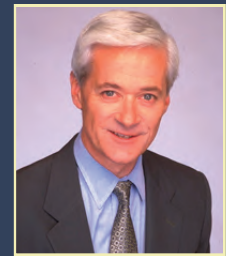
DUNN ON DAMAGES

THE ECONOMIC DAMAGES REPORT FOR LITIGATORS AND EXPERTS



ROBERT L. DUNN

Please enjoy the following article, reprinted from *Dunn on Damages*, with my compliments!

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LOST PROFITS AND LOST BUSINESS VALUE— DIFFERING DAMAGES MEASURES

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"Today most scientists would say a law of nature is a rule that is based upon an observed regularity and provides predictions that go beyond the immediate situations upon which it is based." [1]

Some experts argue that certain principles of finance and economics developed based upon our free market system, including its capital markets, necessarily guide and constrain the calculation of business damages for litigation. In particular, these experts believe that lost profits damages cannot materially exceed, if at all, the lost business value of an enterprise. The debate on this topic continues perhaps, in part, because a growing number of professionals are attaining business valuation accreditations and applying the related body of knowledge for free market asset valuations to litigation damages computation assignments.

Lost profits or lost business value damages are determined for the alleged legal wrongdoing, which may entail facts and circumstances contradicting the "immediate situations" observed in a free market system. Therefore, certain "laws" or principles derived from the "real world" (not related to litigation) may or may not apply to the computation of damages. The expert is advised to select principles of finance and economics developed from free market observations and "immediate situations" that best parallel and fit the facts and circumstances of the subject legal dispute. From the array of choices, certain such principles are not inherently superior and controlling compared to others.

Business damages may be expressed as the value of a lost stream of economic income with a valuation date as of or following the date of defendant's legal wrongdoing. Plaintiff's loss may be measured either as lost profits or as the lost business value, particularly when the lost business value is determined based upon the income approach. Since both lost profits and lost business value may be based upon the discounted cash flow methodology, some practitioners believe the alternative damages values rely upon the same financial and economic principles, including a discount rate commensurate with the risk plaintiff would have borne. As a result, some experts opine that the related damages amounts should be approximately equal but, in any event, lost profits damages cannot materially exceed the lost business value.

> By using the WACC…the lost business value and the lost profits are the same (after adjusting for taxes). This is as it should be. … Economically, it is difficult to comprehend that the present value of all the profits of a business enterprise would be greater than the tax-adjusted fair market value of the entire business.[2]

PREMISES FOR PARITY IN APPROACHES

Lost profits and lost business value damages will be equal only if the alternative computations employ the same premises and calculation factors, including but not limited to the same valuation date, standard of value, information set, unresolved risk factors, loss period, discount rate and offsetting mitigation. If parity or equality exists for all such considerations or variables, then lost business value and lost profits damages are merely mirror discounted cash flow exercises. As a practical matter, opposing experts seldom agree on all damages model premises, calculation factors and input data. More importantly, the facts and circumstances related to a particular case, coupled with the court's objective to measure plaintiff's loss of "but for" economic income in terms of the potential award amount needed to make the plaintiff economically whole, may require a lost profits damages computation that is markedly different than a standard business valuation.

LOST BUSINESS VALUE AND LOST PROFITS MAY BE DIFFERENT

Lost business value and lost profits often are different approaches to measuring damages, which may result in markedly different damages amounts. Lost profits damages need not be constrained by plaintiff's alleged lost business value, particularly when measured as of the date of defendant's legal wrongdoing. In fact, lost profits measured on or about the trial date may be well below (e.g., $0 damages) or significantly above the lost business value as of the date of legal wrongdoing.

Damages amount differences arise, among other potential reasons, because business valuations may be based upon less information than lost profits damages, some or all risks contemplated in a violation-date business valuation may be resolved by the trier of fact, or the discount rate used for the business valuation to reflect an asset transfer price from a willing seller to a willing buyer is greater than the discount rate appropriate for a plaintiff suffering a constructive forced sale of an asset. A standard business valuation is defined by the following precepts, which may not apply to lost profits determined for litigation purposes.

- A business valuation is based upon the information known or reasonably knowable as of the valuation date, which typically for litigation is the date of defendant's alleged wrongdoing and constructive or actual taking of plaintiff's asset.

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- The standard business valuation measures plaintiff's loss using finance and economic principles developed from free market observations about asset pricing between willing buyers and willing sellers, including the related observed or determinable discount rates.

