

# *Economic Damages*

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## *Theory and Calculation of Economic Damages*

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***Presented by:***

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Managing Partner of the Long Island office of Empire Valuation Consultants  
Trained professional in preparing damage calculations, business valuations and performing forensic accounting.

Experience covers economic damages, valuations for matrimonial and estate tax purposes, gift planning, shareholder disputes, and buy/sell agreements.

### **Trial Testimony**

- New York State Supreme – Nassau County
- New York State Supreme – New York County
- Federal Court – Eastern District of New York
- Federal Court – District of Massachusetts

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## Pasquale Rafanelli, CPA/ABV, ASA, CVA/CBA/MAFF, CFE, CDFA®

Pasquale Rafanelli, a Senior Manager at Empire Valuation Consultants, brings more than 13 years of experience providing business valuation, forensic accounting and advisory services to closely held companies, attorneys, accountants and financial professionals.

He has performed valuations and forensic examinations of various classes of equity, general and limited partnership interests, carried interest, limited liability company membership interests, C-Corporations, S Corporations, stock options and warrants. These valuations and forensic examinations have been for purposes included gift and estate planning, financial reporting, purchase price allocation, employee stock ownership plan administration, other corporate planning and reporting, buy/sell, merger and acquisitions, family law matters, business damages, lost profits, corporate litigation, and shareholder disputes.

### **Trial Testimony**

- New York State Supreme Court – Suffolk County

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## LOST PROFIT ANALYSIS

### I. OVERVIEW OF CASE LAW AND EVIDENTIARY STANDARDS

- Compliance
- Experts will be required:
  - Knowledge
  - Show facts
  - Basis for conclusion

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## LOST PROFIT ANALYSIS

### II. ROLE OF THE PRACTITIONER IN LOST PROFITS ANALYSIS

The practitioner may be engaged to provide services as a consultant, an expert witness or in some other capacity, including acting as a trier of fact, special master, court-appointed expert, referee, arbitrator, or mediator

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## LOST PROFIT ANALYSIS

### III. LOST PROFITS CLAIMS

A. Damages can be broken into three main types:

1. Actual or Compensatory Damages
2. Nominal Damages
3. Punitive Damages

The focus of this presentation is on actual or compensatory damages related to a claim for lost profits.

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## LOST PROFIT ANALYSIS

### III. LOST PROFITS CLAIMS

B. Lost profits usually involve either a breach of contract or tort, other than negligence.

1. Contract Disputes
2. Torts, other than negligence

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## LOST PROFIT ANALYSIS

### IV. LEGAL PRINCIPLES OF PROVING DAMAGES

Causation – Proximate cause is an act from which an injury results as a natural, direct, uninterrupted consequence and without which the injury would not have occurred.

*Without causation, there are no damages.*

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## LOST PROFIT ANALYSIS

### IV. LEGAL PRINCIPLES OF PROVING LIABILITY LEADING TO DAMAGES

#### A. Transaction Causation – concept of “but for”.

Loss Causation – plaintiff must prove that their loss is related to the breach or wrongful act.

The fact of damage is required to be proven with reasonable certainty.

Once the fact of damage has been established, the amount of damage can be calculated.

Of note and significantly, the defendant’s acts need not be the sole cause of the plaintiff’s lost profits.

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## LOST PROFIT ANALYSIS

### IV. LEGAL PRINCIPLES OF PROVING DAMAGES

#### B. Foreseeability (Contract Damages Only)

Damages for lost profits are recoverable only if they are reasonably foreseeable by the breaching party at the time of contracting.

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## LOST PROFIT ANALYSIS

### IV. LEGAL PRINCIPLES OF PROVING DAMAGES

#### C. Certainty

Damages for lost profits are recoverable only if the plaintiff can prove that the damages related to lost profits are reasonable and that they have been calculated using reliable factors with out undue speculation.

Damages cannot be “unduly speculative” and need to be calculated to a “reasonable degree of economic certainty”.

