Litigation Economics
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Economatrix Research Associates, Inc
An Economic and Financial Consulting Firm

10 Mistakes Damages Experts Make in Lost Profits Valuation

1. Failure to Analyze the Relevant Economy

Economic conditions have shifted dramatically over the past two decades, including the subprime crisis of 2008–2009, the COVID-19 recession, recent tariff policies, and geopolitical conflicts affecting energy markets. Understanding these conditions is critical to reliable projections of economic loss. Financial performance during strong economic environments, such as 2004–2007, may not be representative of weaker market conditions, including the COVID downturn. Applying peak results to materially different market environments may lead to exaggerated damages estimates.

2. Failure to Conduct an Industry Analysis

Industry conditions vary significantly, with some sectors expanding while others contract. Competitive intensity, margin structures, regulatory environments, and market concentration differ across industries, influencing profitability. Regulatory changes can materially affect growth and financial performance. A credible lost profits analysis requires a clear understanding of the industry landscape, including growth trends and structural constraints.

3. Role of an Industry Expert

The damages expert should possess a working knowledge of the relevant industry, often gained through prior engagements. In some cases, however, retaining an industry expert may be appropriate. Such experts can provide insight into market conditions, expected market share, competitive dynamics, and industry-specific developments. They may issue independent reports and testify as expert witnesses. The damages expert may rely upon these opinions and analyses.

4. Selecting an Anomalous Revenue Base

Lost profits are typically measured by forecasting but-for revenues and deducting incremental costs. Selecting the appropriate base revenue level, often the last full year before the loss event, is critical. If the selected base reflects an anomalous period driven by non-recurring factors, projections may be distorted. Experts should analyze historical financial performance to identify a representative baseline and distinguish between typical results and outliers.

5. Using a Speculative Growth Rate

But-for revenues are typically estimated by applying a growth rate to the selected base period. Unsupported growth assumptions may materially overstate damages. Growth rate selection requires expert judgment supported by case-specific analysis of firm performance and market conditions.

6. Failure to Conduct a "Reasonability" Test

After developing a but-for revenue projection, the expert should evaluate whether the results are commercially realistic. What market share does the analysis imply, and is the result commercially plausible? Does the analysis imply that a relatively small firm would rapidly become a leading industry participant? Such outcomes should be examined in light of competitive dynamics and economic realities.

7. Deducting the Relevant Incremental Costs

Lost profits require deducting the appropriate costs from projected but-for revenues. These costs are typically incremental, while fixed costs, such as rent and general overhead, are often excluded. Some expenses may also be semi-variable and increase once operational capacity thresholds are reached. Proper identification of these items is essential to an accurate damages calculation.

8. Failing to Consider Mitigation

Under the law, plaintiffs have an obligation to mitigate damages, including pursuing alternative opportunities. In some cases, a plaintiff may argue that it could have performed both the lost business and its current operations. This is often a fact-specific issue requiring input from damages and industry experts. Mitigation can significantly affect both the magnitude and duration of damages, including the availability of alternatives, timing of recovery, and contractual limitations.

9. Using a Risk-Free Discount Rate

Using a risk-free rate, such as the long-term U.S. Treasury bond rate, to discount future lost profits can materially overstate projected damages. This approach assumes a level of certainty inconsistent with the inherent uncertainty of projected profits and is not economically supportable. An appropriate discount rate should reflect the risk and variability of the projected cash flows. Failure to incorporate risk may result in an overstated measure of damages.

10. Determining the Appropriate Risk Premium

The discount rate for lost profits should include a risk premium reflecting the uncertainty of the projected income stream. This premium, added to the risk-free rate, should be informed by market-based benchmarks and comparable investment risks. Determining the appropriate premium requires expert judgment supported by data on returns, volatility, and comparable assets. Failure to properly account for risk may overstate damages.

Relatively small valuation assumptions can materially affect claimed damages.

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