

BUSINESS DAMAGES: LOST PROFITS OR LOST BUSINESS VALUE?

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I. INTRODUCTION

This paper discusses techniques for calculating lost profits in business litigation matters. It approaches the problem from a financial perspective rather than a case law perspective. The paper is not a thorough discussion of case law on the subject and it should only be used in connection with the author's oral presentation.

II. LEGAL BASIS FOR RECOVERY OF LOST PROFITS

A. **California Civil Code §3333.** Breach of obligation other than contract. For the breach of an obligation not arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate for all the detriment proximately caused thereby, whether it could have been anticipated or not.

B. **California Civil Code §3300.** Measure of damages for breach of contract. For the breach of an obligation arising from contract, the measure of damages, except where otherwise expressly provided by this code, is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom.

C. **Proximate Cause.** Recovery of damages for loss of profits is subject to the general principle that damages must be proximately caused by the wrongful conduct of the defendant. This principle governs the recovery of all compensatory damages. Some early cases suggested that the requirement of proximate cause was less stringent in tort cases. No logic supports the suggestion. Proximate cause of damages is the same thing, whether the underlying claim is based on contract, on tort or on both.

D. **Reasonable Certainty.** The second requirement for recovery of damages for loss of profits is that the damages be proven with "reasonable certainty."

1. Those courts that have gone further than a simple statement that "reasonable certainty" is required have almost invariably recognized that the rule applies only to the *fact* of damages, not to the *amount* of damages.

2. Proof of the fact of damages in a lost profits case means proof that there would have been some profits.

3. Once this level of causation has been established for the *fact* of damages, less certainty (perhaps none at all) is required in proof of the *amount* of damages.

4. While the proof of the *fact* of damages must be certain, proof of the *amount* may be an estimate, uncertain or inexact. (Citations omitted.)

E. **Foreseeability.** Courts routinely state that damages must be foreseeable to be recovered in a breach of contract case. It appears, however, that the foreseeability rule has been somewhat superseded by the principle of proximate cause.

1. Foreseeability of damages is a contract principle. When lost profits are claimed in a tort action, no demonstration of foreseeability is required.

III. LOST PROFITS: FINANCIAL BASIS

A. **Three Conceptual Areas.** Lost profits damages claims fall, generally, into three conceptual areas: those in which a business suffers reduced income, but continues to exist; those in which a business ceases or terminates some or all of its operations; or those in which a business never commenced operations.

B. **"Methods."** A calculation of lost profits invariably requires certain factual assumptions about the level of profitability that would be attained, but for the happening of some tort or breach of contract. Some authors have referred to the following bases of assumption as *methods* of calculating lost profits, but intellectual scrutiny indicates that these approaches are not truly alternative "methods." Nevertheless, they are:

1. Before-and-after method. In this method, the operations of the subject company are projected from some historical results as if there had been no damage to the subject company. These projected results are then compared to the actual results during the period of the effect of the alleged acts.

a. This approach is generally best suited to a business having an established pattern of activity or track record.

b. This approach depends on the expert's ability to establish and support a proven historical track record of the plaintiff so that the pre-damage period and/or post-damage period can serve as benchmarks.

c. The financial analyst must be careful to consider factors such as seasonality and unusual or non-recurring factors.

2. The yardstick approach. This method requires the analyst (a) to identify some "comparable" company or industry benchmark and (b) to plot the hypothetical performance of the subject company along performance lines of the comparable company or industry. The actual performance of the damaged company is compared to the "yardstick" projection and the difference is the basis for the loss calculations.

a. This approach is best suited when the plaintiff does not have a sufficient period to prove a historical financial track record for the business.

b. The difficulty with this method lies in identifying substantially similar companies or industry benchmarks.

c. Proper application of this approach may require adjustments to be made in the comparable company or industry data.

d. In some cases, a comparable, but unaffected, division or branch of the plaintiff may provide the necessary benchmark.

e. In some cases, a regression analysis can be used to establish the level of correlation existing between the "yardstick" data and the historical data of the subject company. Conceptually, regression analysis is a time-series method which measures the extent to which one set of data depends upon, or is influenced by, another.

