Litigation Economics SERIES SUMMER 2025

Economatrix Research Associates, Inc
An Economic and Financial Consulting Firm

Key Issues in Assessing Business Interruption
Lost Profits Claims

1 Lost Revenues are Not Lost Profits

One of the most common mistakes and misunderstandings about business interruption lost profits claims is that lost revenues are the measure of loss. This is wrong. It is an error often made by plaintiffs who own closely held and small businesses. Lost profits are the lost revenues less the costs that would have been incurred to achieve those lost revenues. The size of the difference between the lost revenues and the lost profits can vary greatly depending on the cost structure of the business.

2 Converting Lost Revenues to Lost Profits

This part of the process involves some *financial analysis* and maybe some *cost accounting*. The financial analysis would differentiate between costs that are fixed and ones that vary with output. It is the latter, sometimes called incremental costs, that should be deducted from lost revenues.

3 Determining the Causal Linkage Between the Alleged Actions of the Defendant and the Damages

In some cases, this may be clear, but in others not as much. It depends on the fact pattern that the expert may be given to assume. However, the expert should also conduct his or her own economic and industry analysis to rule out other causal factors. It is common that the damages expert analyzes the macroeconomic and microeconomic environment to determine if such factors played a role in the alleged changes in the performance of the plaintiff's business.

4 Unique Industries & Industry Experts

Some industries are unique and specialized. Sometimes, this may require an industry expert to be retained. Such an expert may issue a separate report which, in turn, can be utilized and relied upon by the damages expert. It is common, if not the norm, that the damages expert is not an expert in the industry in which the plaintiff operates. However, while cases differ, the damages expert still may do his or her own industry analysis so as to become more familiar with the industry and understand the plaintiff's position in that industry.

5 Mitigation

A key concept in damages measurement is mitigation. Did the plaintiff exercise reasonable efforts to mitigate its damages? If, for example, the plaintiff alleges that the defendant did not honor a contractually agreed upon supply agreement, were other sources of supply readily available? Was the issue just a price difference? If so, that difference *might* be the extent of the damages.

6 Length of the Loss Period

The damages expert needs to determine the length of the loss period. This is often affected by mitigation opportunities. If the plaintiff lost a specific business opportunity, how long would it take to find an alternative? In cases where there is a contract time period, that *may* determine the length of the loss period. The length also needs to be one that a court would find reasonable.

7 Forecasting Lost Revenues

In constructing a lost revenue forecast, the expert needs to assess the past performance of the business and how its revenues varied with causal and related factors such as the performance of the national and regional economy, as well as the specific industry. Did most companies in the industry experience a similar decline in revenues or did most grow while the plaintiff's declined? The expert may not know the answer to such questions unless some industry analysis is conducted.

A basic step in creating a revenue projection is to estimate past growth and relate such growth to changes in causal variables such as growth of the economy. Then either an average of past revenues or a specific revenue level may be used. This will depend on case-specific factors.

The result is a *"but-for"* revenue projection. Lost revenues are then computed by deducting actual revenues from the but-for revenues.

8 *Before-And-After* Method and the *Yardstick* Approach

Two commonly used projection methods have been widely accepted in Federal and State Courts. The *before-and-after method* uses past performance to assess differences in revenues and profits. The *yardstick* approach uses some industry analysis to compare how the plaintiff performed compared to comparable companies in the same industry.

9 Discounting Projected Losses

Discounting brings future projected amounts to present value terms through the use of a discount rate. That rate not only takes into account the time value of money, but it also adjusts for the risk and uncertainty of the projection. This adjustment is done by the addition of a risk premium to the risk-free rate. One common error in loss measurement is using a risk-free rate to discount projected lost profits. This is very wrong as it implies that the risk inherent in the projected income stream is similar to that of a U.S. Treasury bond.

Of course, that is very wrong. The difference in the risk-free rate and the risk-adjusted rate can be significant depending on the plaintiff and its industry. The longer the projection, the more significant this issue may be.

10 Expert Credentials

Litigants need to be sure that the expert has the proper credentials. These may include a graduate degree, preferably a Ph.D. in economics, as well as having a tenured, full professorship teaching graduate level economics and finance at an accredited university. In addition, the expert should also have a significant publication record, including books published by major publishers (not self-published) and peer-reviewed scholarly journal articles. Ideally, such articles should be related to the field of litigation economics and finance.

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