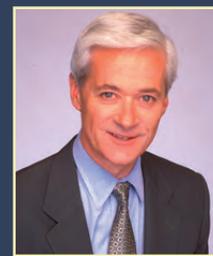


DUNN ON DAMAGES

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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RICHARD M. WISE, FASA, MCBA, CVA, FCA, FCBV, CA•IFA, CFE
rmwise@wiseblackman.com

Mr. Wise, a Finance graduate of McGill University, Montreal, is founder of Wise Blackman. Past president of the Canadian Institute of Chartered Business Valuators and former governor of the ASA, he is a Fellow of the Ontario Institute of Chartered Accountants, author of *Financial Litigation - Quantifying Business Damages and Values*, co-author of *Investigative and Forensic Accounting Practice Issues* (CICA), and a member of the ASA BV Committee and Standards Subcommittee. Mr. Wise writes and lectures extensively in both countries.

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CROSS-EXAMINATION OF PLAINTIFF'S LOST-PROFITS DAMAGES EXPERT



RICHARD M. WISE
FASA, MCBA, CVA, FCBV,
CA • IFA, FCA

Wise, Blackman, LLP
Montreal, Quebec, Canada
rmwise@wiseblackman.com

INTRODUCTION

The damages expert relies on counsel regarding (a) the underlying facts, (b) the recovery theory under which damages are being claimed, and (c) the requisite measure of damages, and will review the various heads of damage with respect to the statutory, contractual, or other legal basis for each compensable category.

The expert's quantification of economic damages, whether in contract litigation or in tort litigation, may involve determining (a) the loss of profits suffered by a plaintiff's business, or (b) the impairment of the value of the business, which had been adversely affected by the alleged wrongful acts of the defendant. In some cases, it may involve a combination of both, or even that the business may have been totally destroyed. Depending on the nature of the claim and whether the plaintiff is an established or unestablished business, the lost profits may be past, present, and/or future.

Whether the expert either quantifies the loss of future profits or deter-

mines the loss in the value of the business, he or she must (a) project a reasonable level of lost future economic income (numerator, or multiplicand), and then (b) convert these projected lost profits to a net present value (i.e., a capital sum), by applying a capitalization factor (denominator or divisor) or discount factor (multiplier) the expert developed after analyzing the risk-profile of the projected stream of lost profits.

The calculation of these variables is judgmental and often open to intense cross-examination both in lost-profits litigation and valuation disputes. The various inputs making up the lost-profits numerator and rate-of-return denominator used by plaintiff's expert are typically dissected and critiqued by defendant's damages expert and challenged by defendant's attorney in cross-examination.

DAMAGES FOR LOST PROFITS — OVERVIEW OF METHODOLOGY

The plaintiff's expert must support a reasonable approach to the quantification of

economic damages so that the plaintiff can demonstrate that the losses are proven with reasonable certainty or reasonable probability.

Most lost-profits damage calculations are made by adopting one of the following three approaches:

