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Valuation & Litigation BRIEFING

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Uncharted territory

Recovering lost profits for a new or unestablished business

Lost profits are a common measure of damages in commercial litigation. But how do you prove lost profits for a new or unestablished business that has no earnings track record? Most courts permit unestablished businesses to recover these damages, provided they show the existence and amount of lost profits with "reasonable certainty."

Looking to the future

Regardless of whether a damaged business is established or unestablished, proving lost profits requires experts to predict the plaintiff's future performance. If the business is established, the expert analyzes its historical earnings and uses that information to estimate the profits it would have earned but for the defendant's alleged wrongful conduct. In doing so, causation is key. So, an expert considers a variety of factors — both internal and external — that aren't caused by the damaging act but may cause the plaintiff's future performance to improve or decline compared with its past performance.

For an unestablished business, an expert's job is essentially the same, but without the benefit of historical performance as a benchmark. The factors the expert considers include:

- Management quality (its skills, experience and track record with similar businesses),
- Business plans and financial projections (see "Can experts rely on management projections?" on page 3),
- Performance of comparable companies,
- Industry and market statistics and benchmarks, and
- Risk factors, such as the damaged business's age, stage of development, growth rate and expected time to reach profitability.

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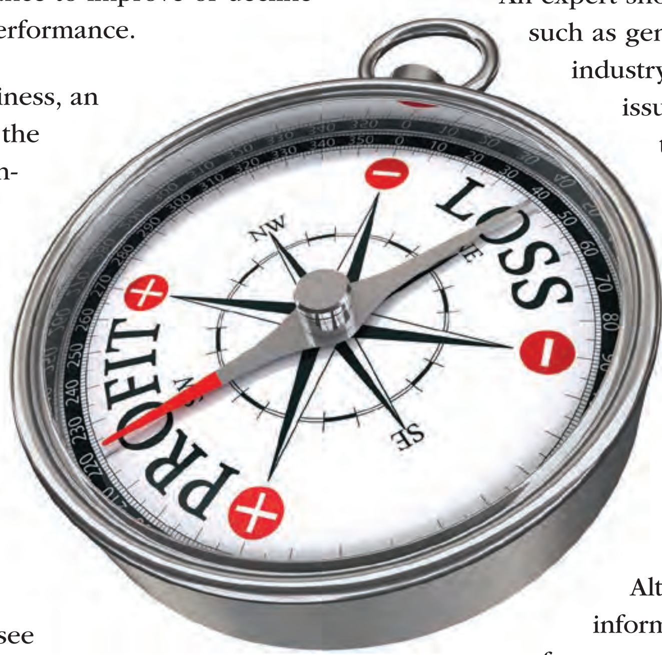


An expert should also consider factors — such as general economic conditions, industry developments or legal issues — that would have affected the business's performance regardless of the defendant's alleged wrongdoing. The expert needs to analyze the impact of these factors to isolate the impact of the defendant's alleged misconduct on the plaintiff's performance.

Considering postincident events

Although not absolutely necessary, information about the business's performance after the incident that triggered the litigation (that is, hindsight) can be valuable

CAN EXPERTS RELY ON MANAGEMENT PROJECTIONS?

Generally, management's internal projections are the best predictor of future performance because no one understands the business, the industry and the market better than management. With that in mind, however, it's important for a damages expert to ensure that management projections are reliable.

In *Merion Capital, L.P. v. 3M Cogent, Inc.*, for example, the Delaware Chancery Court accepted management's cash flow projections as a reliable starting point in valuing a company in connection with litigation arising out of a merger. Although *Merion* wasn't a lost profits case, the court's discussion of the reliability of management projections is instructive.

Generally, the court said, it "prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations." The court explained, however, that management projections may be less reliable, and not entitled to the same level of deference, if:

- Management had never prepared projections beyond the current fiscal year,
- There was a likelihood of litigation, and
- The projections were prepared outside of the ordinary course of business.

Absent evidence that management projections are unreliable, or that management had a conflict of interest when preparing them, a damages expert will usually be permitted to rely on them in calculating lost profits.

in proving lost profits with reasonable certainty. This is particularly true for unestablished businesses that lack a preincident track record. Also, it can be extremely difficult to identify truly comparable businesses, so the plaintiff's postincident record may be the best benchmark available.

One common approach for calculating lost profits is the "before and after" approach, which bases damages on a comparison of profits before and after the defendant's alleged misconduct. When a plaintiff's business is unestablished, there's no "before." But the plaintiff's postincident performance in alternative or parallel business endeavors can serve as a proxy in measuring the expected success of the business opportunity that was lost as a result of the defendant's alleged wrongdoing.

For example, management's strong postincident performance in alternative business activities — that is, activities pursued to replace the lost opportunities for which the litigation was brought — lends support to the argument that the plaintiff would have been successful but for the defendant's alleged misconduct. Although profits from such activities tend to mitigate any potential damages award, their absence might cast doubt on management's abilities and, therefore, make it more difficult to prove lost profits with reasonable certainty.

