Business value as a measure of loss in litigation contexts: Reflecting business “reality” over hypothetical “fantasy”

Farley J. Cohen and Prem M. Lobo

“In this the real life? Is this just fantasy? Caught in a landslide, no escape from reality…”
- Freddie Mercury / Queen, “Bohemian Rhapsody”

In commercial litigation matters, counsel for both plaintiff and defence often find themselves obliged to turn their attention from the initial (and ever important) liability portion of the case to the also-important damages portion. With respect to damages, counsel need to consider, among other things, what damages will be claimed at trial, how to prove damages, what case law may apply with respect to specific damages being claimed, and whether damages-quantification expert witnesses need to be retained to prepare a report and testify at trial.

The purpose of damages is most often to restore a plaintiff to the position he or she would have been in had an alleged wrongful act or breach not occurred. In many 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 with the actual cash flows that were earned by the plaintiff, with the difference representing the quantum of loss.

In some contexts, as an alternative to the “but for” versus actual lost cash flow analysis, a business value approach may be considered to quantify loss. Namely, loss may be quantified 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 that a business has suffered harm as a result of an alleged wrongful act. Instead of quantifying loss as its lost cash flows for a finite period of time, the loss may be calculated as the loss in value of the entire business, indefinitely.

Expert witnesses are usually retained when the quantification of loss is not readily apparent to the court and requires specialized accounting or financial analyses to assist the court in determining what amount of damages to award. Expert witnesses often have to make important decisions with respect to whether a “lost cash flow” versus a “business value” approach is applicable in a particular case. Litigation counsel, in turn, need to understand the rationale for the approach chosen or suggested by the expert and need to play an active role in providing the expert with relevant case law on the subject.

The choice of “lost cash flow” versus a “business value” approach can have a significant impact on the dollar value of loss being claimed. In addition, the inappropriate use of one or another in a particular context may impact the credibility of the expert witness and jeopardize the claim for damages.

This article addresses the situations in which a “lost cash flow” approach versus a “business value” approach to quantifying loss is appropriate. Although it is written from the perspective of an expert witness who has to decide between the two approaches, it is directed towards litigation counsel who have to understand the approach chosen and its underlying rationale, ensure consistency with relevant case law and, potentially, cross-examine an expert witness on his or her choice of one method over another.

In particular, this article will touch on the following topics:

- What is meant by a “business value” approach to quantifying loss versus a “lost cash flow” approach?
- In what litigation contexts might it be appropriate/inappropriate to use a business value approach to quantifying loss?
- What are the underlying assumptions behind using a business value approach to quantify loss, and when are these assumptions valid?
- 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?

The theory of loss quantification and the difference between a business value and lost cash flow approach to loss quantification

The purpose of loss quantification

In order to fully understand the business value approach to loss quantification, it is helpful to begin with first principles – namely, by discussing the purpose behind the quantification of loss.

The ultimate objective of loss quantification is to calculate, in an objective and independent manner, with due diligence and consideration of the available facts, assumptions and restrictions of each situation, the financial loss, if any, incurred by a plaintiff as a result of the alleged actions of a defendant. A quantification of loss should normally restore a plaintiff to the position that he or she would have been in had an alleged wrongful act or breach not occurred.

The loss quantification is usually prepared at a particular (current) assessment date. Relative to the current assessment date, loss may have occurred in prior periods (i.e., a “past loss”) and may be expected to continue into future periods (i.e., a “future loss”), either for a finite period of time or, sometimes, indefinitely into the future.
“Compensation” or “restitution” is an important characteristic of loss quantification. Eminent Canadian law professor and author Stephen Waddams states that “the object of compensatory damages is to put the party complaining in the position that would have been occupied ‘if the wrong had not been done’ or ‘if his rights had been observed.’” Note that it is ultimately up to a court to decide whether a particular amount (or amounts) quantified by a valuator (or valuators) will restore a particular plaintiff to a position of “wholeness,” or whether some alternate amount(s) or other remedy established by the court would be more equitable.

