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The Use of "Business Value" as a Measure of Loss in Litigation Contexts: Deciding When it is Appropriate, Methodology, and Issues to Consider

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This paper was presented at the 2010 Joint ASA-CICBV Business Valuation Conference in Miami, Florida. The following represents an abstract, table of contents, and the introduction of the paper. Please contact the author at plobo@cohenhamiltonsteger.com if you would like a copy of the full paper.

ABSTRACT

The purpose of loss quantification is to restore an injured party to the position he or she would have been in had an alleged harmful act not occurred. In many corporate commercial litigation contexts, this requires an analysis of "but for" and "actual" cash flows, with the difference representing financial loss. Business valuators may, in some cases, consider using a *business valuation* approach to quantify financial loss. Namely, business valuators may calculate loss as the *"fair market value"* of a business, contract or other specified asset.

There are a number of important conceptual questions that need to be considered before using a business value approach to measure loss. For instance, in what contexts might a business value approach be applicable/inapplicable? How would the business value methodology be different from that used in non-loss quantification contexts? Should hindsight information be used? How would one set an appropriate discount/capitalization rate? How might one reconcile loss conclusions reached using a business value methodology versus a differential cash flow methodology? How do income taxes factor in? These are some of the important conceptual and practical issues that are considered in this paper, together with real life, practical examples to illustrate various points.

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The Use of "Business Value" as a Measure of Loss in Litigation Contexts: Deciding When it is Appropriate, Methodology, and Issues to Consider[1]

"Nothing is more difficult, and therefore more precious, than to be able to decide"
Napoleon Bonaparte

"For everything there is a season, and a time for every purpose under heaven"
Ecclesiastes 3:1

1.0 INTRODUCTION

The purpose of loss quantification is most often to restore an injured party (a "plaintiff") to the position he or she would have been in had an alleged wrongful act or breach not occurred. In many corporate commercial litigation contexts, this requires an analysis of the cash flows that would have been earned by a plaintiff *"but for"* an alleged wrongful act or breach and comparing these to the *"actual"* cash flows that were earned by the plaintiff, with the difference representing the quantum of business loss.

In some contexts, as an alternative to the "but for" versus "actual" *lost cash flow*[2] analysis, business valuators ("valuators") may consider employing a *business value* approach to quantify loss. Namely, valuators may decide to calculate loss as the *"fair market value"* (or the diminution in fair market value) of a business, contract, stream of income or other specified asset as a result of the wrongful act or breach.

For instance, assume a plaintiff business pursues legal action against a former employee of the company who resigned from the business, improperly solicited customers of the plaintiff and set up a competing business. As a result, the plaintiff was forced to shut down one of its operating divisions. After examining the facts of the situation, a valuator may establish that, "but for" the alleged improper solicitation, the customers that were "lost" would otherwise have continued on with the plaintiff, the division in question would have continued to operate indefinitely, and mitigation was not feasible. Therefore, a valuator might consider calculating the plaintiff's loss as the fair market value of the plaintiff's shut-down division at a particular loss assessment date.
Ultimately, the use of business value as a measure of loss requires a careful consideration of the facts of each loss quantification context. There are a number of key assumptions that underlie whether a business value approach is appropriate to use in a particular context. Indeed, using a

[1] The author is grateful to Tylar St. John of Cohen Hamilton Steger & Co. Inc., for her assistance in researching this paper. This paper is dedicated to the memory of Adam Pete Lobo.

[2] Also referred to as "lost profits".

business value approach versus a lost cash flow approach can have a material impact on the calculated loss.

The purpose of this paper is to explore and understand the following:

1) What is meant by a "business value" approach to quantifying loss versus a "lost cash flow" approach?
2) In what litigation contexts might it be appropriate/inappropriate to use a business value approach to quantifying loss?
3) What are the underlying assumptions behind using a business value approach to quantify loss and when are these assumptions valid?
4) What is the methodology behind the calculation of business value for loss quantification purposes (and, how is the methodology different from that used in the lost cash flow approach, and when calculating business value in *non-litigation* contexts)?
5) What discount rate/capitalization rate should be used to arrive at business value?
6) What are some of the special issues that need to be considered when applying a business value versus lost cash flow approach to quantify loss?

This paper is divided into three parts. Part I discusses the theory of loss quantification, and contrasts between a business value versus a lost cash flow approach. Part II discusses the appropriateness of using a business value approach. Part III discusses the methodology for performing a business value versus a lost cash flow analysis and special issues to consider.