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## LOST PROFIT ANALYSIS

### V. LOSS PERIOD

The length of the loss period can vary depending on the underlying cause of action and upon the underlying facts of the case

- A. Breach of Contract
- B. Torts, other than negligence

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## LOST PROFIT ANALYSIS

### VI. MEASURES OF LOST PROFITS

- A. Lost Profits

Calculation:

What would have happened “but for”

Less: what actually happened as a result of the breach  
(mitigating profits)

Equals = Lost Profits

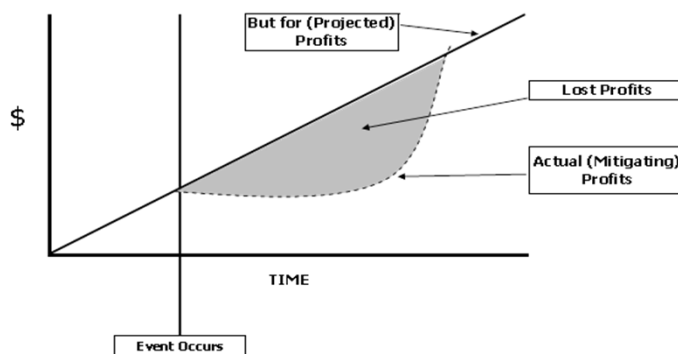
- B. Regardless of methodology used, the plaintiff’s loss is the difference between but for (projected) and actual (can be projected)

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## LOST PROFIT ANALYSIS

### VI. MEASURES OF LOST PROFITS



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## LOST PROFIT ANALYSIS

### VII. CALCULATING LOST REVENUES

The first element in the determination of lost profits is the calculation of lost revenues. This section discusses the normal methods of calculating lost revenues.

- A. The "Before and After" Method
- B. The "Yardstick" (or "Benchmark") Method

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## LOST PROFIT ANALYSIS

### VII. CALCULATING LOST REVENUES

#### C. Calculation Based on the Terms of the Contract

1. An Accounting of Defendant's Profits
2. Other

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## LOST PROFIT ANALYSIS

### VII. CALCULATING LOST REVENUES

#### D. Final Considerations Regardless of the Method Used

1. Past and Future Lost Revenues
2. Do the Calculated Lost Revenues Make Sense?

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## LOST PROFIT ANALYSIS

### VIII. COST ESTIMATION

After establishing the amount of lost revenues, the practitioner will need to calculate the costs associated with the generation of those revenues.

- A. Concept of Avoided Costs
- B. Analysis of the plaintiff's Cost Structure
- C. Fixed Versus Variable Costs
  - 1. Non-statistical Methods of Cost Estimation
  - 2. Statistical Methods of Cost Estimation
  - 3. Do the Calculated Avoided Costs Make Sense?

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## LOST PROFIT ANALYSIS

### IX. PREJUDGMENT INTEREST ON PAST LOSSES

Awarding prejudgment interest converts time-of-incident damages into time-of-judgment damages, allowing the plaintiff to be fully compensated for the loss of use of those funds.

Courts have considerable discretion in the calculation of prejudgment interest, including the interest rates to be applied and the manner of computing interest.

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## LOST PROFIT ANALYSIS

### IX. PREJUDGMENT INTEREST ON PAST LOSSES

Rates that might be used for the calculation of prejudgment interest include but are not limited to:

- o Prime Rate
- o Defendant's After-Tax Borrowing Rate
- o Plaintiff's Cost of Capital
- o Treasury Bill or Bond Rate
- o State Statutory Rate
- o A stated rate pursuant to a contract between the parties.

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## LOST PROFIT ANALYSIS

### X. FINANCIAL DISCOUNTING OF FUTURE LOST PROFITS TO PRESENT VALUE

- A. The Time Value of Money
- B. Ex Post Methodology Versus Ex Ante Methodology
- C. Methods of Determining Discount Rate
- D. Mid-Year Versus End-of-Year Discounting
- E. Adjusting for Risk in Projected Profits Versus Accounting for Risk in the Discount Rate

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## LOST PROFIT ANALYSIS

### XI. TAXES AND DAMAGES

In general, lost profits damages are taxable as ordinary income to the party to which damages are paid. Also, generally, whether received as a result of legal judgment or settlement, tax treatment is the same for lost profits damages. As such, lost profit calculations are typically prepared on a pretax basis. To the extent that the plaintiff received tax benefits as a result of losses caused by the purported bad act, such benefits are generally not considered.