Parallel business activities — or postincident activities that would have occurred regardless of the defendant's actions — can be even more effective. For example, the plaintiff may have been developing two distinct product lines. If the defendant's alleged misconduct damaged one of the product lines, the plaintiff's postincident success with the second product line might provide some evidence of management's ability to turn a profit with the first.

Raising the bar

Although lost profits damages are available for new and unestablished businesses, the evidence offered to support such damages will be subjected to a higher level of scrutiny. So it's important to work closely with your expert to build a solid case. ◆

Business valuations for SBA 7(a) loans: What's required?

The Small Business Administration (SBA) 7(a) program offers guaranteed business loans at competitive terms. SBA regulations require an independent business valuation from a "qualified source" in connection with certain 7(a) loans. It's important for borrowers and their advisors to understand when a valuation is required and what an SBA valuation entails.

When are valuations required?

Valuations may be required if the 7(a) loan proceeds will be used to finance a change in ownership. Generally, a change in ownership involves 1) a buyer that purchases a 100% interest in a business, or 2) a business that purchases 100% of one or more of its owners' interests. If no change in ownership is involved, a valuation isn't required. But it's important to note that a loan used to refinance a previously financed change in ownership may require a valuation.

It's important for borrowers and their advisors to understand when a valuation is required and what an SBA valuation entails.

If the transaction involves a change in ownership, the SBA requires a valuation if the total amount financed — less the appraised value of any real estate or equipment being financed — is more than $250,000. A valuation is also required if the buyer and seller are closely related (for example, if they're business partners or family members).

Who may perform the valuation?

If a valuation is required, the valuator must be independent and qualified. The independence requirement means the valuator can't have an interest in the transaction's outcome. This typically prevents the deal's broker or lender from providing a valuation.

The SBA's Standard Operating Procedures (SOPs) define "qualified" valuator as someone who regularly receives compensation for business valuations and has earned one of the following credentials: Accredited Senior Appraiser (ASA), Certified Business Appraiser (CBA), Accredited in Business Valuation (ABV), Certified Valuation Analyst (CVA), Accredited Valuation Analyst (AVA) or Accredited Business Certified Appraiser (ABCA).

The SOP also stipulates that:

- The lender must request the valuation for its own purposes (though a broker may recommend a valuator),
- The lender must not use a valuation prepared for another party (though it may pass the cost on to the borrower),

- The engagement's "scope of work" section must identify whether the transaction is an asset or stock purchase and specify what's included in the sale (including any assumed debt), and

- The valuation report must contain the valuator's opinion of value and qualifications, as well as a signature certifying the validity of the information the valuation contains.

Additionally, the lender must obtain a copy of the financial information relied upon by the valuator and verify that information against the seller's IRS transcripts.

Will your valuation pass muster?

To ensure a valuation meets with the SBA's approval, be sure that the lender engages a qualified, independent valuator. It's also important to hire someone who's familiar with SBA valuation guidelines. ◆

Statistics and big data play a supporting role in litigation

As the business world becomes increasingly complex, so does commercial litigation. Often, the sheer volume of documents, data and transactions involved makes it difficult to establish causation, quantify losses or calculate damages. Analytical techniques, such as statistical and big data analysis, can make these tasks far more manageable and cost-effective.

Using statistics

Under the right circumstances, statistical analysis makes it possible to extrapolate the results of sample data to establish a claim for a larger population with reasonable certainty. Examples of the use of statistics in litigation include:

- Estimating damages in False Claims Act cases by extrapolating the results of a sample of claims to the entire population of claims rather than proving each claim individually,

- Using regression analysis or other statistical methods to estimate costs in calculating lost profits,

- Using regression analysis to establish unlawful age discrimination by showing a positive correlation between age and termination rates, and

- Using government or industry statistics to estimate a plaintiff's work life expectancy, projected earnings or benefits in employment litigation.

It's critical in these cases to involve experts with statistical analysis experience to ensure that the statistics being used are reliable, the population is properly defined and the sample is representative of that population.

Using big data

In a litigation setting, big data typically refers to the use of powerful computers to analyze extremely large data sets to reveal patterns, trends and associations.

In fraud cases, big data can be used to reveal patterns that would be difficult or impossible to spot using conventional methods. For example, fraud perpetrators often create phony invoices with round numbers — like $1,000, $5,000 or $10,000 — or that fall just under the approval limit. Big data analysis can sift through enormous amounts of data to identify vendors with an unusually high percentage of such amounts.

Financial analysts also sometimes use Benford's Law to detect fraud patterns in sets of tabulated data. (According to the law, the greatest percentage of numbers begins with 1 or 2, while the smallest percentage begins with 9 — thus, deviations from these patterns may indicate that data has been manipulated.)

Recently, the Securities and Exchange Commission (SEC) brought its first fraud action based on analysis of large volumes of trading data. In the case *In the Matter of Welhouse & Associates Inc.*, the SEC charged an investment advisor with "cherry-picking," alleging that the advisor improperly allocated options trades that had appreciated in value during the course of the day to his personal or business accounts, while allocating trades that had depreciated in value to his clients' accounts.