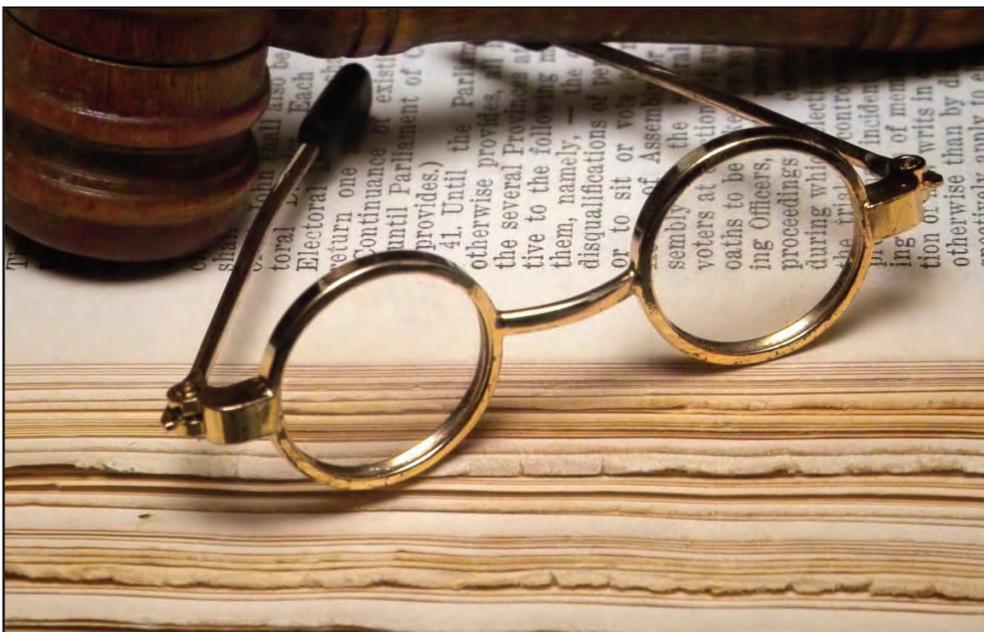
1. Before-and-After Approach;
2. Yardstick (Comparable) Approach; and
3. Sales Projection (*But-For*) Approach.

BEFORE-AND-AFTER APPROACH

This approach is generally best suited to a business having an established track record of operations or pattern of activity. It compares actual (adversely affected) operating results during the damage period to normalized, *but-for* results. Adopting this approach, the expert estimates, or extrapolates, plaintiff's *but-for* results during the damage period based on (a) normalized actual results experienced by plaintiff prior to defendant's alleged damaging acts and (b) normalized actual results after the injurious effects of the event have subsided. The plaintiff's adversely affected, actual results during the damage period are compared to the pre- and post-damage periods' actual results, which serve as "benchmarks," considering seasonality, cyclicity, and any non-recurring or unusual items, as applicable. Often, in practice, only the "before period" is available for purposes of projecting plaintiff's *but-for* results for the damage period.

When plaintiff's past operating activity is used for projecting the *but-for* results in the damage period, the assumptions underlying the projections must be reasonable and supportable. Courts typically reject speculation, con-

Continued on next page



jecture, double-counting, and “leaps of faith.”

YARDSTICK (COMPARABLE) APPROACH

The Yardstick Approach may be suitable if the plaintiff’s business does not have a sufficiently long historical track record and, consequently, the Before-and-After Approach is not feasible.

Adopting this approach, the expert compares the plaintiff’s adversely affected results during the damage period to those of similar companies (“guideline companies”¹), if available, or to industry performance which may serve as a yardstick, and reconstructs the operating data of the plaintiff on a *but-for* basis. In this regard, the damages expert analyzes available financial and operating data of the guideline companies. Adjustments are then made, as appropriate, to the respective financial data of the plaintiff and of the guideline companies so as to minimize any material differences in the accounting policies or practices as well as business or industry conditions. Non-recurring, unusual, extraordinary, and discretionary items are also adjusted, as necessary.

The difficulty with this approach lies in (a) properly identifying similar guideline companies, businesses or industries that would serve as meaningful yardsticks or “comparables,” and (b) demonstrating that the lost profits claimed by plaintiff, appropriately adjusted, would be comparable to the profits generated by the guideline companies.

In some cases, a comparable, but unaffected, division or branch of the plaintiff may provide the necessary yardstick. For example, a plaintiff operating a chain of retail stores in which Store A has been injuriously affected, might consider the operations of one of its other (unaffected) outlets, Store B, assuming that Store B has similar characteristics with respect to size, demographics, strategic location, competitive environment, floor space, parking facilities, and so forth. In such a case, regression analysis² may prove useful in forecasting *but-for* sales of damaged Store A.

