

Business Valuation Monitor

Value creation perspectives for corporate executives and the investment community June 2010

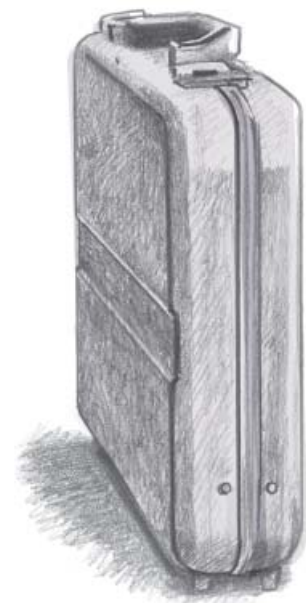
Heightened requirements for early-stage company damages claims: The need for proper analysis and support

Businesses that have sustained damages as a result of breach of contract, patent infringement, unfair competition or other “bad acts” will often seek to recover economic damages. For established businesses, monetary damages can be measured by lost profits, a reasonable royalty, or in rare cases, the destroyed value of the business. New-business claims, on the other hand, frequently involve a claim for the value of the entire business, since the alleged act often results in the business being unable to continue operating subsequent to the act.

The new-business rule

New-business lost-profits claims were historically unavailable in most jurisdictions. The common law doctrine called the new-business rule once operated as an absolute bar to any recovery where the claimant was not yet an established enterprise. Courts generally held that lost-profits claims made on behalf of new businesses were inherently speculative: “[W]hen the business is in contemplation, but not established, profits that may be anticipated therefrom are too speculative, uncertain, and conjectural to become a basis for the recovery of damages...for the subsequent loss of profits.”¹

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¹ No Ka Oi Corp. v. Nat'l 60 Minute Tune, Inc., et al., 71 Wn. App. 844 (Wash. Ct. App. 1993).

Heightened requirements for early-stage company damages claims: The need for proper analysis and support (continued)

The new-business rule enhanced predictability and judicial efficiency because it singled out one or a few facts and made it or them conclusive of legal liability. However, many viewed it as inherently unfair because it allowed would-be defendants to avoid liability for damages they caused merely because the aggrieved party was a new enterprise.



The reasonable-certainty standard

Over time, most states have rejected the new-business rule and now look to the legal standard of “reasonable certainty.” Simply put, courts will permit the recovery of lost profits where their extent and occurrence can be ascertained with reasonable certainty. In economic terms, reasonable certainty can be thought of as minimal speculation. There is no bright-line test for reasonable certainty; instead, it is proven by degrees. Not surprisingly, the more evidence that can be introduced to minimize speculation, the better.

This concept can be broken down further into (1) whether damages have actually occurred; and (2) the actual amount of the damages, which is usually harder to prove. In this discussion, we will focus on the actual amount of the damages.

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Evidence allowed for new-business damages

Even with the “safe harbor” afforded by the reasonable-certainty standard, a new business still has a more difficult time proving that it will be (or but for the act of the defendant would have been) profitable. Courts have generally allowed plaintiffs to introduce several types of evidence by which lost profits might be calculated, including:

- evidence of profits of similar businesses owned by the plaintiff or even third parties;
- evidence of future profits earned by the plaintiff’s business after the breach or tort;
- evidence of future profits earned by the defendant’s business after the breach or tort; and
- expert testimony, economic and financial data, market surveys, and market analyses.

For an established business, this evidence may provide additional substantiation for an otherwise robust analysis; for a new business, this evidence may represent the sole basis for a claim. The question for new businesses is whether damages are made reasonably certain by proof of facts that enable a rational estimate of their amount. Robert L. Dunn provides support for this concept in his book on damages for lost profits, wherein he states that courts have

tended to sustain lost-profits awards “as long as the approach is rational and the trier of fact is given a basis upon which to assess the evidence.”²

Qualitative factors to consider

Courts will also consider qualitative factors presented by the expert to gauge the probability of success of a new business and therefore the reasonable certainty of the amount of the damages claim. The following list includes some of the qualitative factors that should be considered in the assessment of any business but are especially important for a fledgling business:

- **Capital adequacy** — Is the business self-funding or reliant on additional external capital?
- **Prior business experience** — Has the management team successfully started other businesses?
- **Prior business experience in the industry** — Is this a familiar or new industry for management?
- **A written business plan** — Is there a comprehensive plan complete with assumptions?
- **Unique or proprietary technology or services** — Does the company have a competitive advantage that can be leveraged?
- **Demonstrated market acceptance** — Even if the company is prerevenue, has it moved beyond proof of concept?
- **Realistic revenue and expense forecasts** — Are the forecasts possible to achieve? Are they anchored in market evidence?

² Dunn, Robert L., *Recovery of Damages for Lost Profits*, Page 391, 5th Edition. Lawpress Corporation, 1998.

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Heightened requirements for early-stage company damages claims: The need for proper analysis and support (continued)

Quantitative indications of new-business risk

Success rates for new businesses versus established businesses can provide evidence showing specific hurdles faced by newer businesses. An excellent article by David A. MacPherson and Stanley P. Stephenson³ notes that there are quantitative approaches available to adjust lost profits for new-business survival rates.

