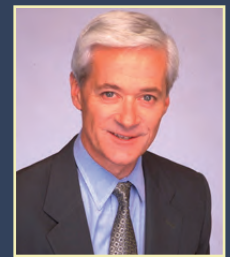


DUNN ON DAMAGES

THE ECONOMIC DAMAGES REPORT FOR LITIGATORS AND EXPERTS



ROBERT L. DUNN

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Please enjoy the following article, reprinted from
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DAMAGES MEASUREMENT AND THE BUSINESS VALUATION REPORT—CHALLENGES AND PITFALLS



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INTRODUCTION AND OVERVIEW

Business damages are often based upon the value of a lost stream of economic income. Some experts measure the loss as the change in plaintiff's business value on or about the date of defendant's alleged legal wrongdoing. Other experts determine the loss on or about the trial date by evaluating what the plaintiff would have accomplished "but for" the defendant. These alternative damages computation methods are referred to as the business valuation ("BV") approach and the lost profits ("LP") approach, respectively. An expert using the BV approach frequently prepares a written valuation or appraisal report either to support or rebut the plaintiff's damages.

This article explains the fundamental differences between the two approaches; addresses theoretical issues related to the alternative methods; and, then, presents examples of challenges and pitfalls of preparing a valuation or appraisal report to measure business damages. In many instances, a LP study may be more defensible and better serve the client's interests than a BV report.

BV v. LP METHODOLOGIES—THEORETICAL AND PRACTICAL DIFFERENCES

The BV methodology encompasses three valuation approaches—the income approach, the market approach and the asset-based (or cost) approach. As a going concern, the value of a business reflects the present value of the economic income (cash flow) to be returned to the owner or

investor, even if determined by market indicators of such value. Thus, the BV income approach is the focus of this article.

The BV income approach and the LP methodology are theoretically similar since both involve cash flow projections that are discounted to a valuation date; however, the BV and LP methodologies in principle and practice typically result in materially different damages amounts. **Table 1** below presents the primary reasons that damages amounts vary under the BV and LP methodologies, including differing information sets (i.e., *ex ante* v. *ex post* data and information), valuation dates, discount rates and periods of loss.

Business damages arise from a variety of alleged wrongs, such as breach of contract, intellectual property misappropriation, or distributorship termination. Losses may be computed as the resultant diminution of business value as of the date of legal wrongdoing or the present value on or about the trial date for the lost economic income over an ap-

propriate period of damages. The two approaches are summarized below.

- Business valuation methodology—Determine the lost business value as the difference between 1) the unimpaired value based upon expected future performance as of the date of legal wrongdoing and 2) the impaired business value usually measured as of the date of injury. The loss or damages is determined using data and information available or reasonably ascertainable as of the valuation date, which may be well before the trial date.
- Lost profits methodology—Evaluate the "but for" and actual (impaired) streams of economic income following the date of alleged wrongdoing. The difference between the streams represents the lost economic income. Consider all disclosed and reasonably obtainable information through the date of an expert report and/or presentation of expert testimony, includ-

Continued on next page

TABLE 1
Common Differences between the BV (*Ex Ante*) and LP (*Ex Post*) Methodologies

Consideration	Business Valuation	Lost Profits Analysis
Valuation date	Date of legal wrongdoing	On or about trial date
Data and information for damages computation	Available or ascertainable through valuation date	Available or ascertainable through report/testimony date
Projected stream of economic income	<i>Expected</i> economic income given information as of the valuation date	"But for" or <i>expected</i> economic income adjusted for post-injury date information about risk resolution
Discount rate	Higher rate including subjective risk factor for unresolved uncertainties existing at the valuation date	Lower rate recognizing any risk resolution after the date of legal injury
Discounting	Discount all projected income back to valuation date, then bring forward with prejudgment interest, if applicable	Discount future lost income back to on or about the trial date--Do not discount past losses but bring forward with prejudgment interest, if applicable
Period of Damages	Perpetuity	Limited by law and case facts

ing information arising after the date of the alleged legal wrongdoing. As appropriate, consider whether the business would have performed better or worse than expected as of the date of legal wrongdoing and the extent to which any variances are attributable to defendant compared to other factors.

THEORETICAL ARGUMENTS FOR THE BV APPROACH

A theoretical debate has ensued for many years about whether damages should be measured as of the date of the legal wrong or a later point in time, such as the date of trial. In short, the issue is whether “hindsight” information should be used to determine damages. In 1990, Franklin M. Fisher and R. Craig Romaine (“F&R”) wrote that plaintiff’s loss should be measured on or about the date of the legal violation.

