

Fall 2015

Lost Profits and Damage Calculations

This is the third article in a series on the subject. It was inspired by the lecture of a fellow practitioner which I found particularly relevant. The first article appeared in the December, 2014 issue of this newsletter, the second in June, 2015. So far we covered the applicable standards for expert testimony and an overview of economic damages. This article will identify the damages period, estimating the “But-For” revenues, estimating of costs and expenses, and prejudgement interest.

Reasonable certainty is required for an award of damages, but no single measure of reasonable certainty exists. Certainty as to the fact of damages is required, however certainty as to the precise amount of damages is not. Provided a reasonable underlying basis can be articulated, damages may be estimated. This standard serves to discourage speculation or conjecture. In *Ashland Management Inc. v. Janien* [604 N.Y.S. 2d 912, 915 [1993] the Court stated that “the requirement that damages be reasonably certain does not require absolute certainty. Damages resulting from the loss of future profits are often an approximation. The law only requires that damages be capable of measurement based upon known and reliable factors without undue speculation.” *Texas Instruments, Inc. v. Teletron Energy Management* 877 S.W. 2d 276, 279-280 [Texas 1994] stated “this does not mean that ‘the reasonable certainty’ test lacks clear parameters. Profits that are largely speculative, resulting from activity based on uncertain or changing market conditions, or on chancy business opportunities, on untested products or entry into unknown or unviable markets, or a new or unproven enterprise, can not be recovered.”

For a recovery of damages to be allowed, it must be established that the consequences to the plaintiff of the wrongful act were reasonably foreseeable to the defendant. This rule serves to focus the liability only on those consequences connected to the wrongful acts. There is a duty to mitigate, i.e. the doctrine of avoidable consequences, and the plaintiff is obligated to take reasonable steps to avoid or reduce damages, but does not require the plaintiff to do anything unreasonable or impractical.

Damage period issues

An open damage period is ongoing, and estimates when the company will be on track again. A closed period specifically identifies when the company is back on track. A infinite period means that the plaintiff is out of business and/or will never recover. Other issues include whether the contract is terminable at will and whether the harm caused extend beyond the contract duration; firm survivorship; work expectancy of the principal; terminal value.

The following are common approaches for estimating “but-for” and future amounts, depending on the matter. Constant amount over time; Linear increase or decrease over time; Inverted U shape when projecting over multiple stages of expected product life cycle.

Methods include: Before-and-after method, which compares actual results prior to the wrongful action with results afterwards; Yardstick method, which uses standard operating industry standards; Sales projection method, which compares operations after the wrongful act to a projection based on historical data and economic benchmarks.

In lost profit calculations lost revenues must be offset with costs that would have been incurred in order to generate those revenues. Those costs are considered to have been avoided by the plaintiff as a result of the defendant’s wrongful act. Costs must include direct and indirect costs such as administrative and overhead generally, and variable and semi-variable costs such as those which include a variable and a fixed component. Lost profits are calculated pre-tax, and damage awards are taxable to the plaintiff. The tax benefit of a loss is generally not considered. Taxes on projected profits are generally not generally deducted.

Discount rates used in damage calculations serve 2 purposes, the first one to adjust for the time value of money and the second for risk or uncertainty. Rates could include the risk-free rate such as U.S. Treasuries, or a built-up generated rate such as risk-free plus factors reflecting risk in the particular enterprise, country risks and others. The discount rate could be variable over time depending on risks which may change over time. Most commonly, an ex-ante discounting for forward-looking approach is used: the measurement date is the date of the wrongful act, and only information known at the time is used; projections are from that day forward, discounted back to that day. The present value of damages is a lump sum, on which prejudgement interest can be added. An ex-post approach can also be used, i.e. a backward looking method with the measuring date is after the wrongful act and damages are by using knowledge of events after the date of the wrongful act. It can consider subsequent events. Prejudgement interest is generally governed by statute: it could include the plaintiff’s cost of borrowing on a simple interest basis. Do not hesitate to contact us to discuss these issues.