3. Sales projections (but-for) method. Under this method, operations of the subject company are projected during the damage period absent (i.e., but for) the alleged effects of the defendant's actions. The economic returns projected by this model are then compared with the actual results realized by the subject company during the damage period.

a. This method requires the creation of some type of a forecast of business activity during the damage period based on certain "but for" assumptions.

4. **Summary of Methods.** These "methods" or approaches are discussed in various financial literature as though they are truly different; it appears that they are simply alternative bases for assumptions of "but-for" lost revenues or lost profits. In the "before-and-after" method, the underlying assumption is the historical operations of the business. In the "yardstick" approach, the underlying assumption is a comparison to some external benchmark. In the "sales projections" method, the underlying assumption is some other basis for projecting anticipated revenue or profit during the damage period. Regardless of the chosen "method," the financial analyst should carefully consider:

a. The logical basis for assuming the reasonableness of the hypothetical projection.

b. The existence of factors other than the defendant's conduct that could influence the hypothetical projection (i.e., seasonality, business cycles, competitive forces, general economic conditions, industry conditions, etc.).

c. The financial ability of the plaintiff to achieve the hypothetical projections (i.e., production capacity, capital structure, human resources, management capabilities, etc.).

d. A comparison of the hypothetical projections in relation to the plaintiff's historical operating activity.

C. Profits as Damages. Lost profits damages are usually defined as lost net profits; all costs must be deducted.

1. For breach of contract, this means the contract price less cost of performance.

2. For lost profits generally, this means the lost gross revenue minus all "expenses saved."

3. Recovery of lost gross revenues or lost gross profits is correct when gross revenues or gross profits are the same as net profits.

D. Estimating Costs. Once the loss of sales volume caused by defendant's alleged misconduct has been estimated, the loss of profit thereon (sales minus related costs) must be determined because damages relate to lost *net profits*. Estimating costs is essential to any lost profits analysis.

1. The plaintiff's historical financial (including costs) data is usually the basis upon which to estimate the "but for" incremental costs.

2. An analysis of variable expenses, semi-variable expenses and fixed expenses will be undertaken.

IV. CALCULATION OF DAMAGES

A. Definition of Financial Terms.

1. Gross revenue. Increase in assets as a result of the sale of goods or services.

2. Gross profit. Revenue minus direct costs of sales. Sometimes referred to as gross margin.

3. Net profit. Revenue minus all costs of sales and all expenses incurred in operation of business.

4. Variable expenses. Expenses that vary with the level of revenues. For example, food costs in a restaurant, direct labor in a factory, water expense in a laundromat, etc.

5. Fixed expenses. Expenses that do not vary with gross revenues (within a relevant range of production). For example, rent expense, insurance expense, administrative salaries, etc.

6. Semi-variable expenses. Expenses that are part fixed and part variable. For example, telephone charges may have a fixed monthly component plus a variable component relating to long distance or high volume use.

7. Overhead. Overhead is a broad category of expenses that may include both variable and fixed expenses. These expenses are generally not directly traceable to the finished goods (or services) that are produced. In sophisticated cost accounting systems, overhead expenses are allocated to finished goods through some overhead allocation system. It is a complicated factual question whether overhead expenses are "saved" when gross revenues are lost.

B. Lost Profits Calculations.

1. Using one or more of the "methods" discussed in the earlier section, the analyst projects the plaintiff's assumed financial activity (gross revenue, gross profit, net profit) during some past or future damage period.

a. The facts and assumptions underlying the analyst's projection should be explored by opposing counsel to determine their legitimacy.

2. The projected financial activity may be gross revenues, gross profits or net profits.

3. The actual results during the past or future damage period are subtracted from the projected results during the damage period.

a. This calculation yields a "difference" in financial activity expected and financial activity achieved.

b. If the differential measure is gross revenues, those revenues should be reduced by expenses "saved" because the revenues were not achieved.

i. All direct costs relating to the lost gross revenues should be subtracted to compute net profits lost.

ii. Variable costs relating to the lost gross revenues should be subtracted to derive lost net profits.

iii. Depreciation expense should probably not be deducted from lost gross revenues to derive lost net profits, although some cases have held to the contrary (see Dunn).

