Legal Intelligencer

Financial Damage Measurement: A Refresher

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As a practicing forensic accountant, I have performed more financial damage analyses than I can remember. I am periodically reminded of this fact when I review and purge files in storage. Invariably, I come across a file (or two) of which I have no immediate recollection. A subsequent review of the file usually refreshes my memory.

In performing these reviews I have come to realize I have worked on numerous financial damage claims arising from contract disputes, criminal misconduct, negligence and intentional torts. Industries involved have included dairy processing and distribution, other manufacturing, food services, not-for-profit entities, real estate development, software development, transportation and other industries not named here.

While performing these reviews, I cannot help but draw analogies between case assignments. Regardless of the case facts, certain steps/thought processes are extremely similar while other portions of the engagement are markedly different. As a consequence, I have come to appreciate a seeming contradiction: all damage analyses are simultaneously the same and different. Perhaps "analogous" is a more appropriate term.

The "sameness" arises from the process of accepting and investigating each matter. For example, two questions asked in every matter are: what is the cause of the alleged damages? and what is the best approach to measure the damages? The answers, of course, will be different and unique to each individual matter. For all of the similarities that can be exist between various matters, we must continually focus on the facts and specific circumstances.

In a recent engagement, the eventual plaintiff in the matter acquired the stock of a service business. Subsequent to the transaction, a competitor contacted and successfully enticed several sales personnel to terminate their respective employment with the acquirer and take competing positions with the competitor. The former employees were parties to employment agreements restricting their ability to solicit and accept business from the acquired customers for a period lasting multiple years. Irrespective of these agreements, after the purchase the competitor hired the former employees and worked with the former employees to solicit and accept a number of clients. The plaintiff (purchaser of the business) instituted litigation to recover financial damages sustained due the combined actions of the competitor and former employees (defendants).

As presented, the plaintiff was seeking compensation for losses incurred due to the alleged improper actions of the defendants. Stated differently, the plaintiff is seeking to be restored to the position it occupied before the defendants allegedly engaged in the objectionable conduct. From the plaintiff's perspective, factors to consider include the timing (i.e., purchase consummated) and the expected revenues from the former customers that were solicited by the competitor.

This understanding of facts and circumstances attendant to the loss claim influence decisions concerning the approach to measuring any loss. Considerations include whether, as alleged, was the business was destroyed or only partially impaired? Does the claimed loss arise from a contract breach? If dealing with a destruction of a business, we may need to perform a valuation of the business as of the date of the alleged misconduct. If dealing with a contract loss, we may utilize a discounted net income or cash flow approach. Whatever approach is adopted, it must be consistent with and appropriate for the alleged loss claims.

As with any financial damage analysis, consideration must be given to the idea of continuing and non-continuing expenses. Stated differently, consideration must be given to which expenses the plaintiff would have incurred if it retained the customer relationships. This is analogous to the cost of goods sold in a manufacturing environment. At times, I find it useful to start with applying the managerial accounting concepts of fixed, semi-fixed, and variable expenses to historical operational data.

As with a manufacturing environment, an issue that can arise in a service environment is capacity. Capacity in this context refers to the personnel capacity to service the customers that were diverted to the competitor. In the litigation matter described above, several individual defendants worked with the competitor to divert certain customers and then accepted employment with the competitor. Within the context of the litigation, the plaintiff is contending that it should have retained the customer relationships.

In this hypothetical context, several questions arise. Would the plaintiff be able to service the former customers with the remaining staff, or would the plaintiff need to hire new employees to replace the former employees? What is the expected customer attrition rate? Customers, even absent the alleged damaging act, cannot be expected to be retained forever and, therefore, it is critical to consider the reasonableness of the attrition expectations. While easy to articulate the theory, without representative company attrition history and/or industry customer attrition data, this figure can be very difficult to support. These are just two of potentially dozens of inputs that require careful analysis and judgement to ensure reasonableness.

In the aforementioned claim arising from the alleged violation of the employment agreements, the plaintiff used a discounted net income approach to measure the loss over a multi-year period of expected performance. The defendants objected, claiming that the loss should be measured using a business valuation approach and asserted that the fair market value of the loss was properly measured by a multiple of the lost revenue. For illustration, the plaintiff projected a loss period extending for five years or more, while the defendant alleged that a multiple of less than two be applied to the lost revenue.

After consideration of the above factors and other facts, the plaintiff's financial damage claim exceeded the defendants' assertions of the fair market value of the lost revenue stream. Some may question whether this outcome is appropriate.

Once again, we must consider the facts of the engagement. The plaintiff acquired all of the stock of an operating business. The acquisition was based upon certain considerations, including considerations of ongoing customer relationships. As alleged, the defendants diverted customers and took other prohibited actions in known violation of existing agreements. At the time of the diversion, the plaintiff had consummated the acquisition and was expecting a return on its investment.

The defendants' assertion of fair market value and a business multiple approach raised several theoretical questions. For example, the concept of fair market value encompasses several assumptions. One of these assumptions is the idea of a willing buyer and willing seller. In the loss scenario outlined above, there was no willing seller. Absent a willing seller, a question arises regarding whether a fair market value standard would be applicable. If a fair market standard of value is inapplicable, then we must ascertain what standard of value should be applied. Would investment value be appropriate? The plaintiff can argue that they lost something of value and this value was unique to them and, therefore, that investment value is what they are owed. This argument maybe mitigated, however, if the loss is easily substitutable. If a substitute item can be purchased making the plaintiff whole, than it could be argued that the maximum damage could be capped at the value of the substitute. As always, the case facts must be considered and they will lead each financial damage analysis down its own unique path.

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