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valuation & litigation briefing

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Lost profits vs. lost **business value**

Are they mutually exclusive?

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In breach-of-contract cases and other types of commercial litigation, plaintiffs often seek to recover lost profits, lost business value or both. Each type of damage measure seeks to capture the loss in economic benefits to an injured party. However, the relationship between these two measures of damages is a common source of confusion.

Although both types of damages are available under certain circumstances, in many cases they overlap, which can result in improper double recoveries. Unfortunately, court decisions in this area have been inconsistent. Misunderstood business valuation concepts have led some judges to allow inflated damage awards.

Profit and loss

The availability of damages for lost profits or lost business value depends in part on applicable federal or state law. But most courts agree that, when a defendant's conduct destroys a business, the proper measure of damages is the business's fair market value on the date of loss.

In breach-of-contract cases, courts often limit damages to a plaintiff's lost profits during the contract term — even if the breach causes the plaintiff to go out of business. The rationale is that, if the defendant hadn't breached the contract, it could have terminated the relationship at the end of the term, and the plaintiff would have lost the defendant's business anyway.

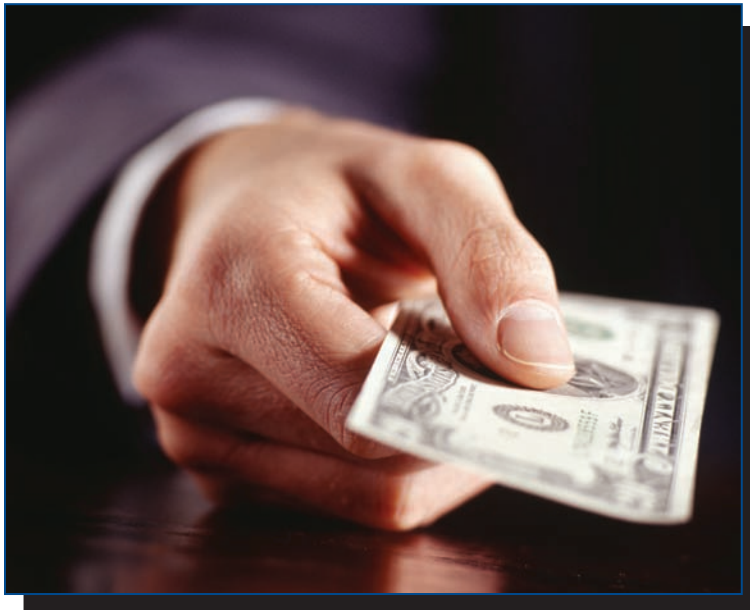
A plaintiff might counter, however, that if the defendant hadn't ended the contract prematurely, it would have had time to develop new business to replace the loss.

In other cases, a plaintiff may be entitled to lost profits, lost business value or both. In "slow death" cases, for example, in which a defendant's conduct injures — and eventually kills — the plaintiff's business, both damage measures may come into play.

No double dipping

Double dipping may occur when lost profits and lost business value damages relate to the same time period. The value of a business is based on the future profits a hypothetical buyer can expect to earn. This is true regardless of the valuation method.

When the income approach to valuation is used, the relationship between profits and value is obvious. Under this approach, a valuator uses discounted cash flow or some other method to convert anticipated future earnings into a present value. Damage measurements for both lost profits and lost value focus on cash flow estimation and timing. They also take into account the risk associated with the probability of achieving a projected cash flow stream. But even if market- or asset-based valuation methods are used, a business's earning capacity must be considered.



The failure of some courts to understand this concept has led to improper double recoveries. For example, in *Jim-Bob Inc. v. Mehling*, the court allowed a plaintiff to recover damages based on both lost profits and lost business value for the same time period.

The plaintiff's valuation expert relied on market-based methods, and the court erroneously concluded that there was no

Locking up a claim for lost profits and value

A 2005 case illustrates the circumstances under which an award of both lost profits and lost business value may be appropriate. *Vehicular Technologies Corp. v. Titan Wheel International Inc.* involved a dispute between two manufacturers of automotive lockers — devices that improve traction for off-road driving and other difficult conditions.