**Lost cash flow approach**

Often, the quantification of loss requires the determination of the cash flows that a plaintiff business or individual would have earned but for the alleged wrongful actions of another party (the defendant) and comparing these with the actual cash flows that the plaintiff did generate. The difference between the two represents the quantum of loss. As such, this approach will be referred to as the “lost cash flow” approach.

Assume that the plaintiff, Company A, manufactures and sells two models of window blinds to retailers – the “Sunrise” and the “Sunset.” Prior to the infringement described below, each model accounted for 50 per cent of total company sales. The mechanical components and operating process of the Sunrise are protected under patents held by Company A, whereas the Sunset is not. Assume that the defendant and competitor, Company B, has replicated the Sunrise blind, which it sells at a lower price and under the name “Eclipse.” Company A alleges that the Eclipse blind infringes its patents on the Sunrise, and has initiated legal action against Company B.

Company A has noticed a significant loss in Sunrise sales that corresponds roughly to the time that Company B began selling Eclipse blinds. Sales of Sunset blinds before and during the alleged infringement have remained constant and are expected to continue as such.

If Company A takes Company B to court and successfully proves infringement, then Company A will likely be able to recover its losses arising from its lost Sunrise sales.

Company A would have experienced a past loss from the start of the infringement period up to the loss assessment date, represented by the difference between the cash flow that Company A would have earned from the Sunrise blind “but for” the alleged infringement and the cash flow that Company A actually earned from selling the Sunrise blind to the loss assessment date. Company A will also likely experience a future loss from the loss assessment date to the date that Company B is ordered by the court to stop selling infringing Eclipse blinds.

Some observations to be made from this example are as follows:

- Company A has experienced lost cash flow, but the loss is not expected to continue indefinitely into the future.
- The lost cash flow relates to one product, but Company A continues to sell another product, which is unaffected by the infringement.
- Company A has remained and is expected to continue in operation despite the infringement.

Given the above facts and context, in this situation, the use of a lost cash flow approach is appropriate.

**Business value approach**

In contrast to the “temporary” business loss example presented above, there may be circumstances whereby the loss is more “permanent” in nature, and the quantification of loss may require the valuation, on the basis of fair market value, of a division of or an entire business, contract, stream of income or other specified asset. These circumstances may arise in “tort” or “breach of contract” contexts as discussed in the next section of this article, “The appropriateness of using a business value approach.”

Consider, for example, the fact situation outlined in the example above, whereby Company B infringes on Company A’s patents on Sunrise blinds. However, this time, assume that the Sunrise is the only line of blinds that Company A manufactures and sells. As a result of the infringement, Company A has experienced a significant decline in Sunrise sales. Company A attempts to recover market share by cutting selling prices but is unsuccessful. Company A encounters financial difficulties, is unable to introduce an alternative product or pursue another course of action to alleviate its difficulties and is forced to cease operations.

If the shareholders/stakeholders of Company A take Company B to court and successfully prove infringement, they may be able to claim lost cash flow from the infringement until the date that Company A ceases operations (the “cessation date”) and, more significantly, may be able to claim the business value of Company A as at this date. The business value represents the loss of “permanent” ongoing future cash flow value as a result of the infringement.

In this case, the lost cash flow is represented by the difference between the cash flow that Company A would have earned from the Sunrise blind “but for” the alleged infringement, and the actual cash flow earned from selling the blind. The lost business value represents the ongoing and permanent loss of future cash flow from the cessation date going forward into perpetuity.

Some observations to be made from this example are as follows:

- Company A has experienced lost cash flow, and the cash flow loss is expected to continue indefinitely into the future, representing a loss of business value.
- The cash flow loss relates to the only product Company A manufactures and sells, and has affected its ability to operate as a viable business.
- Company A has ceased its business operations completely as a result of the infringement.

Given the above facts and context, and, in particular, the indefinite duration of the loss in this situation, the use of a lost cash flow approach for the past loss and a business value approach for the future loss is appropriate.