iv. The treatment of overhead expenses in this type of calculation is complicated. Some overhead expenses may be fixed, and therefore not "saved" when gross revenue is lost; these fixed overhead expenses should not be deducted from lost gross revenue to derive lost net profits. Alternatively, some overhead expenses may be variable indirect expenses and they are therefore "saved" when gross revenue is lost. These variable overhead expenses should, arguably, be deducted from lost gross revenue to derive lost net profits.

v. Generally, tax benefits are not to be considered in computing economic loss damages.

aa. A plaintiff seeking to recover investment or other losses is not required to offset taxes saved as a result of write-offs of the losses.

bb. A plaintiff seeking to recover lost profits is not required to deduct the taxes it would have had to pay on the profits to arrive at net profits.

4. **Discounting.** Future lost profits should be discounted at an appropriate rate because the purpose of the award of damages is to provide a fund that, with principal and interest, will yield plaintiff an amount equivalent to its loss. The discount rate will have two components:

a. A component to recognize the time value of money, i.e., that one dollar to be received at some point in the future is not worth one dollar today; and

b. A component which recognizes the risk of achieving the profit expectation. This component is frequently referred to as the "risk premium." (See discussion in section V.)

THE RELATIONSHIP OF PROFITS TO BUSINESS VALUE

A. **Valuation Theory.** It is generally recognized that the fair market value of an asset is the present value of its future earning capacity, discounted at an appropriate risk-adjusted rate to compensate the holder for the risks of ownership.

B. **Business Valuation.** Although there are many complicated methods for valuing a business, in concept, they all revert back to a "present value of future benefits" theory.

1. Market data approaches. These methods approach the business valuation issue by means of some marketplace comparison (comparable sales, guideline company approach, marketplace rule-of-thumb analysis).

2. Income approaches. These methods estimate the value of a business by capitalizing some present income estimate or discounting a future income estimate (capitalization of earnings or cashflows, discounted future earnings or cashflows, price/earnings ratio analysis).

3. Hybrid approach. A method that incorporates some aspect of earnings and assets.

C. **Profits and Value.** In its simplest conceptual form, value is the present sum of all anticipated profits.

1. When anticipated profits are discounted at a risk-adjusted rate commensurate with the security of the investment, their present sum equals the value of the business.

2. In some circumstances, particularly *small* businesses, the risk-adjusted rate may be dramatically different from the risk-free rate.

a. In very small businesses, it is not unusual to conclude that an appropriate risk-adjusted discount rate is 40%, 50%, or even as high as 100%. (Stated inversely, these discount rates amount to multiples of income of 2.5x, 2.0x, and 1.0x, respectively).

3. Given the relationship of value to profits (value equals PV of profits), the present value of a business' lost profits cannot logically exceed the value of the business.

4. If the present value of lost profits exceeds the value of the business, a plaintiff would be compensated for more than it lost.

D. **Discount Rate.** Many methods have been proposed to empirically determine the discount rate for a stream of anticipated future business income, but all the methods incorporate a significant amount of judgment by the analyst or appraiser. Consequently, it must be concluded that the proper discount rate is, among other steps of *objective* financial analysis, a matter of subjective judgment.

1. Notwithstanding the judgments inherent in discount rate selection, if the "correct" benchmark for the discount rate is the marketplace, the present value of all profits will equal fair market value of the business.

2. If the "correct" benchmark for the discount rate is the risk of future profits to the owner of the business (investment value), then the present value of future profits will equal investment value of the business.

a. Investment value is defined as value to a particular investor based on individual investment requirements, as distinguished from the concept of market value, which is impersonal and detached.

E. Proffered Theories of Discount Rate Rationale. Following are some proffered theories of discount rate rationale that may or may not be appropriate in certain circumstances (and not necessarily agreed to by this author):

1. The correct discount rate for discounting anticipated profits is the discount rate for the business as a whole (market value discount rate). Theoretically, this is a detached assessment of the risk of the continuity of anticipated profits.

2. Since the income flow is owned by the present, existing business, the appropriate discount rate to assign to the anticipated income flow is the subjective risk of that income flow to its owner (investment value). The investment value discount rate would usually be lower than the market value discount rate, resulting in a higher present investment value than present market value. Theoretically, a plaintiff would not be over-compensated in this type of analysis because the plaintiff already owns the present value of the anticipated profits, given the plaintiff's subjective risk of receiving those profits.