The violation did not merely deprive the plaintiff of the stream of returns that would have accompanied the asset. It also relieved the plaintiff of the uncertainty surrounding that stream. To use hindsight is to ignore the latter effect.¹

Konrad Bonsack promptly responded by stating the following:

The Court thus made a distinction between the market value and the intrinsic value of an asset at the time of the violation. Market value is limited to the knowledge available at the date of the violation and is based on the expected future benefits and costs associated with the asset. Intrinsic value is dependent upon future actual benefits and costs, unknown at the time of the violation. ... under the traditional rules of property, the benefit of unexpected accruals and the cost of unforeseen losses lie with the owner of the property. ... The risks associated with the asset at the time of the violation may have converted through time into actual profits or losses or both.²

The BV approach is consistent with the F&R view. Hindsight is not used since the valuation date is on or about the date of the alleged legal wrongdoing and the valuation is based upon information then

available or reasonably ascertainable. Further, the BV discount rate (e.g., WACC or a build-up rate) reflects the required rate of return to adequately compensate an owner or investor for bearing the risk and uncertainty. Therefore, BV approach proponents contend that a properly prepared business valuation 1) identifies unresolved risks and uncertainties as of the valuation date, 2) converts such uncertainties into an appropriate expected value and, thus, 3) does not compensate plaintiff for risks that the plaintiff did not bear by use of a BV discount rate.

EX ANTE v. EX POST INFORMATION – THE USE OF HINDSIGHT

A business valuation is essentially an *ex ante* methodology that does not directly incorporate hindsight information into the projected, expected stream of economic income. In accordance with BV standards and guidance, only information available or reasonably ascertainable as of the valuation date is considered even if the trial is held years later.

Ex ante is a Latin term meaning “beforehand” or “before the event.” In contrast, *ex post* is the Latin term for “after the fact.”³ In the context of litigation, the terms respectively relate to the use of information that is available through the alleged wrongdoing date compared to on or about the trial date. By the time of trial, certain risks and uncertainties existing as of the *ex ante* date may have been resolved in full or part.

Court decisions reflect acceptance of both approaches; however, the general trend is toward the use of *ex post* data and information, as recently summarized by Michael J. Wagner:

The ‘outcome’ or ‘*ex post*’ measure of damages is by far the most common type of damages awarded in commercial litigation. It is a calculation that attempts to put the plaintiff in the same economic position that the plaintiff would have been if the legal violation had not occurred. All information up until the time of trial is used to make the most accurate calculation of damages possible.⁴

Damages based upon an *ex ante* approach may compromise the reliability of the expert’s report and the expert’s courtroom testimony, particularly when 1) the intrinsic value of the alleged lost economic asset as revealed over time is at issue and 2) the court is inclined to place greater reliance upon *ex post* than *ex ante* data and information.

COMMON THEMES OF BV REPORTS PREPARED FOR LITIGATION USE

Business valuation reports are submitted for litigation to measure any damages and, for example, involve disputes over a directed suspension of contract rights, termination of a product distributorship, and alleged detrimental reliance upon false representations in a joint development agreement. Typical but not universal attributes of these BV reports and the attendant case facts include the following:

- The alleged lost business opportunity would have been manifested after the date of the purported legal wrongdoing.
- Plaintiff would have retained its business (i.e., would not have sold it) “but for” defendant’s actions.
- The written BV report presented an opinion or conclusion of value, and was not characterized as only a calculation of value or limited appraisal.
- The BV report stated compliance with the valuation standards of the American Institute of Certified Public Accountants, American Society of Appraisers, National Association of Certified Valuation Analysts and/or Uniform Standards of Professional Appraisal Practice, as well as IRS Revenue Ruling 59-60.
- The standard of value typically was *fair market value*.
- The valuation analyst relied upon business projections prepared by company management, which were not independently verified by the expert. Further, the management projections bore no resemblance to company historical returns.
- The valuation analyst did not perform meaningful, if any, evaluation of information arising after the valuation date

Continued on next page

to compare *expected* and actual outcomes, including assessment of the causes for any post-valuation date variations.

- The expert could have measured damages by a LP study instead of using the BV approach.