**The appropriateness of using a business value approach**

Now that the distinctions between the business value and lost cash flow approaches have been discussed, identifying the circumstances in which it is appropriate to use one approach rather than the other can be explored.

**Permanent loss of business or cash flow**

The permanence of the loss in question is an important criterion to justify the use of a business value approach in a loss
quantification context. Permanence can manifest itself in the following scenarios (among others):

- There is a complete business shutdown or cash flow loss.
- The business winds down initially, and then there is a complete shutdown or cash flow loss (the “slow death” scenario).
- A portion or segment of a business shuts down (or there is a partial cash flow loss), but the rest of the business carries on operations.

**Complete business shut down or cash flow loss**

A business value approach is applicable in situations where a business has been permanently and completely shut down or destroyed as a result of the actions of a defendant.

For example, assume that Company A was a successful manufacturing business operating from owned premises. Company A hired Company B to carry out roof and structural repairs at its premises. During the process, some of Company B’s staff were negligent in their work. As a result, the roof at the premises collapsed, destroying Company A’s equipment and inventory and forcing manufacturing operations to cease. Company A’s customers were greatly inconvenienced and chose to purchase from a competitor. Customers have indicated that they have signed contracts with the competitor and will not return to Company A, destroying any hope of Company A rebuilding its business. In this situation, Company A can likely seek to recover its lost business value against Company B.

The concept of quantifying loss using business value where there is a permanent and complete loss of business is cited in a number of Canadian and U.S. legal cases. In *Jim’s Hot Shot Service Inc. v. Continental Western Insurance Co. and Sun West Insurance Agency,* the court indicated that “when, as in this case, the claim is that a business was destroyed by negligence, the measure of damages is the difference in fair market value immediately before the negligence caused damage and the fair market value that remained when the business stopped…”

Similarly, in *Taylor v. B. Heller and Co.* the court recognized that “the action for damages for destruction of a business [should be] measured by the difference between the value of the business before and after the injury or destruction.”

In either case, the value of the business after a complete business shutdown would either be negligible or represent any net residual proceeds received or recoverable from the liquidation of any remaining assets.

Other notable cases that echo the same concept include *Indus Craft Inc. v. Bank of Baroda* and *Aetna Life & Casualty Co. v. Little.*

**Business winds down initially, and then completely shuts down**

A business value approach is also applicable in situations where a business has been harmed, carries on operations for a period of time during which it experiences lost cash flows, and then is forced to cease operations as a result of the harm (sometimes described as the “slow death” scenario).

For example, assume that Company A was a food service business involved in supplying meals for airlines. Company A obtained the necessary licences, permits and approvals from government regulators to allow it to operate as a food service business. Company A also obtained comprehensive insurance coverage from Company B, an insurance provider. In January 2009, Company B erroneously filed a statement with government regulators indicating that Company A’s insurance coverage had been terminated for non-payment of premiums. Company A’s licences were suspended for two months and then reinstated when the erroneous insurance statement was rectified. However, in that time, many of Company A’s airline customers stopped purchasing from Company A, and over the course of 2009, others also followed. Company A experienced ever-increasing operating losses as 2009 proceeded, before shutting down operations in December 2009.

In pursuing legal action in a situation in which the alleged action led to a company’s demise, the plaintiff can seek to recover lost cash flow for the period during which it attempted to continue to operate, as well as lost business value with respect to lost cash flow beyond January 2010.

The concept of quantifying both lost cash flow during a business wind-down and lost business value for lost future value is cited in *Jim’s Hot Shot Service Inc. v. Continental Western Insurance Co. and Sun West Insurance Agency.* In this case, the court indicated that “loss of profits prior to cessation of a damaged business is properly allowable as an element of damages in addition to an allowance for a market value diminution because the interim profit losses experienced prior to liquidation of the business are not reflected or compensated for in the market value determination.”

**A portion or segment of a business shuts down**

A business value approach is also applicable in situations where a segment of a business or a distinct stream of cash flow has been permanently lost as a result of some harm done, but the overall business continues to operate.

