



## SURVEYING THE DAMAGES

VALUATING LOST PROFITS AND LOSS OF BUSINESS PRESENTS COMPLEXITIES

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**E**mploying damage experts in lost economic earnings cases is frequently beneficial for both plaintiff and defense attorneys. Juries are often not sufficiently trained and their members are rarely skilled in determining damages.

As such, their determinations do not always consider all relevant facts pertinent to each case. An experienced expert can also provide additional insight regarding the financial elements of the case, discover previously unknown relevant information, and offer assistance concerning potential values for settlement purposes, which can all result in significant changes to the success and value of a case.

Business damage claims can typically be categorized into one of two conceptual categories: (1) cases in which a business experiences diminished profit; or (2) cases in which a business ceases or terminates its operations as a result of the alleged actions.

Economic damage claims can be calculated by analyzing either the lost future profits of the business or the lost value of the business. If the business has not been completely destroyed, then it may be able to recover lost profits. If a business has been completely destroyed, however, the appropriate measure of damages is most often the market value of the business immediately prior to the alleged wrongful act of the defendant.

Whether damages are calculated as lost profits or lost business, the objective is to return the plaintiff to the position it would

have been in but for the alleged actions of the defendant. The decision of whether an economic damage case is a lost profits or loss of business value case should be given significant consideration, ideally near the beginning of a case, by the attorney and the damage expert.

### Double Recovery

Calculating lost profits involves forecasting income streams and converting them to present value. Damages are typically the difference between the profits that the plaintiff would have expected to have earned but for the defendant's alleged wrongful actions and the actual profits earned (including historical profits since the alleged wrongful act) and those projected to be earned into the future.

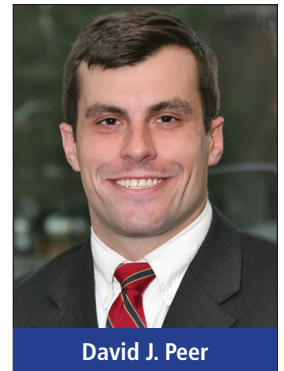
Calculating lost business value involves a similar methodology. When an income-based valuation method is employed, calculating lost business value is comparable to determining lost profits, except that the business has no actual profits.

Plaintiffs occasionally attempt to claim the right to both the value of their business at the time it was destroyed and the lost future profits that would have been realized had their business allegedly not been destroyed by the alleged wrongful actions of the defendant.

Typically, a business cannot recover both lost profits and the lost market value of the business, as the value of a business is its expected future cash flows discounted to present value. Courts typically consider such



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claims to be an attempt at double recovery.

A possible exception to this occurs when the injured company operated for a period of time after the defendant's alleged wrongful action and then terminated operations as a result of the alleged wrongful actions of the defendant. This is because the interim operating losses prior to the liquidation of the business are not included in the determination of market value as of the date of liquidation.

In order to calculate this type of "slow death" case, damage experts should be mindful never to claim lost future profits for the period beyond the valuation date, lest the plaintiff receive double recovery.

### Different Analyses

The differences between a lost profits analysis and a loss of business value analysis include (1) the loss recovery period; (2) the inclusion of the events after the defendant's alleged wrongful action; (3) the impact of income taxes; and (4) the assumptions regarding the seller.

In a lost profits case, damages are generally for a specific time period, with the damages equal to what the business would have produced in the loss period minus what the

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business actually produced during this period. Future losses are then discounted to present value generally as of the trial date.

In determining the term of the damage period, experts typically consider numerous factors, including life cycles, technology, competition, and the regulatory environment. Additionally, the plaintiff is sometimes obligated to mitigate potential losses. When the business is destroyed, the lost future cash flow is now permanent and the market value of the business is determined based on the assumption that the earnings would have continued into perpetuity.

When calculating lost profits, the analysis includes earnings from the date of the alleged wrongful actions to the date that the plaintiff has been able to mitigate the damages. Damage experts consider facts and events that occurred after the alleged damaging actions.

In a loss of business value analysis, the expert will perform a business valuation as of the date of the alleged wrongful action. This valuation will only consider facts that were

known or knowable as of the valuation date.

Lost profit damages are most often taxable income to the plaintiff.

Therefore, to reduce the lost profit by the amount of taxes that the business would have paid would constitute two deductions for taxes and result in the plaintiff receiving less profit than it would have but for the alleged wrongful actions of the defendant.

When performing a lost business calculation, however, the financial expert generally applies income taxes. This is because it is the net after-tax cash flows that hypothetical investors view as the return on their investment and, therefore, are typically used by experts in the calculation of a business's market value.

In a loss of business value analysis, the expert is considering a hypothetical, willing buyer-seller. However, in a lost profits calculation, the identity of the seller is known and the seller is typically not considered to be willing.

The calculation of lost profits and loss of

business value is a complex undertaking that is highly dependent upon the specific facts of each case. Damage experts should have well-analyzed and credible positions and be able to support their conclusions.

Experienced damage professionals will have years of forensic accounting and business valuation expertise and experience calculating lost economic earnings due to the occurrence of allegedly harmful events. These calculations are based on three primary components: (1) the causal link between a specific, alleged wrongful action and alleged lost profits, (2) the profits that would have been achieved but for the specific, alleged wrongful action, and (3) the profits that were actually achieved despite the specific, alleged wrongful action.

Damage experts should have a thorough understanding of these components that provides insightful, objective feedback regarding the merits of a claim for economic damages, especially in assisting counsel in its effort in successfully settling cases. ■