WHEN A BV REPORT IS ACCEPTABLE

The BV methodology is appropriate under certain circumstances and, sometimes, may be preferable to a LP study, such as illustrated below.

- Plaintiff's legal claim specifically involves the value of an asset at a date well before the trial and hindsight or *ex post* information is not especially relevant. Examples may include the value of a professional practice at the separation date for a divorce or the value of an asset said to be involved in a fraudulent transfer.
- Case evidence indicates that the plaintiff would have disposed of the asset on or about the date of the alleged legal wrongdoing but for the defendant's interference.

Generally, a BV report prepared to measure damages will not be challenged *per se* if the opposing financial expert also prepares a BV report.

TEN EXAMPLE CHALLENGES AND PITFALLS FOR MEASURING DAMAGES BY THE BV METHODOLOGY

1—Erroneous Belief that the BV Methodology Is Appropriate and Preferred by the Courts

BV methodology proponents believe that a plaintiff's loss should be measured as of the date of alleged legal wrongdoing, and argue that a plaintiff should not be rewarded (or penalized) for future favorable (or unfavorable) resolution of uncertainties. These experts believe the BV methodology is acceptable to and preferred by the courts, at least for the instant lawsuit.

Case example: The BV report affirmatively stated that the damages measure for a destroyed business "is" the market value of the business at the date of defendant's alleged legal wrongdoing.

Court decisions state that the BV and LP methodologies are alternatives, but often reject the BV methodology in favor of the LP approach. A recent example was documented in a United States Court of Appeals decision dated March 10, 2010 regarding *Anchor Savings Bank v. United States*. The government argued that any damages should be based upon the fair market value of the disposed entity if sold under non-distress circumstances. The government's argument was rejected and the court affirmed damages awarded based upon the lost profits methodology.

The government's interpretation of *Lincoln* is incorrect for two reasons. First, *Lincoln* recognized two permissible methods of measuring damages: (1) the market value of a lost income-producing asset ('lost asset' or 'lost asset value' damages); and (2) future lost profits that could have been derived from the lost income-producing asset ('lost profits' damages). ... Neither decision mandates that one measurement method must invariably be used, as opposed to the other. ... (The court) considered the two permissible methods ... Ultimately, the court concluded that the most accurate approach was to base the award of damages on RFC's actual post-breach profits.⁵

In *Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicoff & Kotkin*, 247 Conn. 48, 717 A.2d 724 (1998), the Supreme Court of Connecticut also affirmed that the measure of damages for a destroyed business is not limited to lost business value:

We next address the question of whether lost profits are an appropriate measure of damages for the destruction of a nascent enterprise. The defendants argue that the appropriate measure of damages for the destruction of a business is its going concern value at the time of its destruction rather than lost profits. The plaintiff argues that the present value of a stream of expected future profits is an appropriate way to value a business and that it is therefore an appropriate meas-

ure of damages. We conclude that it is proper to award damages for the destruction of an unestablished enterprise and that lost profits may constitute an appropriate measure of damages for the destruction of such an enterprise.

2—Incorrect Belief that a BV Report Prepared for Litigation is Exempt from the BV Standards

Some BV experts mistakenly believe that BV reports prepared for litigation are exempt from the BV standards and, thus, base opinions or conclusions of value upon important but unverified assumptions, which would have been vetted if the BV analyst prepared the report in a non-litigation setting. The misplaced belief may stem from the premise that litigation experts can work with stipulated facts and assumptions,⁶ which the expert anticipates will be proven by other witnesses or through evidence presented at trial. The BV expert developing and reporting an opinion or conclusion of value, said to be in compliance with the applicable valuation standards, bears an independent responsibility to perform sufficient investigation to support the conclusion, as exemplified in USPAP 2010-2011 rules.

Standards Rule 9-4

In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must collect and analyze all information necessary for credible assignment results. ...

(b) An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of: ...

(iii) past results, current operations, and future prospects of the business enterprise...⁷

Courts expect a litigation expert to adhere to reliable methodologies and perform the same requisite work to support his or her opinion as if the findings were developed for non-litigation purposes:

Ultimately, the object of the court's Rule 702 reliability inquiry is to ensure that the opinions expressed by

Continued on next page

testifying experts 'adhere to the same standards of intellectual rigor that are demanded in their professional work.'⁸

The various BV standards do not provide a general exemption for the litigation-related development of an opinion or conclusion of value; however, for example, the AICPA Statement of Standards on Valuation Services No. 1 provides for an exemption from its Reporting standard.⁹ The AICPA BV standard is instructive in distinguishing between LP studies and BV assignments, and discussing when the BV standards must be followed.