EX ANTE V. EX POST INFORMATION AND DAMAGES

A business valuation uses only the information known or reasonably knowable as of the valuation date, even if the valuation specialist performs the service at a much later point in time. Likewise, *ex ante* damages are based upon the information available or reasonably knowable through the date of defendant's wrongdoing. Franklin M. Fisher and Craig R. Romaine ("F&R") argued for *ex ante* damages measurement in their seminal article "Janis Joplin's Yearbook and the Theory of Damages."[3] F&R contend that the objective is to make the plaintiff whole as of the time of the violation; a plaintiff should not be compensated for risks it did not bear; lost economic income should be discounted to t=0 at a risk-inclusive rate; the t=0 loss should be subject to a risk-free rate to trial; and "Hindsight should not be used."

Konrad Bonsack promptly responded to the F&R article.[4] Bonsack traced the development of legal theory from medieval times and noted a shift from *ex ante* to *ex post* damages determination methodologies. Bonsack explained and defended *ex post* damages considering that the objective should be to "Restore the plaintiff … for all time"; injury occurs over time and the violation and trial are not simultaneous; a legal violation is not a legitimate asset exchange and may be the constructive passage of title and forced sale; the owner had the rights to both the risks and rewards of the lost asset; the passage of time may bring to light the asset's intrinsic value; and "Hindsight should be used," which returns either the risks or the rewards of the asset to the plaintiff.

COURT DECISIONS GENERALLY FAVOR THE *EX POST* METHODOLOGY FOR COMPUTING DAMAGES

Written court decisions tend to adopt and support the *ex post* methodology, but exceptions exist. Although the choice between the *ex ante* and *ex post* methodologies for measuring damages still varies among legal jurisdictions, the trend for many decades (if not centuries) has been toward use of the *ex post* methodology.

> Experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages, and forbids us to look within. [5]
>
> There are few significant cases that reject the admission of ex post data to assist the trier of fact's determination of lost past profits or lost future profits.[6]
>
> In summation, substantial case law indicates that experts can, and indeed should, incorporate all information, even information relating to events that occurred after the date of damage or after the date of hypothetical negotiation in the damages analysis. One could argue that, if the goal is to ascertain the amount of damages that would return the plaintiff to the same position it would have been in but for the unlawful act, the expert should use all available information in reconstructing the but-for-world so that the resulting award reflects all the events that have contributed to or limited the damages suffered by the plaintiff.[7]

DISCOUNT RATES FOR LOST BUSINESS VALUES OR LOST PROFITS

Discount rates are used for a variety of purposes and under differing circumstances outside of litigation. These discount rates expressed as percentages vary from single to higher double-digits. Achieved rates of return on actual investments can reach the 20-30 percent range, such as for successful venture capital firms. As historical returns, achieved returns relate to risk-resolved streams of economic income. On the other hand, prospective investments often are valued with discount rates that include additional premia for unresolved risk that has not been removed from the income projection. For example, discount rates of up to 70 or 80 percent may be applied to initial venture capital investment opportunities or early-stage, extremely high-risk pharmaceutical technologies. Of course, if such hoped-for income streams truly were adjusted to an *expected value*, as defined in business valuation and other literature, then the valuation discount rates could more closely approximate the relevant, achieved rates as reported by such services as Morningstar.

Lost economic income projections often are presented in the litigation arena, either as the basis for a business valuation or for the determination of lost profits. The "but for" projection for either approach likely will be challenged by opposing counsel and witnesses. For example, defense counsel may argue that

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"Conversations with the Masters"

Bob Dunn and Everett Harry appear in the NACVA series, "Conversations with the Masters."

This program was videotaped at the NACVA Annual Consultants' Conference in June, 2010, at which Bob and Ev gave a two-hour presentation. The brief video covers a range of subjects from discounting future damages to present value to the use of business valuation techniques to calculate lost profits damages.

To see the video, and hear Bob and Ev, click on this link:

CLICK HERE

plaintiff's alleged lost business value or lost profits damages is based upon overly optimistic and unattainable premises in the "but for" world. To a large or possibly full extent, the trier of fact may resolve these issues of risk for the projected or "but for" stream of economic income. If the trier of fact is unable to resolve all of the projection uncertainty, then the discount rate may contain a factor or factors to account for unresolved risk or risk that is not otherwise addressed in the projection model for lost economic income.

