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Tips for Working with Damages Experts to Establish Lost Business Value

By Brent K. Bersin – December 5, 2018

Assessing and measuring economic damages in commercial litigation typically requires the testimony of an expert witness. Economic damages are often assessed in terms of lost profits or lost business value. Before retaining an expert, be sure to familiarize yourself with the key concepts regarding the lost business value theory of damages and the related role of the damages expert.

Role of the Damages Expert

Economic damages represent the measurement and amount of a monetary award sufficient to compensate a plaintiff for losses resulting from the defendant's alleged conduct. The measurement of damages is predicated on the specific causes of action (e.g., breach of contract, tortious interference, or unfair competition) and the available remedies afforded by relevant case law or statute (or both). In seeking a damages award, a plaintiff must prove the underlying elements of both liability and causation, though in most instances a damages expert's assessment of damages is based on an assumption of liability, subject to proof of liability through lay witnesses and documentary evidence. For a damages expert, damages are measured under the "but for" predicate, meaning what would have occurred "but for" the defendant's alleged conduct.

Lost Business Value Framework

Lost business value represents an *ex ante* measure of damages resulting from the diminution or destruction of the value of a business. Overall, business valuation is a function of the expected future income or net cash flows of the business indefinitely, discounted to present value as of the valuation measurement date (typically the date of alleged harm). The determination of lost business value, unlike lost profits, should consider only factors known at the date of the value measurement. The table below is a summary of some key differences between the calculations of lost profits and lost business value.

Lost Profits Versus Lost Business Value

Issue	Lost Profits	Lost Business Value
Initial Measurement Date	Judgment Date (past and future losses)	Valuation Date
Information Considered	Ex Post	Ex Ante
Period of Damages	Discrete or Fixed Period	Perpetuity
Earnings Measure	Incremental Income	Net Cash Flow
Income Taxes	Pre-Tax	After-Tax

If a subject business has been "destroyed" due to alleged actions of the defendant, the damages expert estimates the "but for" value of the business. The "but for" value of the business assumes that it continued operating absent the defendant's alleged conduct. The "but for" valuation generally serves as the estimate of damages, as it presumes that the "actual" business value is zero or negligible due to its destruction. In circumstances where the subject business value has been significantly impaired or diminished, but not destroyed, by the alleged actions of the defendant, damages are measured as the difference in the estimated "but for" value (absent the harm) and "actual" value (with the harm) of the subject business.

Standard and Premise of Value

When determining lost business value, both the standard and premise of value must be identified. The standard of value represents the conditions under which business value is measured. *Fair market value* is the most prevalent standard to measure lost business value. The U.S. Internal Revenue Service (IRS) defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." The IRS defined fair market value in its Revenue Ruling 59-60.

The premise of value refers to the purpose and circumstances of the valuation. In most cases, *going concern value* is used in determining lost business value. *Going concern value* presumes that the subject business will continue to operate into the future indefinitely.

Valuation Approaches and Methods

There are three primary approaches to measuring lost business value based on accepted valuation theory: (1) the income approach, (2) the market approach, and (3) the cost approach. An overview of the three approaches and related calculation methods are provided below.

> **Income approach.** The income approach values a business based on the present value of expected future income or cash flows from the business. The present value (as of the valuation date) of the income or cash flows is determined by applying a risk-adjusted, market-based discount rate. The income approach includes two principal calculation methods: (1) capitalization of earnings and (2) discounted cash flow (DCF). Under a capitalization of earnings method, lost business value is calculated by dividing the income stream for a single period (typically one year) by a capitalization rate (i.e., discount rate less long-term growth rate). This method is typically used when the subject business is mature, when long-term growth is expected to be stable, or when both circumstances are present. A DCF valuation is calculated by preparing a multiyear, discrete projection period, which is added to a "terminal value." Terminal value captures the remaining value of the business from the end of the discrete projection period into perpetuity (i.e., assumes a going concern premise).
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> **Market approach.** This approach uses market and transactional data to determine business value. The theory behind this approach is that measures of value for similar companies that have been sold or transferred in arm's-length transactions represent a reasonable proxy for the specific business that is being valued. There are two key

methods for determining value under the market approach: (1) the guideline publicly traded company method, which identifies similar publicly traded companies and their related trading or pricing multiples; and (2) the guideline transaction method, which identifies similar company transactions or sales from which pricing multiples may be discerned or computed. The subject multiples derived under either or both methods may be applied to the subject business's income or cash flow measure to estimate business value.

Cost approach. This approach measures business value by determining the fair market value of the subject business's assets and liabilities. This approach may be used in valuing asset-heavy businesses or businesses without a consistent or established history of earnings, among other reasons.

Information Sources for the Valuation

The valuation of lost business value will require the review and analysis of pertinent information, along with independent research by the damages expert. Counsel can assist the damages expert in collecting and requesting the required information which may include the following, among other things:

- Financial statements, including (i) income or profit and loss statements, (ii) balance sheets, (iii) statements of cash flows, and (iv) statements of retained earnings
- Federal tax returns and accompanying schedules
- Product line level financial statements
- Accounting general ledgers
- Accounts receivable and accounts payable listings
- Perpetual inventory listings
- Depreciation and amortization schedules
- Fixed asset ledgers
- Business budgets, forecasts, and projections
- Historical revenue by customer
- Loan agreements
- Shareholder agreements
- Operating agreements
- Customer agreements or contracts
- License agreements
- Market share and competitor analysis
- Business purchase or sale offers
- Prior valuations of the business

Conclusion

The choice of the measure of damages is based on the specific case facts and applicable case law. In commercial litigation, lost profits is the most prevalent measure of economic damages while lost business value is more case-specific. Lost business value is typically considered as a measure of damages for the destruction of or diminution in value of the business or when the calculation of lost profits is deemed too speculative. Continuing dialogue between counsel and the damages expert is essential, as is further research of relevant case law.

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