MacPherson and Stephenson cite a number of studies that address business survival risk, such as Headd (2003)⁴, Phillips and Kirchhoff (1989)⁵, and Knaup (2005)⁶. The studies draw from various data sources, but all of them attempt to show how, statistically, new businesses fare from inception through a number of years. The authors suggest that the analyst consider the following when developing a company-specific survival rate using average survival rates from inception:

- **Timing of the exit** — Most business exits take place within the first two years of inception. This implies that if the subject company has survived its first two years, the conditional survival rate will be higher than the average survival rates from inception.
- **Revenue growth rate** — A higher growth rate increases the likelihood of survival.
- **Type of exit** — Not all exits denote failure. Some businesses may have executed a planned exit.

The authors then suggest three principal ways to use these survival rates to adjust lost profits:

- Shortening the length of the loss period
- Weighting the economic returns by the risk of survival
- Increasing the discount rate to account for survival risk

Other experts have used raw business failure data from the Dun & Bradstreet Corporation to build company-specific survival rates. But the underlying data may not be publicly available and therefore may be difficult to obtain and use. Nonetheless, the principle holds true that if experts can find appropriate empirical data, they should use it. At the same time, however, an expert should use caution when extrapolating statistics from general business failures to apply to a specific company or industry. For example, restaurants may have greater failure rates than painting contractors because of the typically higher up-front need for fixed capital investment. Many industry trade groups provide statistics on their members; additionally, an expert can access governmental statistics for specific industries. If general business failure statistics are inappropriate and the claim is substantial, then it may be cost-beneficial to commission a proprietary study in support of a particular assumption.

Selected cases

The following are notable cases that demonstrate the importance of meeting the legal standard of reasonable certainty.

Relying solely on management projections construed as speculative

In *ZixIt Corp. v. Visa USA Inc.*, No. 99-10187-K (Dallas Co., Texas, Dist. Ct., 192d Judicial Dist.), the plaintiff presented expert testimony that relied wholly on management projections to assess a \$1.2 billion loss. The defendant, on the other hand, presented numerous studies and market analyses showing that management's forecasts ran counter to industry and market conditions and therefore would be difficult, if not impossible, to achieve. The jury agreed with the defense team and its more empirically based analysis, rendering a defense verdict based on the speculative and unsupported nature of the plaintiff's position. This example is given to drive home the point that empirical, or external, evidence will typically trump the *ipse dixit*⁷ of management or an expert. In this case, the defendant's expert did a better job of minimizing the speculative nature of its claim even though defendants, in general, have the burden to prove or disprove the uncertainty of the damages amount as long as the certainty of damage has been established.

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Success rates for new businesses versus established businesses can provide evidence showing specific hurdles faced by newer businesses.

³ MacPherson, David A. and Stephenson, Stanley P., "Lost Profits Damages to New Businesses: Adjusting for Survival," *Journal of Business Valuation and Economic Loss Analysis*, Volume 1, Issue 1, 2006.

⁴ Headd, Brian, "Redefining Business Success: Distinguishing Between Closure and Failure" *Small Business Economics* 21 (August 2003): 51-61.

⁵ Phillips, Bruce D., and Kirchhoff, Bruce A., "Formation, Growth and Survival: Small Firm Dynamics in the U.S. Economy." *Small Business Economics* 1 (March 1989): 65-74.

⁶ Knaup, Amy E., "Survival and Longevity in the Business Employment Dynamics Data: *Monthly Labor Review* 128 (May 2005): 50-56.

⁷ "*Ipse dixit*" means "of oneself" and is used when an individual claims a "fact" based on the individual's own knowledge or experience without external validation.

Heightened requirements for early-stage company damages claims: The need for proper analysis and support (continued)

Actions of the plaintiff and defendant may indicate that forecasts are speculative

The actions of the plaintiff and defendant often serve to confirm that income forecasts are speculative and cannot be achieved with reasonable certainty. In *MindGames, Inc. v. Western Publishing Co.*, 218F. 3d 652, 657 (7th Cir. 2000), the plaintiff asserted a claim for lost profits based on an alleged breach of duty of a distributor to promote *Clever Endeavor*, a board game. *Western Publishing Co.* (*Western*) had previously marketed highly successful board games, including *Trivial Pursuit*. *MindGames, Inc.* (*MindGames*) asserted it lost \$40 million in royalties that it would have earned had *Western* not failed to carry out the promotional obligation the contract imposed on it.