For example, assume that Company A sources and sells promotional merchandise such as embossed pens, golf balls, calculators and USB keys to businesses. The company is organized into three geographical divisions – Eastern, Central and Western Canada – each of which is headed by a sales manager. As the head office is in Europe, Company A relies on each manager to effectively run his or her division and manage customer relations. Assume that the manager for Eastern Canada resigns, sets up a competing business and improperly solicits all or most of the Eastern Canada customers away from Company A. Company A is unable to mitigate and as a result is forced to terminate Eastern Canada operations and divest its remaining assets.

In pursuing legal action against the manager arising from a breach of fiduciary duties and solicitation of customers, Company A may be able to claim lost business value due to the permanent loss of Eastern Canada operations.

**Inability to fully mitigate loss of business or cash flow**

What is implicit in the “permanence” criterion discussed above is the assumption that the business in question is unable to fully mitigate its lost business or cash flow. Stated another way, in order to be able to claim “business value” as a measure of loss, a plaintiff usually needs to demonstrate that it was unable to recapture or replace lost business, or restart business operations, or somehow alleviate its “permanent” loss.

In the above example, in order to successfully claim the business value of its Eastern Canada division as its loss, Company A will likely have to demonstrate that it was unable to recapture the solicited customers or, if it attempted to do so, why its efforts were unsuccessful.
With respect to mitigation, a plaintiff is expected to make “reasonable” attempts to minimize its losses; a plaintiff will usually not be faulted where mitigating would necessitate taking on excessive risks, or pursuing financially or operationally infeasible or uneconomical alternatives.

**Breach of contract**

The term of a contract and the clauses in a contract are usually very important in determining whether a lost cash flow approach or business value approach is applicable in a particular scenario.

**Contract clauses or term of a contract**

To illustrate the importance of contract clauses, assume that Company B licenses Company A to manufacture shoes under a designer brand owned by Company B. Company A pays a royalty to Company B but otherwise keeps the profits from sales of licensed apparel. The licence is a “contract” that stipulates various terms, conditions and responsibilities of both parties. It renews automatically every five years but can be terminated at the option of either party with four months’ notice. The licence had been renewed continuously since it was awarded 20 years ago.

Assume that Company B is dissatisfied with the marketing and sales performance of Company A and decides to terminate the licence two years into the current five-year term, effective immediately. The licence in question is crucial for Company A’s survival, and without it the company is forced to cease operations.

Company A pursues legal action against Company B, alleging breach of contract. If Company A successfully proves a breach of the contract by Company B, the question is whether it will be able to claim lost business value or lost cash flow and, if the latter, over what period of time. Contractual terms indicate that either party could terminate the contract with four months’ notice. Notwithstanding the fact that the licence contract was renewed over the past 20 years, Company A may be entitled to receive its lost cash flow for only a four-month period from the date of termination. As an alternative, at most, Company A might be entitled to claim its lost profits for the remainder of the current contract term (i.e., for three years). Given the clear “out” clause in this particular contract or, at most, the remaining three-year contract term, a quantification of lost business value would not seem to be appropriate in this context.

One of the leading Canadian authorities on contractual damages is **Hamilton v. Open Window Bakery Ltd.** In this case the plaintiff, Hamilton, had entered into a 36-month contract with the defendant, Open Window Bakery (“OWB”), to market and sell baked goods in Japan. The contract could be terminated immediately without notice if Hamilton acted in a manner that was “detrimental to the reputation and well-being of OWB,” or could be terminated with three months’ notice after commencement of the 19th month of the contract.

OWB proceeded to terminate the contract 16 months into its term, effective immediately, alleging that Hamilton had indeed acted in a manner that was detrimental to the reputation and well-being of OWB.

Initially the trial judge held that OWB had wrongfully terminated the contract, and awarded damages representing the remaining payments that would have been made over the remaining 36-month term, less a factor of 25 per cent to reflect the risk that OWB may have exercised its right to terminate at some point before the end of the term of the contract.

The Court of Appeal, however, held that the three-month notice-period clause in the contract represented the “minimum guaranteed benefits” under the contract and, therefore, the maximum amount of damages that could be payable to the plaintiff.