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## LOST PROFIT ANALYSIS

### XII. MITIGATION OF DAMAGES

The plaintiff has an obligation to mitigate its damages. The duty of mitigation requires that the plaintiff take appropriate actions to overcome the damage purportedly caused by the defendant.

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**LOST PROFIT ANALYSIS****XIII. OTHER ISSUES AFFECTING LOST PROFITS ANALYSIS**

- A. Distinguishing Between Violative and Nonviolative Acts
- B. Distinguishing Various Violative Acts
- C. Impact of Subsequent Events
- D. Changes in the Economic Environment

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**LOST PROFIT ANALYSIS****XIV. ALTERNATIVE DAMAGE MEASURES OTHER THAN LOST PROFITS**

- A. Out-of-Pocket Costs
- B. Decrease in Value Caused by the Defendant's Misconduct (Diminution of Value)

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## LOST PROFIT ANALYSIS

### XV. SPECIALIZED DAMAGES AREAS

- A. Newly Established Businesses
- B. Intellectual Property Infringement Damages
- C. Antitrust Violation Damages
- D. Securities Fraud Damages
- E. E-Business Impact on Damages

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## LOST PROFIT ANALYSIS

### XVI. CONCLUSION

- A. Typically claimed as an element of economic damages in a litigation:
  - The wrongful act of the defendant caused a loss;
  - and
  - The amount of the loss can be estimated with reasonable certainty. You may also see terms like a “Reasonable Economic (or Accounting) Certainty”.
  - The estimated damages cannot be unduly speculative.
- B. Only lost “Net” profits are allowed as damages.
- C. Lost profit can only be claimed over the loss period.

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# COMMENTS AND QUESTIONS???

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## Presenters



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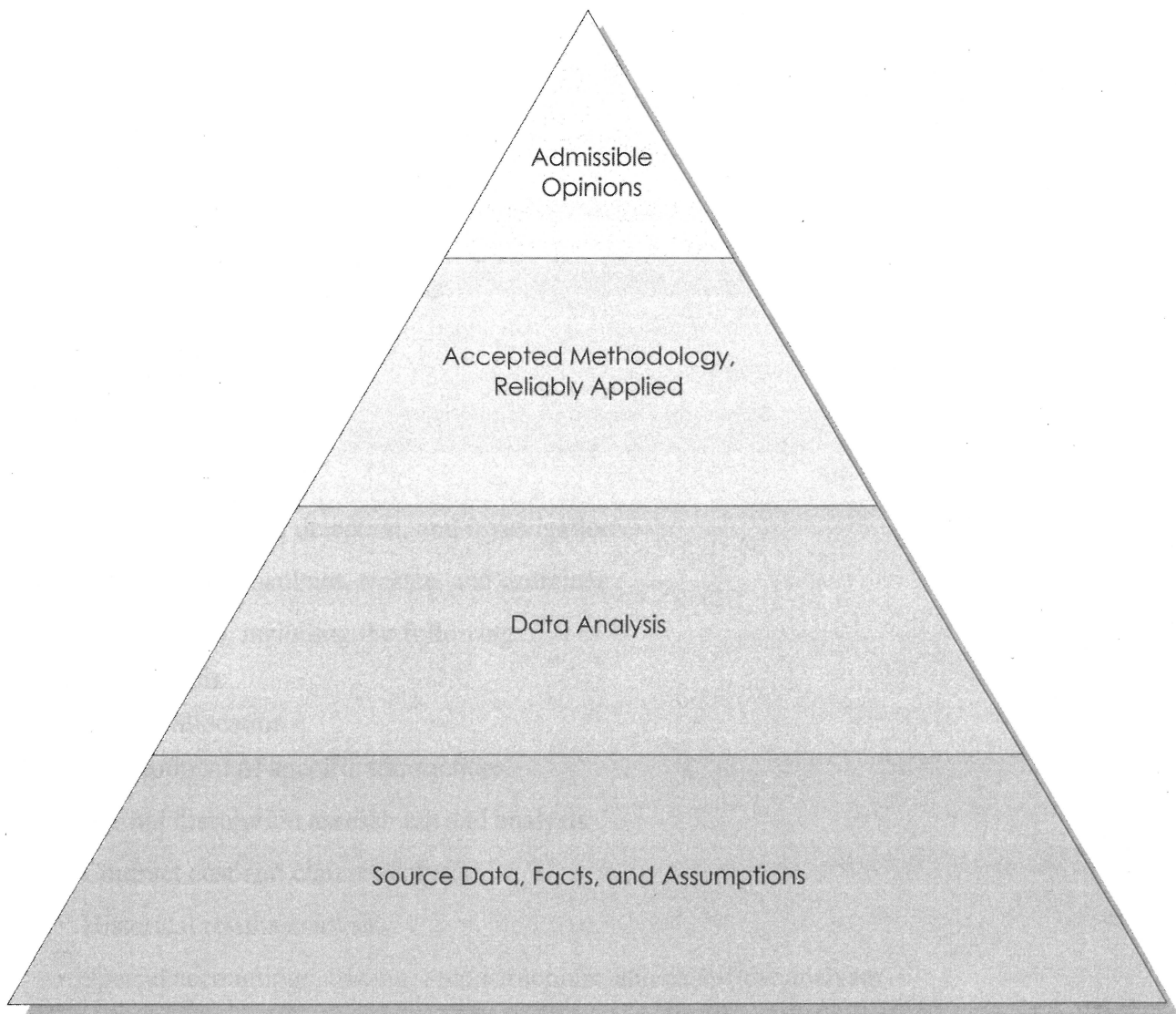
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## **APPENDIX B: TESTIMONY PYRAMID**