The defendant, doing business as "Tractech," dominated the locker market, but the plaintiff, Vehicular Technologies, had developed a superior (and cheaper) product. Tractech's CEO approached Vehicular about a licensing or other business arrangement.

During negotiations, Vehicular divulged confidential information about every aspect of its business, and Tractech's CEO promised not to use this information except for purposes of the negotiation. He also promised not to copy Vehicular's product. But these promises were knowingly false.

After the deal fell through, the defendant began marketing an exact copy of the plaintiff's product (later re-engineering it slightly to circumvent Vehicular's patent). This competition from Tractech hurt Vehicular's business and, eventually, Vehicular sold all of its operations to another company. Vehicular sued Tractech for breach of contract and other causes of action, presenting evidence of both lost profits and lost business value.

Vehicular's damages expert testified that between 1996 (when Tractech introduced its competing product) and the 2002 buyout, the company lost about $20 million in profits. He also estimated that Vehicular's value on sale was diminished by about $17 million. The jury awarded Vehicular a total of $16.3 million.

On appeal, Tractech argued that, to the extent the jury awarded damages for lost business value, those damages duplicated the lost profits damages. The court disagreed, accepting the expert's reasoning that "valuation of a business is by definition all about the future."

But for the defendant's wrongful conduct, the court explained, "Vehicular would have earned substantial additional sums (the lost profits damages) from 1996 to 2002, and then, in addition, would have garnered an additional $17 million on the sale of the business in 2002."

The court concluded that "substantial evidence" existed to show that "the damages were not duplicative, but would actually compensate Vehicular for the harm caused by Tractech's torts."

double recovery because the expert "did not specifically incorporate profits" but instead "looked to an earlier purchase offer."

The court in *Jim-Bob* failed to recognize that, even if a valuator uses a method that doesn't specifically include profits in the calculation, fair market value is still based on a business's ability to generate profits. So a damage award based on lost business value as of a specified date combined with lost profits after that date is duplicative.

In some cases, however, both types of damages may be available if they relate to different time periods. (See "Locking up a claim for lost profits and value.")

Duplicative doesn't mean identical

It's important to understand that, even though damages based on lost profits and lost business value overlap, the two measures aren't necessarily identical.

In theory, when a defendant's conduct diminishes the value of a plaintiff's business, the difference between the "before" and "after" values may equal the present value of the plaintiff's lost profits on the valuation date. But calculating lost profits and lost business value may involve different sets of assumptions, leading to different results.

For example, while a fair market value analysis looks at a business from the perspective of a hypothetical willing

buyer, a lost profits calculation may involve consideration of the plaintiff's specific tax situation or other factors that cause it to earn more (or less) than a typical investor.

A valuator may assess risk differently depending on whether damages are based on lost profits or lost value, which may affect the discount rate used to convert future profits to a present value. In addition, the valuator may discount the business value for lack of marketability or liquidity.

Another potential difference between lost profits and lost value is the role of hindsight. Business value generally is based on facts known or reasonably knowable on the valuation date, regardless of what has actually transpired between that time and the trial date. But it may be appropriate to consider subsequent events in determining the amount of lost profits.

Know the difference

To effectively support or oppose damage claims in commercial cases — and avoid duplicative awards — it's important to understand the relationship between lost profits and lost business value. A financial expert can help determine which type of damage measure is appropriate and explain the reasons to a judge or jury. ❑

"Fair value" in dissenting shareholder cases

In most states, "fair value" is the legal standard of value in dissenting shareholder cases. Unfortunately, the term "fair value" is ambiguous and can have different meanings depending on the circumstances and the purpose. Many state statutes don't provide a clear-cut definition of the term, leaving interpretation to the courts. The meaning of fair value may vary slightly from state to state — resulting in confusion about fair value and its relationship to fair market value.

Fair value vs. fair market value

Fair market value is commonly defined as the price at which property would change hands between a willing buyer and a willing seller when neither is under any compulsion to buy or sell and when both parties have reasonable knowledge of all relevant facts.

Yet dissenting shareholder cases often involve minority shareholders who were squeezed out as part of a merger, reorganization or recapitalization. In other words, in most cases, they're *unwilling* sellers. The concept of fair value is intended to prevent controlling shareholders from obtaining an unfair benefit by forcing minority shareholders to accept a discounted price.