Illustrations Relating to Litigation Engagements and Certain Controversy Proceedings

6. *Illustration 1.* Do lost profits damages computations fall within the Scope of the Statement?

7. *Conclusion.* No, unless the computations are undertaken as part of an engagement to estimate value (SSVS paragraphs 1, 2, and 8). ...

10. *Illustration 3.* If a start-up business is destroyed, is the economic damages computation within the scope of the Statement?

11. *Conclusion.* There are two common measures of damages: lost profits and lost business value. If a valuation analyst performs an engagement to estimate value to determine the loss of value of a business or intangible asset, the Statement applies. Otherwise, the Statement does not apply (*Illustration 1*). In order to determine whether the Statement applies, a member acting as an expert witness should evaluate whether the particular damages calculation constitutes an engagement to estimate value with respect to the business, business interest, security, or intangible asset or whether it constitutes a lost-profits computation.¹⁰

3—The BV Standards Increase the Expert's Burden in Defending the Conclusion of Value

The BV expert presenting an opinion or conclusion of value as a litigation service assumes the self-imposed burden of de-

fending his or her findings as compliant with the applicable BV standards, which provide a convenient cross-examination checklist for opposing counsel. The various BV standards, as well as the pertinent IRS revenue ruling, include relatively lengthy, detailed lists about the types of information to be evaluated by the BV analyst in developing the opinion or conclusion of value.

In contrast, the LP study is not subject to any general or detailed standards promulgated specifically for such analyses. Many certified public accountants preparing LP studies, for example, are subject to the AICPA's consulting standard,¹¹ which contains only seven broad standards that are applicable to many types of consulting services. A CPA expert, for example, preparing a LP study can still be questioned about analyses performed and information considered, but opposing counsel will not be able to legitimately suggest that the expert failed to comply with detailed professional standards designed just for the LP methodology.

4—Fair Market Value (or Similar) May Be Difficult to Prove and Irrelevant

The BV analyst can use alternative standards of value, but BV reports issued for litigation often select *fair market value* as the benchmark. The reported FMV may be hypothetical only because the analyst cannot locate and produce reliable information showing that plaintiff's business really could have been sold at or near the reported value.

Case example: The BV report stated FMV as the standard of value but, surprisingly, the written report concluded that the market approach to valuation was not appropriate because of a lack of market-comparable data for the appraised business. The expert admitted at deposition that he was unaware of several unsuccessful private placement memoranda prepared by the company shortly before the alleged wrongful conduct by the defendant. The failed PPM's were based upon similar business projections as used by the expert, which the capital market already rejected.

The BV analyst should consider whether a third party viewpoint (e.g., FMV, investment value) is relevant at all for the plaintiff. Case facts may reveal that the plaintiff intended to hold and

operate its business and had no intention selling the enterprise on or about the date of the alleged legal wrong. If so, the damages expert may focus on directly valuing the loss from the plaintiff's perspective, rather than attempting to prove what the lost business opportunity would have been worth to some well-informed, disinterested third party.

5—Lost Business Opportunity May Be Contradicted by Ex Post Information

A business valuation is developed based upon the information available or reasonably ascertainable as of the valuation date; however, the trial often occurs many years later. In the interim, considerable additional information generally arises that may contradict the BV premises about the projected business opportunity. The trier of fact may assign relevance to *ex post* information and reject the BV "blinders" approach to post-valuation date information.

For better or worse, information often arises after the date of alleged legal wrongdoing that resolves prior uncertainties in whole or part, which the court may consider in evaluating any damages. Thus, the court's acceptance and use of *ex post* information may contradict the BV analyst's *ex ante* conclusion of value.

Case example: Oil and natural gas exploration and extraction operations were stopped in mid-2001 by the government's directed suspension. Defendant's BV expert valued any loss as of mid-2001 using the existing crude oil price of less than \$20 per barrel, which was forecasted to increase only modestly in ensuing years. By the time of the trial, about ten years later, crude oil prices had occasionally surpassed \$100 per barrel. In a related case, the court ruled that an average \$55 per barrel of crude oil was appropriate for the subject historical period. As a result, defendant's expert had to amend his original report to reflect *ex post* price information, as well as to update projected operational costs. In this instance, defendant's expert was fortunate that the court accepted an amended report with an altered valuation date and supporting information.