**Owen v. Cannon in Delaware Court of Chancery
Case 8860-CB decided June 17, 2015¹**

Two shareholder groups were at odds in this fiduciary duty, fair value case involving Energy Services Group, Inc. a reseller of electricity. The plaintiff was cashed out at a value of \$26.3 million for his stock based on a 2013 management’s projection. The plaintiff argued that the expert’s appraisal was used to obtain a line of credit to fund the shares being retired; he also disagreed with the tax rate used is inconsistent with the company’s sub-chapter S status. The plaintiff suggested \$53.5 million as the correct value. Although he agreed to use the projection described above, he finally stated that

¹ <http://courts.delaware.gov/opinions/download.aspx?ID=225220> The opinion was written by the incoming chancellor, C. Bouchard.

its purpose was inconsistent with the valuation of his shares. The plaintiff commissioned a separate appraisal.

The 2 principal areas of disagreement are thus: whether to tax effect earnings to reflect the S corporation status, and which projection to use. The Court could not find anything wrong with the original projection, since it reflected management's best estimates at the time. Consistent with the Delaware Court's earlier findings, the Court prescribed that the earnings be tax-effected consistent with the S corporation status. The Court returned its valuation of \$42.2 million. This is the first opinion authored by the recently sworn-in Chancellor of this important business court.

New, or Not so New ways a Business Appraiser can help you

As has been described in the press, many middle-market businesses were started in the seventies and eighties by managers who are now ready to retire. The market for closely-held businesses is holding fairly well, and there appears to be plenty of capital for any transition. Many of our clients who several years ago wanted us to help with their estate planning, now want us to *independently* look at the offers they receive from employees/managers and investors. We are qualified for this work because we have valued many similar or not-so-similar businesses, have the training, and because we have no conflict of interest in supporting a value. Generally, that value should be used as a starting point for reviewing an offer; the client can often re-shape an offer into a more palatable offer.

Relationship between Non-Compete Agreement and Goodwill in Divorce

Can a solo professional practice have commercial goodwill, i.e. non-individual goodwill? How do the concept of fair market value and the notion of a covenant not-to-compete fit? The husband in a divorce case was a licensed financial advisor. As his expert pointed out, sales depended on his business development efforts in cultivating his own clients. Because of the trust in the advisor, it would have been difficult to transfer the book of business to another. Also, security sales were made based on the advisor's assessment of suitability to the client. The valuation expert used an income approach, concluding that the business was worth \$443,200. In the same breath, he indicated that the business, in fact, was only worth its net asset value or \$27,000 because the professional did not sign a non-compete agreement and that without that non-compete, no third party would pay more than net asset value. The husband had a personal goodwill value of at least \$500,000 as measured by the amount he would have expected to receive before agreeing to sign a non-compete agreement. Most states, but not all, require that only the non-personal goodwill be included in the value at divorce. Several business valuation experts, in fact, do not address any non-divisible goodwill in valuing a solo practice because the relationship between professional and client is so strong and instrumental as a driving force for the business.

The wife's expert used an excess earnings method, a difficult to support methodology particularly when few fixed assets drive the business. On rebuttal, the husband's expert discredited that method, and the Court found the value for marital

dissolution purposes to be \$27,000. The point turns on the definition of fair market value, determined by hypothetical buyers and sellers. In a divorce, the practice is generally not sold, and only the divisible, i.e. commercial goodwill is included so as not to create a windfall for either party. See *K.T. v. M.T. Texas Appeals 2015*, LEXIS 8558 decided August 13, 2015.

Self-Cancelling Installment Notes

The estate of the owner of several sport franchises has sued accounting firm Deloitte, indicating that the firm made a number of errors in valuing SCINs without the benefit of the actuarial value of the owner's life. As structured, SCIN allowed heirs to receive assets on the installment plan, with the note cancelling at death. The Service has indicated that it was seeking Billions of dollars from the estate as the value was found to be below fair market value.

J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to \$300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users. Court decision analysis is prepared from the perspective of a BV analyst, not from that of an attorney.

©J.L. Pierson & Co. LLC 2015

J.L. PIERSON, ASA
368 Heights Road # 2392
Darien, CT 06820

<http://www.NYNJCT-BV.COM>
(203) 325-2703
(203) 434-4648

Change Service Requested

NYNJCT-BV.com
(203) 325-2703 (203) 434-4648