Cherry-picking and similar frauds are difficult to spot and often go undetected until a whistleblower reports it to the SEC or some other fraud indicator reveals itself. But the SEC was able to use big data analysis to prove that the advisor didn't, as he claimed, follow his firm's prescribed pro rata allocation procedures. Rather, he allocated a disproportionate number of profitable options trades to favored accounts (accounts belonging to the advisor or to someone with the same last name), while allocating unprofitable options trades to client accounts.

Making the most of technology

For years, financial experts have used statistical analysis to help make the litigation process more cost-effective. Big data analysis takes this a step further, using modern technology to sift through enormous amounts of data to uncover fraud or other wrongdoing that, until now, often went undetected for years. ◆

Avoid costly disputes with a buy-sell agreement

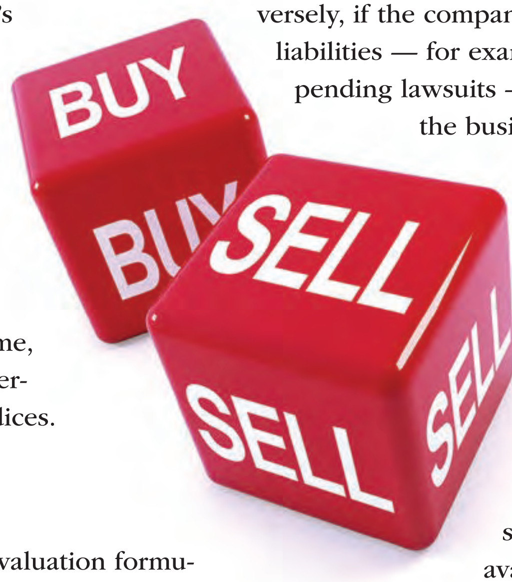
A buy-sell agreement can be key in helping avoid disputes over ownership rights, control, and the value of a company when an owner leaves the business. The agreement gives the company or remaining owners the right, or obligation, to buy a departing owner's interest after a "triggering event" occurs, such as death, disability, divorce, termination of employment, or some other event. Whether the buy-sell is triggered voluntarily or involuntarily, it's critical for owners to protect their financial interests with an agreement that's legally enforceable and comprehensive.

Define buyout terms

Comprehensive buy-sell agreements explicitly define the appropriate standard and basis of value to apply to owners' interests. For example, an agreement might prescribe "fair market value" as defined in Revenue Ruling 59-60. For minority interests, fair market value implies a minority, nonmarketable basis of value.

Conversely, an agreement might use the term "fair value" and define it to refer to each owner's pro rata share of the entire company's controlling, marketable value.

Other important valuation parameters include the appropriate "as of" date and payout mechanisms. Funds might be generated from life insurance proceeds, bank loans or seller financing. If exiting owners (or their estates) will be paid over time, it's important to specify duration, interest rates and variable-rate market indices.



Avoid ambiguous or outdated valuation formulas

Some buy-sell agreements prescribe valuation formulas to avoid the time and expense of hiring valuators. Unfortunately, these formulas may be oversimplified or outdated.

If controlling owners engage in financial misstatement or deny minority shareholders' access to facilities or financial information, buy-sell agreements might call for forensic accountants.

Consider an agreement that stipulates the company is worth four times annual earnings. What does the term "earnings" really mean? One valuator might assume it refers to accounting net income and another might use pretax earnings, adjusted for depreciation and amortization, interest expense, nonrecurring items, and quasi-business expenses. Different interpretations can lead to substantial variance in opinions.

Imagine that the hypothetical company has been reserving cash to purchase land adjacent to its plant for future expansion. The prescribed rule of thumb doesn't account for excess working capital and, therefore, is likely to undervalue the business. Conversely, if the company has significant contingent liabilities — for example, environmental cleanup or pending lawsuits — the formula might *over*value the business.

Specify the financial data to be used

Suppose an owner dies on February 10, 2017. Would the valuator rely on 2015 audited financial statements, unaudited internal records for the trailing 12 months, or the 2016 audited financial statements (which might not be available until April 2017)?

Thorough buy-sell agreements specify how to determine financial statement dates and the requisite level of assurance (compilation, review or audit). If controlling owners engage in financial misstatement or deny minority shareholders' access to facilities or financial information, agreements also might call for forensic accountants.

Predetermine the agreement's appraisal timeline

Remaining shareholders seldom are in a hurry to buy back shares, but exiting shareholders — or their surviving family members — have a financial incentive to cash out quickly.

Valuation often takes longer than owners anticipate, especially if the buy-sell agreement calls for multiple experts or valuation disputes arise. Predetermined timelines can establish reasonable expectations and help ensure buyouts are completed in a timely — but not rushed — manner.

Stay on top

It's essential to ensure the valuation under your agreement is well reasoned and supportable and to update the agreement periodically as circumstances change. With foresight and the help of an experienced valuator, you'll come out ahead. ◆