**Exceptions**

From the discussion above, it follows that if contractual exit clauses or the contract term are not clearly set out, a claim for business value might be an option, given the particular contextual factors of a loss quantification scenario. For instance, in the example of the shoe manufacturer cited above, assume that the licence in question did not specify a term or did not specify any clear notice period for termination. In this case, a valuator might consider that the contract in question would continue to be valid and enforced by both parties indefinitely into the future, thus supporting the use of a business value approach.

Additionally, in some cases, business value may be claimed if the breach of contract was particularly egregious or in particularly bad faith. For example, in **United Roasters Inc. v. Colgate-Palmolive Co.** the plaintiff was awarded compensation for loss of business value in a breach of contract case. The defendant terminated a contract during a period when its right to do so was unchallenged. However, upon terminating the contract, the defendant refused to return the plaintiff’s manufacturing assets, putting the plaintiff out of business. In effect, although the defendant terminated the contract pursuant to the contractual terms, its actions before and after the termination were egregiously harmful to the plaintiff. In this case, awarding the plaintiff its lost cash flow over a normally reasonable notice period was not considered fair.

**Methodology and other issues to consider**

**Methodology**

Generally speaking, the methodology behind a business value approach has many similarities to that used in a lost cash flow approach. However, subtle differences should be noted, particularly with respect to the quantum of the discount rate to use, whether or not hindsight can be used, and the inclusion of post-purchase synergies (see table on next page).

**Hindsight**

The question of whether and how to consider hindsight when quantifying loss using a business value versus lost cash flow approach is an important one. Hindsight in valuation and loss quantification contexts refers to the use of “actual” information
### Lost Cash Flow Approach

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<td>1.</td>
<td>Assumes a “temporary” loss of cash flow.</td>
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<td>2.</td>
<td>Often associated with the scenario in which there is a temporary or partial business shutdown or a temporary or partial shutdown of a segment of a business.</td>
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<td>3.</td>
<td>Actual cash flow assumed to eventually recover to “but for” levels.</td>
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<td>4.</td>
<td>Usually applicable in breach of contract contexts with notice periods or contract termination provisions.</td>
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<td>5.</td>
<td>Calculations based on pre-tax cash flow.</td>
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<td>7.</td>
<td>Discount rates reflect the risks associated with the shorter “lost cash flow” time period in question.</td>
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### Business Value Approach

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<td>1.</td>
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<td>Calculations based on after-tax cash flow.</td>
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<td>Discount rates used reflect long-term operating, competitive and financing risks.</td>
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<td>8.</td>
<td>Hindsight usually is not admissible; some exceptions do exist.</td>
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(behavioral data, facts, economic data and so on) known after a particular valuation date or loss assessment date.

The general rule is that hindsight is not admissible in business value contexts except to test the reasonableness of assumptions or projections made at the valuation date, whereas hindsight is normally admissible in loss quantification contexts. However, what is less clear is which approach to take when business valuations and loss quantifications intersect, as in the case of business valuations that are prepared for loss quantification purposes.

It is generally accepted that a valuation is prepared at a specific point in time and, therefore, should reflect facts, information and expectations known at that time. For instance, the court in *Ford Motor Co. of Canada v. Ontario Municipal Employees Retirement Board* summarized the accepted approach to hindsight when it stated “the established legal principle is that, in the process of valuing shares at a particular date, hindsight information is generally inadmissible.” The court went on to note that

it would appear that two general exceptions to the principle have been recognized in Canadian case law. The first exception would appear to be that factual hindsight information – but not opinions or mixed facts and opinions – may be used for two purposes: firstly, to compare actual results achieved after the valuation date against projected or forecasted corporate results said to be reasonably foreseeable on the valuation date; and secondly, to challenge the reasonableness of assumptions made by the valuators. The second exception to the general principle would appear to be that hindsight information may be used to determine the correct value as of the valuation date of an unchanged component…in existence as of the valuation date.