3. The correct discount rate for determining the present value of anticipated lost profits is a risk-free rate. This proposition is based on the assumption that the expected future profits are determined as a fact by the trier of fact, thereby reducing them to a virtual certainty. Consequently, those "certain" profits should be reduced to present value using a risk-free discount rate.

4. If the loss in profits is measured by a particular increased expense, it can be suggested that the increased expense (cost, or implicit loss of profits) should be discounted at a risk-free rate because this "loss of profit" is a virtual certainty. Arguably, there is a different risk of this "certain" increased expense as opposed to the risk of anticipated future profits.

5. The marginal profits that are assumed to be lost in the present dispute are higher risk than the normal, anticipated profits of the business. Therefore, a higher discount rate should be used for those lost profits, resulting in a lower present value. An example of this situation would be lost anticipated profits when those profits strain the existing capacity of the business, or stem from some new and unproven technology of the business, or some other factor that causes them to be more speculative than the ongoing profit from regular operations. Or, it could simply be said that

the marginal or incremental profits of the business (those assumed to be lost in the present dispute) are always riskier than the overall anticipated profits of the business.

6. The marginal profits that are assumed to be lost in the present dispute are lower risk than the normal, anticipated profits of the business. Therefore, a lower discount rate should be used for those lost profits, resulting in a higher present value. An example of this situation would be lost anticipated profits from an identifiable segment of the business that is considered lower risk than the "average" operations or profitability of the business as a whole.

F. **Summary.** If the risk of the future profits is measured by the subjective risk to the present owner (investment value), the present value of future profits can be greater than fair market value of the business. If the risk of the future profits is measured by the hypothetical objective risk of those profits in the marketplace (to hypothetical investors), the present value of profits will equal fair market value. There are other theories of rationale for discount rates for lost profits. Proper discounting will always depend on the facts and circumstances of each case and a careful financial analysis of the risk of the anticipated (or lost) profits.

VI. CONCLUSION

The calculation of lost profits is a complex matter that is heavily dependent upon the unique facts of each particular case. In its simplest form, the calculation is simply a projection of the hypothetical profits that would have existed "but for" the defendant's action, minus the actual profits that did exist after the defendant's action. The basis of the calculation is primarily factual. The financial analyst should have a logical, defensible position supporting his or her assumption regarding anticipated revenues and all costs associated with those revenues. The discounting of lost profits will always require some subjective judgment on the part of the analyst, but the result of the discounting of lost profits should have a relationship to the current value (either fair market value or investment value) of the plaintiff business entity. If the present value of lost profits is significantly greater than the current value of the business entity (or portion that was damaged), compensation to the plaintiff may be greater than the *value* of what the plaintiff lost.

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1. Dunn, Robert L., *Recovery of Damages for Lost Profits*, 5th Ed (Westport, CT: Lawpress Corporation, 1998), p 2. *Mr. Dunn's treatise on damages is comprehensive and authoritative. It is a "must read" for all students of damages. The legal aspects of this paper are liberally quoted (with attribution, but without case citations) from Mr. Dunn's fine work.*
 2. *Ibid*, p 6.
 3. *Ibid*, p 9.
 4. *Ibid*, p 17.
 5. *Ibid*, p 17.
 6. *Ibid*, p 17.
 7. *Ibid*, p 17.

8. *Ibid*, p 77.
9. *Ibid*, p 77.
10. Pratt, Riley and Schweih, ***Valuing Small Businesses & Professional Practices***, 3rd Ed. (New York, NY: McGraw-Hill, 1998) p 830. See also Weil, Wagner and Frank, Eds, ***Litigation Services Handbook, The Role of the Accountant as Expert***, 2nd Ed. (New York, NY: John Wiley & Sons, Inc.) p 30-2.
11. Dunn, *op. cit.*, p 430.
12. *Ibid*, p 465.
13. *Ibid*, p 465.
14. ***The Dictionary of Real Estate Appraisal***, 3rd Ed. (Chicago, IL: Appraisal Institute, 1993).

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