Litigation Economics SERIES

Economatrix Research Associates, Inc
An Economic and Financial Consulting Firm

Ten Mistakes Damages Experts Make in Lost Profits Valuation

1 Failure to Analyze the Relevant Economy

Economic conditions are constantly changing. Sales and profit levels that a plaintiff may have enjoyed in a strong economy, such as the years 2004-2007, may not be as relevant in a weak economy, such as during the 18 month Great Recession that occurred starting in January 2008 and the weak recovery the followed. Taking sales levels from a period of robust economic and industry growth and projecting them into a very weak period may result in an exaggerated projection. Of course, each situation is different and brings with it its own special circumstances.

2 Failure to Conduct an Industry Analysis

Industries can vary considerably. Some may be growing while others may be contracting. Some feature high levels of competition and low margins while in other industries competition may be more limited and the margins could be higher. Certain industries may have large competitors that may make it difficult for smaller firms to gain market share. In addition, if there have been major regulatory changes in the industry, this can affect the company's profitability and growth.

3 Role of an Industry Expert

The damages expert should have some knowledge of the plaintiff's industry. This is often gained through an analysis of relevant data and reports in the course of the litigation assignment. However, some industries are very unique. In such cases an industry expert can be quite useful. The industry expert can provide important, industry-specific information to the damages expert. Ideally, the industry expert would issue an independent report and will also be available to serve as a testifying witness. The damages expert can then rely upon and cite the report and opinions of the industry specialist.

4 Selecting an Anomalous Base for a Revenue Forecast

Lost profits are measured by forecasting lost revenues, which are sometimes called "but-for" revenues, and then deducting the incremental costs associated with these incremental revenues. The lost revenues are forecasted using a starting point or base level. For example, this could be the last full year of revenues prior to an interruption. Considerable care and analysis needs to be used in selecting the relevant base. Experts need to be sure that it is not an anomalous year that was a function of factors that would not likely prevail during the loss period. Part of this determination will be to review the company's revenue history and try to determine what would be a representative revenue level and what could be an outlier.

5 Using Too High a Growth Rate

But-for revenues are projected by applying a growth rate to the appropriate base revenue level. This growth rate is determined by the expert through an analysis of the company's revenue history as well as the relevant trends in the industry and the economy. Ultimately, it is a "judgment call" made by the expert relying on his or her expertise but it also should be a function of an analysis of the relevant data and not just an arbitrary and unsupported number.

6 Failure to Conduct A "Reasonability" Test

Having constructed a "but-for" revenue projection, it is important for the expert to step back and examine the reasonableness of the business level that has been projected. What market share does that level imply? Is it reasonable? For example, does the projection imply that a smaller plaintiff would quickly become one of the leading suppliers in an industry? How likely is such an outcome? What factors is such an outcome dependent upon?

7 Deducting the Relevant Incremental Costs

"But-for" lost profits are measured by deducting the relevant costs from the but-for revenues. These costs are usually incremental costs. It is often the case that fixed costs, such as rent and overhead, are not included in these incremental costs. However, sometimes it is not a "black and white" situation as, in addition to fixed and variable costs, we have semi-variable costs which can be fixed over a certain range of output and can increase as a company's capacity level is reached.

8 Failing to Consider Mitigation

Under the law, plaintiffs have an obligation to mitigate their damages. It may be the case that this means that substitute business can be used to offset that which has been lost due to the alleged actions of a defendant. On the other hand, a plaintiff may contend that it would have done the other business as well as that which has been lost. This may be a fact-based issue but is also one in which the damages expert, and possibly the industry expert, may have opinions about.

9 Using a Risk-Free Rate to Discount Future Lost Profits

One of the major flaws seen in certain expert reports is using a risk-free rate, such as the Long-Term Treasury Bond rate, as the discount rate to discount lost profits. Using such a rate implies that the likelihood of receiving the lost profits is similar to the likelihood that an investor would receive interest and principal payments from the U.S. Treasury – an absurd conclusion. The correct rate is one which captures the risk and anticipated variability of the projected lost profits. Failing to use such a risk-adjusted rate may result in an exaggerated lost profits measure.

10 Determining the Appropriate Risk Premium

The appropriate discount rate to use to discount future lost profits is one which includes a specific risk premium which captures the perceived risk and variability of the specific lost profits projection. This is a premium that is added to the long term Treasury rate which is the rate that is used as the risk-free rate. It is also based upon an expert judgment – but an informed one that considers various market-based rates, and premiums embedded in those rates. In addition, it is also based upon a consideration the rate of return that investors might require in an investment that has risk characteristics of the lost profits projection.

It is important to note that not just future lost profits need to be risk-adjusted. Historical, pre-trial lost profits should also be adjusted for risk and uncertainty. However, given that they would have occurred in the past, the information set related to past losses is different and a different risk adjustment process should apply.

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ECONOMATRIX RESEARCH ASSOCIATES, INC.

1 MEADOWLANDS PLAZA
SUITE 200
EAST RUTHERFORD, NJ 07073
973-639-1300

44 WALL STREET
13TH FLOOR
NEW YORK, NY 10005
212-361-2600

1221 BRICKELL AVENUE
SUITE 9
MIAMI, FL 33131
305-960-8500