Even assuming that the trier of fact can resolve all material risk in the projected stream of economic income used as the foundation for either a business valuation or lost profits computation, a more important issue arises. Should a trier of fact-determined highly-certain stream of projected economic income be discounted at 1) the rate of return that an investor would have sought to purchase the subject asset in a non-litigation, free market exchange, or 2) at a relatively lower rate to recognize and quantify plaintiff's loss by constructive forced sale of the asset's ability to return an element of owner economic profit above plaintiff's marginal cost of capital?

The issue of reasonable mitigation, a legal duty of plaintiff, may complicate the answer to the foregoing question. From the F&R perspective, mitigation alternatives matter little since the lost business value is established at the time of the purported legal violation, which relieved the plaintiff of any asset-holding risk; therefore, F&R contend that a risk-free rate of return from the date of wrongdoing to the trial is fair compensation to the plaintiff. Of course, if plaintiff had not lost the asset, then the plaintiff might have earned a much more favorable rate of return to trial possibly when corroborated by *ex post* or hindsight information. For simplicity and focus on the inquiry posed above, assume that the damages expert is selecting a discount rate only for future losses from the date of trial, the projected lost stream of economic income is highly certain according to the trier of fact, and plaintiff cannot mitigate its losses by buying a like business opportunity on or about the trial date. The question still is valid. Under these premises, business valuation and lost profits damages may employ different discount rates.

- Business valuation damages would be measured using a free market-based rate of return, such as the relevant industry weighted average cost of capital ("WACC"), arguably because the plaintiff will not bear the risk of holding the asset into the future.

- Lost profits damages may be measured at a lesser rate, such as plaintiff's marginal cost of capital. This approach recognizes that the difference between the subject WACC and the plaintiff's marginal cost of capital (e.g., borrowing rate) represents an incremental owner economic profit taken by defendant through a constructive forced sale that is not replaceable given the assumed lack of mitigation opportunities.

H.G. Acuna and F.A. Garb discussed two types of economic evaluations to estimate damages.[8] The authors refer to the two approaches as fair market value ("FMV") and loss of bargain ("LOB"), which can result in a very large difference in the computed loss. The authors identify the following characteristics of LOB damages, for example, as related to breaches of contract.

- Recognizes the agreement terms as if fulfilled, which may significantly impact risk factors, discount factors, market assumptions and other parameters.
- Recognizes no willing seller expecting a "profit transfer" to the buyer.
- Recognizes all expected economic profit as part of victim's denied benefits and doesn't discount to FMV levels.
- Uses an alternative discount rate, such as cost of debt.
- Does not penalize the victim for having other opportunities in its portfolio for reinvestment.
- If a highly certain cash flow, then use a lower risk discount rate to represent the cost of money.

The authors explain their reasoning as exemplified below.

> A FMV approach would not be the appropriate measurement of damages for a LOB resulting from the breach of contract by one of the parties.[9]
>
> In a FMV, calculations are made to determine how much the market would pay for a specific asset. These calculations inherently transfer a profit component from the asset to the potential buyer. … A LOB calculation recognizes all profit as part of the benefits denied to the victim and, therefore, considers it inappropriate to discount future net revenues to FMV levels.[10]

ANCHOR SAVINGS BANK, FSB V. UNITED STATES, UNITED STATES COURT OF APPEALS, MARCH 10, 2010, 597 F.3D 1356— A RECENT DECISION

Anchor Savings bought four failing thrifts from 1982-1985 and was permitted to capitalize negative "supervisory goodwill" to the extent of $550 million toward regulatory capital requirements. In June 1988, Anchor Savings bought Residential Funding Corporation ("RFC"). In August 1989, Congress enacted FIRREA and reversed the treatment of negative goodwill, which caused Anchor Savings to be undercapitalized. As a result, in March 1990, RFC was sold to GMAC for $64.4

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million. In January 1995, Anchor filed suit in the Court of Federal Claims and later was awarded $356.5 million—90% was attributable to sale of RFC and was based on the lost profits for RFC after the sale to GMAC.

The Government (defendant) explicitly argued that business damages should be determined by and limited to the fair market value of the disposed enterprise at the time of its sale. According to the Government, citing other cases to support its position, the "trial court erred as a matter of law by considering post-breach evidence, when the only relevant evidence concerns RFC's market value at the time of the March 1990 sale." More explicitly, the Government offered the following arguments.

- "(D)amages for the loss of 'income producing property' must be measured by the asset's market value as of the time the property is lost, not by the loss of the profits the asset could have produced in the future."
- "(T)he market valuation should already reflect RFC's expected future risks and future profit stream."