Continued on next page

6—Causation Presumption May Be Contradicted by *Ex Post* Information

BV analysts frequently presume that the defendant caused the partial or full destruction of the plaintiff's business and, sometimes, affirmatively present this assumption in the BV report. Thus, many BV analysts focus on evaluating the information available or reasonably ascertainable as of the valuation date, and do not sufficiently investigate post-valuation date information that may reveal the ultimate reasons that plaintiff's business would have failed to achieve the expected results.

A business failure may unfold over several years and not be immediately experienced on or about the alleged wrongdoing date. The ultimate causes of the lost opportunity may include factors beyond the plaintiff's causation theory and that are unrelated to the defendant.

Case example: The BV report disclaimed an opinion about causation for the reported lost business value. However, information produced during discovery indicated that defendant was not 100 percent, or even substantially, responsible for plaintiff's loss. For example, the *ex post* information showed that plaintiff's projected new product sales were not realized because of plaintiff's difficulties in implementing the envisioned technological improvements, plaintiff failed to meet customer technical requirements under manufacturing agreements, and hoped-for new customer relationships simply never materialized for reasons disassociated with the defendant.

The BV analyst providing litigation services may bear an increased burden for information analysis. First, the BV expert needs to gather and review information available as of the valuation date to identify and quantify as-yet unresolved risks and uncertainties with respect to the business projection. Second, the expert should review and assess relevant *ex post* information to determine whether it contradicts the expert's *expected* stream of economic income and the presumption that the defendant caused the claimed loss. The BV analyst should be wary of a potential client who wants to limit the expert to preparing a BV report as of the alleged wrongdoing date under the assumption that all dissipation of plaintiff's business value was caused

by the defendant.

7—Subjective Risk Factor Added to the BV Discount Rate Difficult to Defend

BV analysts discount the *expected* outcome at a risk-inclusive rate, which includes economic compensation for the owners or investors to bear the risk that actual results will vary from the *expected* outcome. The overall discount rate usually is based first upon objective data for expected or required rates of return. In addition, BV analysts may augment the discount rate for subjective or company-specific risks by adding an additional discount rate premium.

When challenged about the selection of the subjective risk discount rate factor, BV analysts often experience difficulty providing empirical support and resort to defending the added risk premium as based upon "professional judgment." This answer alone is of little help to the court and may be rejected. The United States District Court excluded the testimony of an expert because, in part, he could not defend the inclusion of a subjective risk premium in his 18 percent discount rate.

Mr. Fox does not explain where he derived several of the numbers he used to calculate the discount rate, going so far as to boldly add 5.50% to the discount rate based on a category ominously entitled 'other adjustment.' ... Mr. Fox has provided the court with a discount rate, but the court has no means to test whether the discount rate that was chosen appropriately reflects the relative riskiness of the cash flows involved. ... The problem for the court is that Mr. Fox has never explained why he assigned the specific discount rate he did to this case as opposed to any other number. ... It seems, in the final analysis, the 5.5% number is wholly arbitrary. ... Mr. Fox readily admits that he does not know the error rate for his calculations.¹²

Company-specific risk may be addressed more directly in a LP study that considers the eventual resolution of certain business risks as revealed by *ex post* information and, then, makes discrete

adjustments to the business projection model.

8—The BV Implicit Period of Damages May Be Too Long

An opinion or conclusion of value for a business usually presumes that the "but for" enterprise was a going concern and reflects projected economic income to perpetuity. The income method to valuation commonly either 1) capitalizes projected Year 1 economic income or 2) projects economic income for a few years and then incorporates a terminal value. In either instance, the BV approach treats projected economic income in perpetuity.

The BV perpetuity damages period may be found inappropriate by the court either as a matter of law or as speculative. Instead, courts often find that damages are limited to a relatively shorter period of time, certainly in comparison to damages projected without end. The court may find that the nature of the alleged wrong constrains the damages period (e.g., damages are limited to the term of the breached contract) and that projecting losses too far into the future is speculation and conjecture.

In its September 15, 1998 decision regarding *Beverly Hills Concepts*, the Supreme Court of Connecticut provided guidance about an appropriate period of damages for a destroyed business, even though the court was addressing an alleged 12-year damages period.