As set forth in Judge Richard Posner's opinion, the underlying facts really do matter. The minimal amount of sales of the subject product before the alleged breach of contract showed that there was limited product demand, offering the first objective evidence that the plaintiff's lost-royalties claim might be speculative. Also, the decision by *Western* not to exercise its option to renew the contract, informed by its experience with more promising and ultimately successful businesses, pointed to limited market potential for the product. In effect, *Western* had significant experience with similar new businesses and cast a "no" vote on a future relationship with *MindGames*. Finally, after *Western* elected not to renew, *MindGames* did not immediately seek another distribution partner, which undercut its claimed belief that *Clever Endeavor* could have been the next *Trivial Pursuit* with the proper distribution and marketing support. In short, the actions of the plaintiff were entirely at odds with its lost-royalties claim and underlying forecast and strongly suggested that estimated lost royalties and associated lost unit sales were speculative at best.

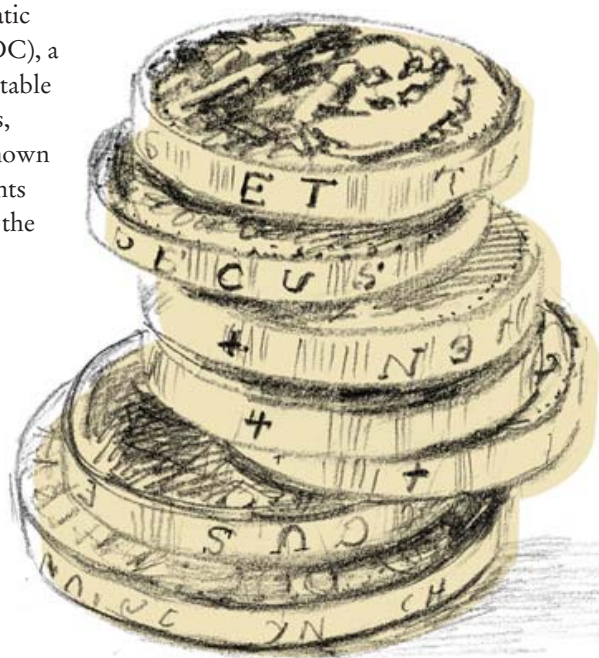
Notwithstanding these actions, and perhaps most fatally for its claim, *MindGames*' brief failed to respond to the defendant's argument that the plaintiff had pointed to no evidence from which lost royalties could be calculated to even a rough approximation. The court noted that even absent the new-business rule, this evidence-based argument was "compelling" and *MindGames*' silence in response was "eloquent." The court affirmed the judgment in favor of *Western*.

Third-party investment alone may not be sufficient to prove reasonable certainty

The presentation of the facts surrounding an investment in a new business can form a convincing basis for proving damages to a company without revenue — even a company with product failures. In the case of the *Bankruptcy Estate of KDC, Inc. v. Harry Kraklow, Cynthia Kandler, Donald Johnson, Jeffrey Covelli, Kenneth Banwart, Darren Massner, Kim Myers, First Products, Inc., and Country Maid, Inc.*, No. 06-C-0402-C (U.S. District Court, Western District of Wisconsin), the plaintiff alleged that the defendants engaged in a systematic scheme to bankrupt *KDC, Inc.* (*KDC*), a startup company developing shelf-stable cookie dough. To calculate damages, the plaintiff hired two nationally known damages experts, while the defendants hired an accounting expert to rebut the plaintiff's experts.

The plaintiff's experts relied upon external third-party investments in *KDC* to establish the value of the company before the defendants' actions. For support, the plaintiff's experts also employed a discounted cash flow analysis utilizing management projections that were included in a private placement memorandum used to raise external capital. The fact that the private placement memorandum was successful in raising over \$5 million provided solid external evidence of the fair market value of *KDC* at the time of the breach, notwithstanding the defendants' accounting expert's assertion that based on a historical financial analysis of *KDC*, the company was insolvent. The court ultimately ruled in favor of the plaintiff, based not only on the successful post-breach financing, but also on *KDC*'s history of attempts to raise capital. Also, the court dismissed the solvency measures used by the defendants' expert, which were more relevant for assessing established companies.

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Heightened requirements for early-stage company damages claims: The need for proper analysis and support (continued)

Conclusion

Given the existing case law, there are several things that experts helping prepare damages claims should keep in mind:

- Minimize the number of speculative components in any new-business claim.
- Don't rely solely on management estimates. Wherever possible, introduce corroborating independent research.
- Consider the actions of the plaintiff and defendant in light of the stated claims. Do actions support the claim, or are they consistent with a speculative claim?
- Assess all quantitative and qualitative factors that will support the probability of success of the new business.

The prevalent legal standard for granting damages, reasonable certainty, is somewhat nebulous and necessarily relates to the facts and circumstances of each case. Furthermore, case law differs from state to state and even in federal jurisdictions, so the expert must know relevant case law in the venue in which testimony will be given. With the proper analysis and support, experts can help clients meet the heightened evidentiary requirements for sustaining economic-damages claims on behalf of new businesses. •

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About the article

This article is based on "Calculating Damages for Startup or Early-Stage Companies," a co-authored chapter excerpted from *The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys*, 2010 edition, edited by Nancy Fannon. Authors included Neil Beaton, partner, Grant Thornton; Larry Breitbarth, director, Grant Thornton; and Tyler Farmer, associate, Danielson Harrigan Leyh & Tollefson.

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