The Court of Appeals rejected the Government's arguments and found that lost profits damages were more appropriate given the case facts.

- 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."
- The objective is to "make the non-breaching party whole. One way to accomplish that objective is to award 'expectancy damages' … Expectancy damages 'are often equated with lost profits …'."
- "Neither decision mandates that one measurement method must invariably be used." "Neither *Lincoln* nor any of our other *Winstar* decisions bars the court from considering post-breach evidence."
- "(I)t seems especially and unreasonably static and wooden to limit the expectation interest to the then-present value of individual assets."

The Court of Appeals acknowledged that the RFC sales price reflected distressed sale conditions (i.e., "blood in the water" or "veritable fire sale") but, regardless, found it inappropriate to measure Anchor Saving's damages as the FMV of RFC at the time of asset disposition.

- "As the Supreme Court has held, 'fair market value presumes conditions that, by definition, simply do not obtain in the context of a forced sale'" and "thrift's lost profits, as expectancy damages related to forced sale …"
- "(T)he breach deprived Anchor of the profits it would have obtained from retaining RFC while at the same time preventing Anchor from investing the proceeds of the RFC sale in a similarly profitable enterprise."
- "In effect, that meant that the proceeds of the RFC sale lost much of their value as a potential source of profit, and thus that the difference between the fair market value of RFC and the proceeds from the sale was not necessarily a reliable measure of Anchor's loss from the breach."

SELECTING A DAMAGES MEASUREMENT APPROACH AND DISCOUNT RATE

Business damages may be determined using alternative methodologies and discount rates. The expert's choices are not necessarily limited or constrained by certain purported "laws" or principles of finance and economics when derived from "immediate situations" not germane to a plaintiff forced away from its "but for" world. Instead, an expert may select from a range of theories, practices and metrics developed outside of the litigations system. For example, rates of return like risk-free, cost of debt and WACC are all evidenced in and derived from the capital markets.

In general, courts have displayed wisdom in neither dictating that certain methodologies or discount rates are preferable for the measurement of business damages nor ruling that certain financial or economic principles impose limits on damage amounts computed using one methodology versus another. Rather, courts have exhibited prudence in seeking harmony among the damages methodology, legal precedents, case facts and the financial award appropriate to make the plaintiff economically whole. As appropriate, the expert may discuss and explore such matters with the attorney-client in the process of selecting a damages computation approach. As a result, the expert may find that at times plaintiff's damages are better measured by the lost business value (e.g., FMV) at the time of legal wrongdoing but for other cases, like Anchor Savings, the damages are better measured by a lost profits approach not limited to the lost business value. ~

"Each theory can describe and explain certain properties, and neither theory can be said to be better or more real than the other. Regarding the laws of the universe, what we can say is this: There seems to be no single mathematical model or theory than can describe every aspect of the universe."[11]

1 Stephen Hawking and Leonard Mlodinow, *The Grand Design*, Bantam Books, New York, 2010, p. 27.

2 Brian P. Brinig and Jeffrey H. Kinrich, "Discount Rate, Risk & Economic Damages: Practical Considerations," *Business Valuation Update*, September 2009.

3 Franklin M. Fisher and Craig R. Romaine ("F&R") argued for ex ante damages measurement in their seminal article, "Janis Joplin's Yearbook and the Theory of Damages," *Journal of Accounting, Auditing & Finance*, Winter 1990.

4 Konrad Bonsack promptly responded to the F&R article in "Damages Assessment, Janis Joplin's Yearbook, and the Pie-Powder Court," *George Mason University Law Review*, Fall 1990.

5 *U.S. Supreme Court, Sinclair Refining Co. v. Jenkins Petroleum Process Co.,* 289 U.S. 689 (1933).

6 George P. Roach, "Correcting Uncertain Prophecies: An Analysis of Business Consequential Damages," *The Review of Litigation,* University of Texas School of Law Publications, Winter 2003, p. 47.

7 Michael J. Wagner, Michael K. Dunbar and Roman L. Weil, "Ex Ante Versus Ex Post Damages Calculations," *Litigation Services Handbook,* Fourth Edition, John Wiley & Sons, Inc., 2007, pp. 8-20.

8 H.G. Acuna and F. A. Garb, "Quantification of Economic Damages Resulting From a Breach of Joint Venture or Joint Operating Agreement," Society of Petroleum Engineers paper #SPE 52961, 1999.

9 Ibid, p. 1.

10 Ibid, p. 2.

11 Hawking, p. 58.