SALES PROJECTIONS (BUT-FOR) APPROACH

Adopting this approach, an economic model is created for the damaged business, using assumptions as to how the plaintiff’s business would have performed *but for* the defendant’s alleged wrongdoing. Based on such assumptions, plaintiff’s expert projects revenues and related costs during the damage period. The *but-for* results (projected revenues minus projected costs) are then compared to plaintiff’s *actual* results during this period. The excess of each year’s projected *but-for* results over actual results is discounted (present-valued) back to the damage date at a risk-affected rate of return.

Because this methodology requires developing an economic model that includes plaintiff’s projected sales and related net profit, a proven, historical track record supporting the expert’s extrapolations may be necessary to convince the court; industry forecasts of growth and profitability, in and of themselves, might not suffice.

To the extent that the *value* of plaintiff’s business, as a capital asset, has been impaired or destroyed, such loss may also be included in the damages quantification. However, the aggregate of (a) the lost profits in the projection period and (b) the decrease, if any, in the value of the business as a capital asset cannot exceed (c) the present value of the plaintiff’s loss of future profits (profits being the principal value-driver), immediately prior to defendant’s wrongful conduct. There can be no double-counting.

In measuring damages for lost profits, the plaintiff’s financial statements are merely a starting point. The loss of revenues, minus the related incremental expenses (variable and direct — see below) incurred to generate those revenues, equals lost “contribution margin”³ (incremental lost profit margin). That is, for every lost dollar of sales, what was the amount of incremental lost profit that would have contributed to the plaintiff’s “bottom line” (i.e., to reducing fixed overhead, which in turn, would have increased the bottom line, pre-tax)?

As lost profits (lost revenues minus related expenses) are lost *net* profits (before income taxes), the identification and estimation of costs are



fundamental to any lost-profits quantification. The damages expert must therefore analyze the cost structure of the plaintiff’s damaged business or asset, distinguishing between the “variable” and “fixed” components of the costs. This is explained in more detail below.

Variable expenses are costs that vary in direct proportion to gross revenues or levels of activity (e.g., sales commissions, labor hours, royalties, etc.). *Fixed expenses* are costs that remain the same regardless of the level of gross revenues or sales volume of the business (e.g., overhead expenses such as insurance, rent, office payroll).⁴ A third category is *semi-variable* expenses, which are part way between fixed and variable expenses and occur because the relationship between cost and sales volume is not always regular or linear, but can take the form of a “step” function, i.e., they change at certain key-activity levels (e.g., additional rent for increased manufacturing or storage space used to support higher sales volumes; or telephone charges that have a fixed monthly component plus a variable component that relates to long-distance usage).

As most variable costs of a manufacturing concern can be directly related to the product itself, fixed costs are usually incurred for the benefit of the entire business enterprise as a coordinated unit. Most fixed costs require allocation
Continued on next page

by the firm's accounting department to processes, departments, divisions, products, or some other identifiable profit center or reporting unit of the total enterprise. For example, head office and administration expenses might be allocated to the various outlets of a chain of retail stores or restaurants.

The defendant will attempt to adduce evidence to show that the expenses of the damaged business are higher than what plaintiff's expert has calculated.

AREAS FOR CROSS-EXAMINATION

It is beyond the scope of this article to comment on qualifying the damages expert,⁵ or on causation and mitigation issues. This article addresses the cross-examination of the plaintiff's expert who has been accepted or qualified by the court as an expert in the quantification of economic damages.⁶

There are many fundamental questions that the defendant's attorney can put to the plaintiff's expert in cross-examination. As deemed necessary, the attorney will formulate these questions with the input of his or her damages expert. At trial, of course, there may well be various other areas giving rise to further cross-examination and/or follow-up questions, some with the input of the cross-examiner's expert, if feasible.