To avoid a windfall to controlling shareholders, many state courts interpret fair value to mean a shareholder's proportionate share of the enterprise's overall value without regard to discounts for lack of control and marketability. Alternatively, some courts define fair value as *marketable* minority value, allowing discounts for lack of control but not for lack of marketability.

Typically, fair value does not reflect the impact, either positive or negative, of the transaction that gives rise to the right to dissent.

It's important to distinguish fair value in dissenting shareholder cases from fair value for financial reporting purposes. Generally accepted accounting principles (GAAP) require organizations to report certain assets and liabilities, such as stock options and derivatives, at fair value rather than at their historical cost. But despite

the use of the term "fair value" in GAAP, the concept is more closely akin to fair market value than it is to state-law definitions of fair value.

Recently, the Financial Accounting Standards Board (FASB) issued Statement No. 157 (*Fair Value Measurements*) to provide guidance on determining fair value for financial statement purposes. For this purpose the definition of fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts." In its explanation of the statement, the FASB notes that "the measurement objective encompassed in the definition of fair value used for financial reporting purposes is generally consistent with similar definitions of fair market value used for valuation purposes."

Synergistic value

A company's value may include a premium for potential synergies a strategic buyer might enjoy in a hypothetical sale. But in most dissenting shareholder cases, the business isn't being sold.

If fair value includes such a strategic premium, it may *overcompensate* minority shareholders and unfairly penalize the controlling shareholders. To avoid this result, some courts hold that a fair value determination shouldn't consider potential synergies.

Fair warning

Business owners often make the mistake of assuming that, as long as they treat minority shareholders "fairly," they've satisfied fair value standards. Others believe they're protected if they engage an investment bank to provide a fairness opinion concerning a contemplated transaction.

But "fair value" has a specific meaning that may not correspond exactly to traditional notions of fairness. An investment banker's opinion that a transaction is fair from a *financial point of view* doesn't necessarily mean that minority shareholders will receive fair value. Both valuation experts and attorneys need to become familiar with state statutes and case law concerning the applicable fair value standard and its definition.

Early analysis

Dissenting shareholder litigation can be complex and expensive. That's why the best time to analyze fair value issues is before a transaction is consummated — under the guidance of a qualified appraiser. ❑

The price of royalty

Calculating damages for patent infringement

Victims of patent infringement often seek to recover lost profits. But patent law also establishes a floor below which damage awards may not fall: A patent holder is entitled to some form of damages on all infringing sales, but for no less than a "reasonable royalty" for the infringer's use of the invention.

This is significant because it allows patent holders to recover damages even if they don't use the patent or can't prove lost profits. It may also increase their damages if a reasonable royalty would be greater than lost profits.

Relationship to lost profits

Reasonable royalty damages are typically thought of as an alternative to lost profits. Yet the two are actually quite closely related. A reasonable royalty is based on the hypothetical negotiators' views — just before the onset of the infringement — of the value of a license, which, in turn, is based on profitability.

In other words, the price a licensor would be willing to accept — and a licensee would be willing to pay — is derived from the profits the patented technology is expected to generate.

15 reasonability factors

In *Georgia-Pacific Corp. v. United States Plywood Corp.*, the court outlined 15 factors to guide experts in calculating a reasonable royalty. Valuators need to consider:

1. Royalties the patent holder received for licensing the patent,
2. Royalty rates the licensees paid for "comparable" patents,
3. The nature and scope of the license — for example, whether the license is exclusive or nonexclusive, or whether it's restricted in terms of territory or with respect to whom the product may be sold,
4. The patent holder's established licensing policies,
5. The relationship between licensor and licensee — for instance, whether they're competitors in the same territory or line of business,
6. The patent's duration and the license's term,
7. The licensed item's value in generating sales of the licensee's other products,
8. The patented product's established profitability,
9. The patented product's utility and advantages over old modes or devices,
10. The patented invention's nature and benefits,
11. The extent to which the infringer has used the invention and that use's value,
12. The portion of the profit or selling price customarily allowed for the invention's (or comparable invention's) use,
13. The portion of profit that should be credited to the invention itself apart from any nonpatented elements or improvements the infringer added,
14. Qualified expert opinions, and
15. The royalty amount a willing licensor and a willing licensee would have negotiated at the beginning of the infringement period.

