigation boom

Rules of thumb are
no substitute for the real thing

Fine-tuning the value estimate
**The importance of
valuation adjustments**

Tiered valuation discounts:
How low can you go?

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Economic bust, litigation boom

In good times, companies typically operate harmoniously with their shareholders, employees, suppliers and customers. But the likelihood of conflict may increase when a company's performance falls short of stakeholders' expectations. The sluggish economy might not be the only scapegoat for lackluster performance. Civil wrongdoings — such as breach of contract or negligence — also cause businesses to lose money.

Many relevant factors

Compensatory damages awards attempt to make plaintiffs “whole” again. The starting point for estimating damages is a succinct damages theory. For example: *If Ms. Einstein had not infringed our patent, ABC Company would have earned more money.* From here, the expert refines the damages theory based on the evidence.



In such cases, the financial expert needs to fully explain the appropriate damages theory and underlying financial assumptions to avoid undermining the attorney's case.

One party's unfair gain is sometimes used as a proxy of the other side's loss.

Factors the expert considers when filtering through financial data include:

Financial projections. The plaintiff or defendant might have projected profits before entering into a contract. For example, financial projections often are used to obtain financing — or internally, to assess an investment's feasibility. They can provide insight into where the company might be “but for” the damaging act, especially if prepared before the dispute arose.

Comparable data. When assessing damages, an expert typically looks at industry averages and competitor performance using data from a reputable source, making sure to measure the financial metrics consistently between the comparables and the subject company.

Defendant's subsequent gains. One party's unfair gain is sometimes used as a proxy of the other side's loss. A defendant's gains might be relevant if the plaintiff alleges unfair competition, a breach of a noncompete agreement or a breach of an exclusivity contract.

Discount rate. The traditional approach to quantifying damages is a discounted cash flow analysis in which the appraiser calculates lost profits over a finite time period and then discounts the cash flow stream to its net present value. The appropriate discount rate is subjective, however, and depends on case specifics. Courts offer little guidance. But experts agree that the discount rate should incorporate the perceived risk of achieving the expected profits and the plaintiff's use of funds.

Accepted methods for quantifying damages

The number of valuation challenges in federal and state courts has been on the rise. Accepted methods for quantifying economic damages include:

Before-and-after method. An expert might, for example, analyze the company's operating history and then show how the defendant's actions caused an aberration in these trends. Damages equal the difference between actual performance and expected performance based on historic trends.

Yardstick method. Another approach is to benchmark the plaintiff's performance against competitors or industry averages. If the expert can establish a clear relationship between the performance of the company and its peers, this external data can support an economic damages claim.

Sales projection method. Some experts predict how a plaintiff might have fared based on financial projections prepared for financing or other external purposes before the defendant's wrongdoing. This method is often reserved for startups and companies with limited operating history.

Quantifying damages is an inexact science — no single method works in all cases.



Damages duration. Most calculations assume that damages occur over a finite period of time, such as a contract's term or a product's useful life. But some losses are permanent. In such cases, economic damages equal the difference between the value of the company before and after the damaging act.

Taxes. Generally, experts calculate damages on a pretax basis, because plaintiffs owe state and federal taxes on most compensatory damages awards. If this is the case, the discount rate the expert applies to lost profits also should be a pretax rate.

Most jurisdictions expect plaintiffs to minimize continued losses.

Other factors. Before arriving at the final damages amount, an experienced expert will ask two more questions:

1. What external factors — such as the loss of a key employee or economic recession — could have lowered profits? After all, the defendant can be blamed only for the loss it caused.

2. Did the plaintiff take steps to mitigate losses? Most jurisdictions expect plaintiffs to minimize continued losses. This includes finding other suppliers or customers.

Remember: The burden of proof for showing that a plaintiff failed to mitigate damages lies with the defendant.

The right person for the job

Economic damages cases draw on many of the same skills required for business valuations, including accounting, financial analysis, benchmarking and discounted cash flow techniques. But economic damages calculations and valuations do differ in some ways.

One key difference is that damages experts enjoy the benefit of hindsight. For example, they may consider how the industry and subject company actually performed during the damages period. But in valuations, subsequent events are taboo unless they were known or reasonably foreseeable on the valuation date.

In any case, an expert with previous experience in damages cases and a thorough understanding of relevant case law and accepted technical methods can make all the difference in whether the case is won — or lost. ●