Without affording the plaintiff's expert a platform or forum to explain and/or reinforce his or her opinion given in direct testimony, the cross-examination of the plaintiff's expert should probe into the following areas, only as necessary, keeping the expert's replies strictly limited, controlled, and confined to the

narrow subject matter contained in the question.⁷

BEFORE-AND-AFTER

APPROACH –

SOME MATTERS TO ADDRESS

- The "Before" (pre-damage) period that was used to determine plaintiff's actual results prior to defendant's alleged damaging act(s).
- Any adjustments made to "normalize" the pre-damage, "Before," results.
- The "After," or "back-to-normal," period used subsequent to the damage period.
- Any adjustments made to the post-damage, "After," results.
- Whether any interpolation by the expert (averaging "Before" and "After" revenues) is truly meaningful or representative.
- Whether the "Before," "After" and/or "But-For" periods had possibly been affected by, or were a function of, seasonal and/or cyclical factors.
- "Normalization" adjustments, if any, made to the "Before" and "After" damage period results, particularly with respect to subjective and judgmental factors.
- Whether there might have been new competitors that entered the marketplace during the damage period.
- Whether substitute, alternative, or competitive products had been introduced in the marketplace during the damage period, thus rendering the pre-damage period results to be unrepresentative, on a going-forward basis, for purposes of estimating *but-for* results.

YARDSTICK (COMPARABLE)

APPROACH –

SOME MATTERS TO ADDRESS

- "Comparability" of the guideline (comparable) companies used by plaintiff's expert in making projections.
- Reliability of the statistical industry data used in estimating plaintiff's *but-for* results, including considerations regarding geographical dispersion.
- Appropriateness of the adjustments made to the financial data of the plaintiff and to those of the guideline companies to minimize any major differences in their respective accounting treatments.
- Whether the time period(s), or time-frame(s), relating to the underlying source data used in making projections are compatible (e.g., automobile dealer sales in May vs. November or department store sales in December vs. March).
- Similarities between each of the guideline companies used as a yardstick and the plaintiff, such as size, product mix, geographic location, customer base and diversity, intellectual-property protection, demographics, capital structure, profit margins, maturity of the business, off-balance-sheet assets and liabilities, depth and experience of management, regulatory issues, etc., as the case may be.
- Whether the respective notes to the guideline companies' financial statements can have an effect on the interpretation of the results used by the expert in performing his/her calculations *vis-à-vis* the plaintiff's business.
- Whether there were any material customer, supplier, labor, and/or other contracts in force that would render the guideline-company results inapplicable to plaintiff's business.
- Whether any related-party transactions involving the guideline companies might distort their results for use as yardsticks or "comparables."
- Steps taken to verify the comparability of the guideline companies and the source data extracted from them.

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SALES PROJECTIONS (BUT-FOR) APPROACH — SOME MATTERS TO ADDRESS

- Duration of the damage period.
- Whether budgets or forecasts made by the plaintiff were already in existence prior to the damages-causing event.
- The major assumptions under which gross revenues/sales volumes were projected.
- Whether expert's underlying assumptions are reasonable and consistent in the light of past performance of plaintiff's business and conditions expected to prevail during the *but-for* period.
- Basis and support for projected costs/expenses.
- How expert accounted for the fact that projections are less "reliable" each year as they go further into the future.
- Definition and interpretation of the term *profits* in "lost profits" and its applicability to the subject litigation (whether it refers to, or should be interpreted as, pre-tax profits, after-tax profits, operating income, profits before management bonuses, profits before discretionary expenses, profits before depreciation and amortization, profits before interest charges, adjusted profits, cash profits, economic income, accounting income, etc.).
- Whether, and to what extent, management interviews were conducted and details of the notes taken by the expert at the interview(s).
- Whether depositions had been taken of plaintiff's management/financial officer.
- Whether there had been a business plan prepared (e.g., furnished to the plaintiff's bank prior to the event).
- Whether expert interviewed independent industry specialists and others, if appropriate.
- Whether plaintiff had future contractual expense-commitments at the damage date that would impact operating results during the post-event damage period (e.g., new labor agreement, new raw materials supply agreement, etc.).
- Whether capital expenditures would be required during the projection period.
- Whether external financing would be necessary during the projection period.