The last factor — the royalty that would be agreed on in a hypothetical negotiation — is the most important one because it incorporates all 14 factors that precede it. In other words, parties negotiating a license would consider all these factors in assessing the patent's value.

Alternatives to infringement

Although not specifically listed as a factor in *Georgia-Pacific*, consideration of noninfringing alternatives is also a key component of a valuation expert's economic analysis. The value of a patent — or a license to use patented technology — is greatly influenced by the competitors' ability to lawfully circumvent the patent.

A competitor might "invent around the patent," for example, or come up with a way to produce its product without the patented feature. The easier it is for competitors to lawfully work around the plaintiff's patent, the lower the price of a license.

To conduct this analysis, the valuation expert works closely with both patent counsel and engineering experts. To determine the impact of alternatives, the valuator considers legal issues, including the scope of the patent.

He or she also takes into account technical issues, such as the feasibility and cost of engineering and producing a noninfringing product. To the extent a license would reduce the cost, risk and time involved in getting a product to market, the value of the license — and, therefore, the amount of a reasonable royalty — would be enhanced.

Hypothetical questions

These are just a few of the complex issues an expert must tackle to calculate a reasonable royalty. The challenge is to adapt the hypothetical negotiations of willing participants to fit a real-world situation in which one party's participation is far from voluntary. ❑

The case of the missing business valuation

In *Caudill v. Roberts*, a recent marital dissolution case, the failure of the wife's lawyer to obtain a valuation of some limited partnership interests led the wife to sue him for malpractice. Although the lawyer was exonerated, this case illustrates the risk of estimating the value of assets without a professional appraisal.

Financial affairs of the heart

In 1999, Dr. Christopher Caudill, a cardiologist, filed for divorce from his wife, Nancy, after a 34-year marriage. At the time of their divorce, the Caudills had accumulated a marital estate that topped $10 million (not including more than $2 million in collectibles and antiques, which they divided by agreement).

In the mid-1980s, the Caudills had acquired interest in eight limited partnerships (LPs), which they used as tax shelters because of Christopher's substantial earnings as a cardiologist. Before the trial, the parties agreed to divide the estate in approximately equal shares, allocating the LP interests to Christopher.

Without obtaining an independent appraisal, the parties valued the LP interests for settlement purposes at negative $412,000, reflecting potential income tax liabilities.

A malpractice suit

Nancy sued her lawyer for malpractice, alleging that he had failed to properly investigate the value of the LP interests and advise her of her rights. This caused her to accept a lower share of the marital estate than she might have claimed.

Before the trial began, Nancy filed a motion for partial summary judgment asking the court to rule that, as a matter of law, the LP interests' values should not be reduced by hypothetical future tax liabilities.

The court agreed, explaining that, in valuing a business for divorce purposes, a court "should not consider the tax consequences of the sale of the business unless … the sale of the business is reasonably certain to occur in the near future."

The court also said the tax consequences could be considered if a property division forced a party to sell a business. Neither of these situations was present in this case.

A lost appeal

Nancy moved for a directed verdict, reasoning that the court's summary judgment ruling on the consideration of tax consequences meant that her lawyer — as a matter of law — had failed to meet professional standards. But the court allowed the matter to go to the jury, which found in favor of the lawyer.

On appeal, the court found sufficient evidence to support the jury's verdict. For one thing, the experts had differing opinions as to the LP interests' value. They also differed concerning the lawyer's obligations in dealing with them in connection with the settlement.

But, regardless of the outcome, obtaining an up-front independent appraisal would likely have saved the parties a great deal of money and aggravation. ❑

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For more than 20 years, Hooper Cornell's team of CPAs, economists, Certified Fraud Examiners, Accredited Senior Appraisers, MBAs and Chartered Financial Analysts has helped legal professionals throughout Idaho and around the country analyze and understand cases involving many types of economic disputes, including commercial litigation, business valuation, personal injury, health care litigation, divorce and fraud. We provide focused evaluations, sound conclusions and expert testimony that translate complex concepts into language that clients, juries and judges can easily understand.

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