# ASSESSMENT OF DAMAGES

## A. Valuation of lost profit

by Frédéric Duponchel, Chairman and CEO of Accuracy
**Accuracy is a corporate finance consulting firm specialising in litigation support.**

**Assessment of damages involves appraisal of the incurred loss *(damnum emergens)* and the lost profit *(lucrum cessans).* Behind financial and accounting calculations, which can seem simple, hide the practical difficulties of interpreting numerical concepts. These difficulties often explain many of the differences between the assessments made by each of side of the argument.**

**Valuation of lost profit: measurement of the earnings of which the victim was deprived.**
Initially, this means identifying the nature of these earnings. The main idea of this approach is to answer the following question, "What could the victim have earned, and what did the victim ultimately not earn, because of default or breach?" These earnings can be direct, such as corresponding to a volume of sales that were lost due to a breach of contract, product copies, or even the defective nature of a production tool. However, identifying the nature of these lost earnings is complicated when they are the indirect consequences of the fault committed. For example,
- The fault may have caused a decline in prices, which would not have happened in its absence, while, correspondingly, sales volumes did not decrease.
- The fault may have influenced other products or activities that were not directly involved. It could, for example, facilitate the penetration of competition in a given market segment, thus leading to a loss of market share.
- The fault may deprive the victim of access to an opportunity (e.g. an investor's inability to buy a company because of the breach of the stock sale agreement by the seller can block the buyer's future access to other acquisition opportunities).

Therefore, the difficulty in this situation is comprehensively identifying all of the gains that the victim has been deprived of, while making sure to include only reasonable and measurable items in this identification. Additionally, the direct causal link between the fault or breach and the lost earnings must be made clear.

**Valuation of lost profit: measurement of the earnings of which the victim will be deprived.**
In many cases, the earnings to be assessed come from either a past activity or operation that continues into the future or a future business or operation. In the first case (the past operation continues), the forecasts can be constructed from projections of past data, giving them a degree of reliability. The assessment of damages must, however, integrate the factors of future modification, such as market cycles and developments, competitor growth, the wear and tear of a product or its image, etc. In the second case (the operation is only in the future), the difficulty lies in projecting future forecasts that are reasonable enough, although they cannot be supported by historical data.
Assessment of damages then includes the development of a business plan based on traceable, realistic assumptions. The approach here involves restoring financial flows from operations by taking into account "normal" conditions such as a market undisturbed by external factors, past cycles projected on the future period, stable prices, etc.

**Valuation of lost profit: measurement of the increase in net worth of which the victim was deprived.**

Once the flows, past and/or future, have been identified and assessed, the assessment of damages requires a valuation of the net worth that the victim would have had in the absence of default, with the difference with its actual net work (therefore, in the presence of default) constituting the lost profit.
The first step involves giving a time frame to these flows. For how long is the victim considered to be deprived of earnings? Consideration should be given to, amongst other things: product aging, the emergence of new brands, the limited duration of contracts, and the aging of key people. The second step involves discounting these flows using a rate, the determination of which is essential for result of the valuation. This rate will take into account the economic conditions of the compensation of the debt and capital as well as the risks specific to the business or operations that generate the flows in question.

## B. Valuation of incurred loss

by Christopher Schmit, Partner, Accuracy

**Valuation of incurred loss: pricing of internal hours in response to damages**
The incurred loss includes the costs that were incurred by the injured party because of the damages sustained. These costs may be comprised of external costs, which are easy to measure and demonstrate (evidenced by invoices). They may also include work performed by employees of the injured party, who have spent time, for example, repairing a defective product, regaining customers (wrongful termination of business relationships), or even designing a replacement product (industrial property).
In this case, a tricky first step is counting the number of hours worked. Only hours spent by the staff involved can be considered, at the expense of other work that itself would have created value for the injured party. Thus, the allocation of under-capacity hours, without value if the dispute did not exist, does not constitute a loss.
A second difficult step is determining the hourly rate that will be used to value these hours. This rate may correspond to the amounts of wages to which costs are added and include a share of the company's fixed costs. It can therefore vary up to fivefold. The fixed costs allocated to the hourly rates represent the company’s costs (depreciation of machinery, supervisory personnel) – rarely associated with the existence of the dispute and the resulting damages – that the company may be forced to mobilise in order to repair the damage. Their inclusion in the assessment will therefore depend on the impact of damages on the company’s activity.

**Valuation of loss incurred: assessment of the contribution to earnings.**
Assessing the incurred loss often means going back to assess the contribution to earnings of a defective product, a lost activity, a contract not renewed, etc.
This loss is often seen as the result of the calculation: lost revenue – corresponding variable costs.
However, performing this simple calculation poses the problem of defining variable costs. The accounting doctrine (“PCG 82”) describes them as “costs that vary with the volume of activity, without there necessarily being exact proportionality between the change in costs and the change in volumes obtained”.
When applied concretely to the assessment of damages, this fixed cost/variable cost distinction amounts to classifying the costs that could have been saved if there had been no damage as variable, an exercise made even more difficult by another distinction existing between “direct” costs and “indirect” costs.
For example, in a case of assessment of damages for wrongful termination of a distribution agreement:

- Should the salaries of the salespeople who were dedicated to sales of the products covered by the contract but also sales of other products be deducted from revenue and therefore be considered variable?
This question raises a problem of information “clipping”: here the data related to the damages should be isolated.
- Likewise, should the salaries of part of the distributor’s financial department, which was restructured two years after the contract was lost, be considered variable?
This question highlights the problem of fixed costs by level: firms gradually adjust their structure following a decline in revenue. This adjustment can be slow, and its financial consequences can be difficult to define precisely.
- How to deal with “indirect” costs, which cannot be allocated, without an intermediate calculation, to the product affected by the terminated contract but are still variable: for example, overtime of the design department or warehouse handlers?
The answer to such questions requires the use of auditing techniques: detailed investigations of cost accounting and cross-checking with management data and non-financial indicators.