Finally, we disagree with the trial court's decision to award lost profits over a twelve year period. We agree with the plaintiff that there is nothing inherently improper about allowing damages for lost profits over a twelve year period. What is improper, however, is to award damages over such a long time span when there is no evidence that the plaintiff would have survived for twelve years, let alone that it would have remained profitable for that length of time. In order to remove the assessment of damages from the realm of speculation, it is necessary to tie the award of damages to objective verifiable facts that bear a logical relationship to projected future profitability. ... We conclude,

Continued on next page

therefore, that the trial court abused its discretion in failing to limit the recovery of lost profits to a reasonable time period.¹³

9—BV Approach Inherently Over- or Understates Damages Compared to a LP Study

The BV and LP methodologies result in differing damages values as of the trial date because of 1) fundamental differences between the approaches regarding valuation dates and application of discount rates, and 2) differences concerning, for example, the incorporation of *ex post* information into the LP analysis.

Presuming that the BV and LP analysts agree that the plaintiff would have attained its *expected* economic income projection, the two analysts will still compute different damages amounts. The business valuation ap-

proach discounts all projected economic income back to the BV valuation date and, then, adds any prejudgment interest computed through the trial (or award) date. Thus, past and future losses with respect to the trial date are subjected to a BV discount rate that typically exceeds the prejudgment interest rate. In contrast, the LP methodology values damages as of the trial date. Past losses are not discounted, but the nominal loss amounts are brought forward with any prejudgment interest computed through the trial date.

Presuming that the LP analyst adjusts the *expected* outcome given *ex post* information, the otherwise existing damages difference between the BV and LP approaches can either increase or decrease. With respect to past losses, for example, the LP methodology will produce either a lower or higher value than

the BV methodology when the LP analyst adjusts the *expected* economic income to reflect the likelihood of subpar achievement given *ex post* information. Conversely, the LP methodology will produce a higher damages value for past losses than the BV approach if the LP analyst adjusts the *expected* economic income to reflect a better outcome given the *ex post* information.

Table 2 below provides examples of differences in past damages only that arise under the BV compared to LP approaches. The relative magnitude and direction of the difference depends upon the interplay of the degree of adjustment of the *expected* outcome and the relative difference between the BV discount rate and any prejudgment interest rate.

Continued on next page

TABLE 2
BV v. LP Approaches — Applied to Past Damages Only

15% discount rate--annually compounded							
7% prejudgment simple interest per year							
Trial at end of Year 5							
Description	Year						Trial
	0	1	2	3	4	5	
<u>BV or Ex Ante Approach</u>							
Expected economic income		\$ 1,000.00	\$ 1,050.00	\$ 1,102.50	\$ 1,157.63	\$ 1,215.51	
Discounted to Yr 0 @ 15% using mid-point convention	<u>\$ 3,919.15</u>	\$ 932.50	\$ 851.42	\$ 777.38	\$ 709.78	\$ 648.06	
With 7% simple interest added to Year 0 total, discounted amount shown above							<u>\$ 5,290.85</u>
<u>LP or Ex Post Approach</u>							
"But for" economic income equal to <i>expected</i>		\$ 1,000.00	\$ 1,050.00	\$ 1,102.50	\$ 1,157.63	\$ 1,215.51	
With 7% simple interest to trial date using mid-point convention		\$ 1,315.00	\$ 1,307.25	\$ 1,295.44	\$ 1,279.18	\$ 1,258.05	<u>\$ 6,454.91</u>
"But for" economic income 50% worse than <i>expected</i>		\$ 500.00	\$ 525.00	\$ 551.25	\$ 578.81	\$ 607.75	
With 7% simple interest to trial date using mid-point convention		\$ 657.50	\$ 653.63	\$ 647.72	\$ 639.59	\$ 629.02	<u>\$ 3,227.46</u>
"But for" economic income 50% better than <i>expected</i>		\$ 1,500.00	\$ 1,575.00	\$ 1,653.75	\$ 1,736.44	\$ 1,823.26	
With 7% simple interest to trial date using mid-point convention		\$ 1,972.50	\$ 1,960.88	\$ 1,943.16	\$ 1,918.76	\$ 1,887.07	<u>\$ 9,682.37</u>

10—Expected Value is an Average But Ex Post Information May Be More Specific

The BV approach is based upon discounting an *expected* stream of economic income. “*Expected cash flow* refers to the sum of probability-weighted amounts in a range of possible estimated amounts; the estimated mean or average.”¹⁵ The *expected* economic income concept is fundamental to the BV approach, and may expose the BV expert to uncomfortable cross-examination. For example, the BV analyst may be asked to describe the alternative outcome scenarios considered in developing the *expected* outcome, as well as the outcome probability assigned to each respective scenario. Then, the BV expert may be asked how the *ex post* information reflects on the ultimate accuracy of the alternative streams of economic income and respective outcome probabilities used to compute the weighted-average *expected* income stream.