- Propriety of, and support for, the particular costing method used ("direct costing" vs. "absorption costing") by the expert.⁸
- Treatment of depreciation and amortization charges in calculating lost profits.
- Treatment of discretionary items (management fees, charitable donations, related-party income and charges, etc.).
- Appropriateness and validity of the terminal, or residual, value of the plaintiff's business.
- Expert's calculation of the discount rate (rate of return) applied in present-valuing the projected lost profits, including considerations regarding:
 - Projection risk.
 - Contingencies.
 - Weighting of the various company-specific factors considered in building up the discount rate.
- Sources, reliability, and relevance of data used.
- Whether costs of another division might be properly allocable to the injuriously affected division, including possible contributory charges.
- Integrity and fair presentation of any graphics prepared by plaintiff's expert to depict various numbers or amounts (whether the graph or chart might

portray a misleading, exaggerated, or unduly dramatic picture).

- Integrity and validity of the inputs to the regression analysis applied, including the independent variable that was used.
- Whether plaintiff's expert had applied sensitivity analyses to check the reasonableness of the input variables (a slight variation of any variable potentially having a material effect on the lost-profits calculation). (The cross-examiner should already have in hand his/her own expert's sensitivity analysis and be prepared to confront plaintiff's expert on this issue.)
- How the expert dealt with inflation in the quantification of damages for lost profits.

CONCLUSION

While the facts and circumstances of every situation will differ, there are certainly enough areas and aspects of an expert's lost-profits damages quantification that can provide the defendant's attorney with sufficient ammunition to create doubt so as to discredit, or at least cause the court to place less weight on, the expert's opinion. Ideally, the cross-examiner should have the benefit of his or her damages expert's professional input. ~

¹ Ideal guideline companies are in the same industry as the company being valued; however, if there is insufficient transaction evidence available in the same industry, it may be necessary to select companies with an underlying similarity of relevant investment characteristics such as markets, products, growth, cyclical variability and other salient factors.

² A statistical technique used to establish the relationship of a dependent variable, such as a company's sales, and one or more independent variables, such as gross domestic product per capita, income, and other economic indicators. By measuring exactly how large and significant each independent variable has historically been in its relation to the dependent variable, the future value of the dependent variable is predicted.

³ "Contribution margin" is defined as revenues less variable costs, including the "variable" component of semi-variable costs.

⁴ Some fixed expenses may be fixed to the extent that they will not vary up to a certain gross-revenue limit; if the revenues are increased above that limit, these expenses will increase, but may remain fixed at the higher amount up to the new gross-revenue limit.

⁶ Federal Rules of Evidence, Rule 702 or the "Daubert Challenge" (*Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993)), and Rule 703.

⁶ See, for example, Robert L. Dunn, *Recovery of Damages for Lost Profits*, Lawpress Corporation (Westport, CT: 2005), 6th Edition (with Supplements to September 2010), Volume 2, Chapter 7.

⁷ See, for example, Robert L. Dunn, *Winning with Expert Witnesses in Commercial Litigation*, Lawpress Corporation (Westport, CT: 2003), Chapters 6 and 7. See also, Richard M. Wise, "What the Expert Witness Should Know About the Cross-Examiner's Trial Tactics," *Financial Valuation and Litigation Expert*, Issue 21, October/November 2009, www.valuationproducts.com, and "The Cross-Examiner's Tactics: What the Expert Witness Should Know," *Business Valuation Review*, Quarterly Journal of the Business Valuation Committee of the American Society of Appraisers, Vol. 23, No. 4, December 2004.

⁸ These alternative methods are explained in a presentation by Richard M. Wise to the Faculty of Law at McGill University, "Quantification of Economic Damages," *The Civil Law of Damages* (Montreal, Quebec: 1996).