It is also generally accepted that the objective of loss quantification is to restore an injured party to the position it would have been in had an alleged wrong not been committed or had a contract been fulfilled. In restoring a plaintiff to a condition of “wholeness,” an examination of actual facts and events arising after the date of the alleged wrong is needed to forecast what would have happened “but for” the alleged wrong, and to compare it with what actually happened as a result of the alleged wrong.

The challenge arises when valuations are prepared for the purpose of quantifying loss. In most cases, hindsight will not be permissible. However, in some instances, in order to restore a plaintiff to a position of “wholeness,” there might be compelling arguments to use hindsight in a valuation. Put another way, in some situations, if hindsight were not to be used, this would result in either a windfall gain or unfair penalization of a plaintiff.

Courts have support the limited use of hindsight in contexts similar to that described above. For example, in *Sinclair Refining Co. v. Jenkins Petroleum Process Co.* in attempting to determine the value of a patent in a breach of contract case the court noted “an imaginary bid by an imaginary buyer, acting upon the information available at the moment of the breach, is not the limit of recovery where the subject of the bargain is an undeveloped patent.” The court noted that when time has elapsed since the valuation date in question, “experience is then available to correct uncertain prophecy. Here is a book of wisdom that courts may not neglect. We find no rule of law that sets a clasp upon its pages and forbids us to look within.”

In short, while not permissible in most valuation scenarios, hindsight may be permissible in particular contexts in which valuations are prepared for the purpose of quantifying loss in order to make plaintiffs “whole” again.

### Conclusion

The decision whether to claim lost cash flow versus business value as damages is an extremely important one for counsel, one that often depends on the facts of a particular legal context. Counsel (and damages quantification experts) need to be able to distinguish between a business value approach and lost cash flow approach to quantifying loss, understand the appropriateness of using a business value versus lost cash flow approach in particular loss quantification contexts, and understand the methodology used for either approach.

What is clear from the analysis in this article are the following:

- There are similarities between a business value and lost cash flow approach; for instance, a projected/estimated stream of “forgone cash flow” is the foundation upon which either calculation is based. Indeed, a lost cash flow approach may
be seen as a subset of the business value approach.

- There are also differences between the two approaches; for example, aside from the fact that the lost cash flow and business value approaches encompass shorter and longer time periods respectively, there may be differing risks and discount rates, and differing treatments of hindsight between the approaches.

- There are specific circumstances in which a business value approach is more appropriate than a lost cash flow approach, and vice versa.

Ultimately, a quantification of loss in a litigation context needs to reflect the facts of the case and “business reality.” If a business is permanently shut down with no hope of mitigation, this “reality” may suggest a business value approach, as compared with a situation in which a business suffers a partial loss of cash flow for a finite period of time, a “reality” that may suggest a lost cash flow approach. If counsel or damages quantification experts “force” a business value approach in a context in which it is not applicable, it may take the damages claim into the realm of fantasy and threaten the credibility of the claim for damages.

Perhaps, when deciding the appropriateness of a particular loss quantification approach or considering the reasonability of assumptions used in arriving at a particular quantum of loss, counsel and damages quantification experts may be well served to repeat to themselves the enigmatic yet soul-searching words of the great Freddie Mercury: “Is this the real life? Is this just fantasy?”

The answer to this question may well lead to a better matching of a particular loss-quantification approach with the factual context it is better suited for.

Notes
1. This article uses the terms “loss” and “damages” interchangeably. Technically, “loss” refers to the harm alleged to have been suffered by a plaintiff, whereas “damages” refers to a sum of money that a court decides is reasonably fair compensation for alleged losses.
2. Also referred to as “lost profits.”
4. Assume also that Company A has elected to claim “damages” against Company B rather than an “accounting of profits” earned by Company B from the infringing product.
5. 353 NW 2d 279 (ND 1984).
7. 47 F 3d 490 (2d Cir 1995).
8. 384 So 2d 213 (Fla Dist Ct App 4th Dist 1980).
12. 2002 OTCC LEXIS 2992 (SCJ).
13. 289 US 689 (1933).