When the court is inclined to consider *ex post* information as relevant, the BV expert faces a dilemma—either deny the relevance of the *ex post* information to his or her opinion, which will not be persuasive to the court, or enter the arena of considering and opining on *ex post* information, which the BV expert sought to avoid.

The LP analyst is not necessarily safe from such cross-examination, but may fare relatively better than the BV expert. First, it is likely that the LP expert already has evaluated and incorporated the *ex post* information into the “but for” projection of lost economic income. Second, the LP expert, by using the *ex post* information, more likely has developed either a defensible single point “but for” outcome or narrowed the spread of “but for” alternative outcomes compared to the dispersion based only upon *ex ante* information.

CONCLUSION

Business valuation professionals demonstrate theoretical and practical knowledge of accounting, finance and economics by attaining a BV accreditation. Then, BV professionals maintain and augment their skills through contin-

uing professional education. The academic, industry and general business expertise of a BV analyst may be transportable to the litigation arena for the measurement of damages; however, the expertise may be better applied through preparation of a competent, reliable lost profits study than development of a BV opinion or conclusion of value.

- ¹ “Janis Joplin’s Yearbook and the Theory of Damages,” Franklin M. Fisher and R. Craig Romaine, *Journal of Accounting, Auditing & Finance*, Winter 1990, page 154.
- ² “Damages Assessment, Janis Joplin’s Yearbook, and the Pie-Powder Court,” Konrad Bonsack, *George Mason University Law Review*, Fall 1990, pages 11 and 20.
- ³ http://economics.about.com/cs/economicsglossary/g/ex_ante.htm and <http://www.investopedia.com/terms/e/exante.asp>.
- ⁴ “Book of Wisdom—Is It Fact or Fiction?,” Michael J. Wagner, *Dunn on Damages—The Economic Damages Report for Litigators and Experts*, Issue 3, Summer 2011, page 7.
- ⁵ *Anchor Savings Bank, FSB v. United States*, United States Court of Federal Appeals, Federal Circuit, Case Nos. 2008-5175, 2008-5182, March 10, 2010, §I.C. 597 F.3d 1356.
- ⁶ AICPA Professional Standards, Statements of Standards for Attestation Engagements, “Applicability of Attestation Standards to Litigation Services,” as of June 1, 2007, §9101.39.
- ⁷ http://uspap.org/USPAP/stds/sr9_4.htm.
- ⁸ *Fail-Safe, L.L.C. v. A.O. Smith Corporation*, United States District Court, E.D. Wisconsin, Case No. 08-CV-310, December 23, 2010, §2.B.2, 744 F.Supp.2d 870.
- ⁹ “Will the Real Business Valuation Standards Please Stand Up? The AICPA’s SSVS Compared to USPAP and Other Business Valuation Standards,” Martin J. Lieberman and David Anderson, *The CPA Journal*, New York Society of CPAs, January 2008, Exhibit 1—Permitted Valuation/Appraisal Reports.
- ¹⁰ “Interpretation No. 1-01, ‘Scope of Applicable Services’ of Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,” published June 2007, effective January 1, 2008.
- ¹¹ AICPA Statement of Standards for Consulting Services No. 1, published October 1991, effective January 1, 1992.
- ¹² *Fail-Safe, L.L.C. v. A.O. Smith Corporation*, United States District Court, E.D. Wisconsin, Case No. 08-CV-310, December 23, 2010, §2.B.4, 744 F.Supp.2d 870.
- ¹³ *Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicoff & Kotkin*, 247 Conn. 48, 717 A.2d 724 (1998).
- ¹⁴ “Economic Damages: Discounting Concepts and Alternatives,” Peter Schulman, *The Colorado Lawyer*, January 1999, Vol. 28 No. 1.
- ¹⁵ Statement of Financial Accounting Concepts No. 7, “Using Cash Flow Information and Present Value in Accounting Measurements,” Financial Accounting Standards Board, February 2000, page 1.