Consistent with AICPA *Professional Standards*, Rule 702 of the Federal Rules of Evidence requires expert testimony be based upon sufficient facts or data, be the product of reliable principles and methods, and that the principles and methods be reliably applied to the facts of the case. Graphically presented, the testimony pyramid might be as follows:



**Source: AICPA, Calculating Lost Profits**



## **APPENDIX C: TYPICAL LITIGATION SERVICES**

Practitioners may provide various types of services or functions in litigation engagements. Some of the more common include:

- Computation of economic damages:
  - o Lost profits
  - o Lost value
  - o Extra costs
  - o Lost cash flow
  - o Mitigation
  - o Restitution
  - o Punitive damage studies
- Professional standards analysis
- Valuation of the following:
  - o Business
  - o Pensions
  - o Intangibles
- Fraud prevention, detection, and investigation
- Bankruptcy consultant, trustee, and examiner
- Tax analysis, including the following:
  - o Tax basis
  - o Cost allocation
  - o Treatment of specific transactions
- Marital dissolution assessment and analysis
- Contract cost and claims analysis
- Historical results analysis
- Special accountings, tracing, reconstructions, and cash-flow analyses
- Antitrust analysis, including the following:
  - o Price fixing
  - o Market share
  - o Market definition

## **APPENDIX B**

- o Predatory conduct
- o Dumping
- o Price discrimination
- Business interruption and other insurance claims and assessments
- Attest services, if specifically engaged to perform them in connection with litigation services

Any of the following functions may be performed:

- Issue identification
- Locating other experts
- Fact finding, including the following:
  - o Asset searches
  - o Market studies
  - o Systems reviews
  - o Interviewing of witnesses
  - o Due diligence
  - o Research
- Analysis
  - o Investigative accounting
  - o Computer modeling
  - o Statistical
  - o Actuarial
- Discovery assistance
- Document management
- Settlement assistance
- Expert testimony
- Trial and deposition assistance
- Posttrial support (such as bookkeeping services and funds administration)
- Negotiations
- Arbitration
- Mediation
- Training
- Case evaluation

## APPENDIX D: EX ANTE VERSUS EX POST