***“The incurred loss includes costs that can be external or internal (work by employees of the injured party...)”***

Katrina Bruening 24/7/10 22:29
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**case study**
**GENERAL LITIGATION**

By **Frédéric Duponchel** and **Christophe Schmit**, **Accuracy**

**Valuation of damages: CASE STUDY**

**Disputes between companies often uncover issues that must be approached with an economic, accounting, and financial eye.**
**Frédéric Duponchel and Christophe Schmit, Partners in Accuracy, a consulting firm specialising in litigation support, present some technical difficulties they have dealt with in valuation of damages. These situations require close collaboration among attorneys, corporate counsel, and financial experts for resolution.**

**Definition of incurred damages**
As part of the implementation of a liability guarantee clause, the buyer of a company is seeking compensation for the amount of the intangible asset depreciation that it recorded in the accounts of a company after its acquisition. The acquisition agreement stipulates that the transferor shall compensate the transferee based on the damages, as defined in Article 1149 of the French Civil Code. Recall that this article states: "The damages due to the creditor are, in general, the losses that it incurred and the gains of which it was deprived, with the following exceptions and modifications." If the depreciation of an intangible asset is indeed a book loss, i.e. recorded in the accounts, does this loss cause harm to the company? In other words, does a decrease in the company's net worth result from this depreciation?
The link between book loss and damages is a question that comes up regularly in litigation, yet it does not have an easy answer. Each case must also undergo individual analysis.
In this case, our report showed that the depreciation involved no damages for the buyer. For this, we performed a detailed analysis of the valuation process that had been used by the buyer and had led to the acquisition price agreed upon by the parties. From this, we showed that since depreciation has no impact on the company's future cash flows or its debt position (the two parameters used in the valuation), it did not change the value of the company in any way.

**Estimates and judgments in the context of closing the accounts**
This same agreement has a clause which attempts to indemnify the buyer against any deterioration of the margin of certain projects originating from a cause prior to the acquisition. This standard clause poses great implementation difficulties in long-term contract trades (construction, engineering, infrastructure), trades for which there are often significant risks in the execution of projects. There are basically two types of these difficulties:
- **Difficulty 1:** A technical problem results from a chain of events, although it is impossible to establish its precise origin. It is therefore difficult to determine whether the cause leading to the created damage occurred before or after a given date. However, the compensation mechanism requires that a final decision be made.
- **Difficulty 2:** The assessment of the financial consequences of a technical problem is frequently based on a subjective assessment of the future situation. One person may optimistically consider the outcome of a dispute with a subcontractor, while the other is likely to have the gloomiest view of this conflict. Again, the compensation mechanism requires that an amount be determined.
Our approach in such a case is based on the following two approaches:
- First, in collaboration with technical teams, we strive to prepare a comprehensive inventory from the information that was available on the date of the agreement. This painstaking work means answering a key question in resolving such disputes, "Regardless of the actual technical situation, what level of knowledge did the company's leaders have regarding the technical problem in question at the time of the agreement?"
- Next, we conduct a quantitative assessment of the risk, which is naturally based on the inventory described above, but also includes the demonstrated ability of the company to

understand the situations of this nature (technical resolution of the problem, negotiation with the customer, negotiation with subcontractors so that they take care of all or part of the problem, etc.). During this exercise, the consistency of the adopted estimate with the historical practices of the company is a particularly crucial point.

**Issues of restoration**

One of our clients has been bound by a cooperation contract with an industrial partner for ten years. Following a court decision, this contract is cancelled, and restoration is necessary, i.e. restore the situation to what it would have been if the contract had not existed.
This requires to a two-step process:
- **Step 1:** Identify, in order to negate the consequences, all financial flows resulting from the cooperation agreement over this period of ten years. In addition to a rigorous approach, the identification of such flows requires a thorough understanding of the economics of the industrial cooperation agreement. This includes compensation for the partners: contributions (in kind and in cash), investments, loans, as well as flows related to the marketing of products (purchases and sales).
- **Step 2:** Starting from this new situation, carry out a simulation of what would have been our client's situation, if our client had worked alone on the market and not through industrial cooperation. For this, in collaboration with our client's operational teams, we establish a business plan which, instead of projecting into the future, covers the past period.

These two steps allow us to determine what the value of our client's net worth would have been if there had been no cooperation agreement and to compare it with its current net worth.

**Different methods of calculating the margin**

One of our clients is accused of illegal marketing practices by one of its competitors. It is seeking an amount equal to its lost profits on the sales that it claims it would have generated if the accusations had not occurred. During our analysis, we realise that the demand is based on a calculation of margin on purchase costs. From a technical standpoint, there are several notions of margin:
- Margin on variable costs, which is based on an assumption of stability of the company's fixed costs.
- Margin on direct costs, in which all of the costs directly attributable to the product are deducted from the selling price.
- Margin on full cost, which allocates to the product all of the operating costs (both fixed and variable, both direct and indirect).

Each of these margins responds to specific situations that depend particularly on the share of total production represented by the disputed production, the duration of the disputed period, the capacity of the industrial tool, etc.
In this case, we show that the margin on purchase costs, besides the fact that it does not fit any standard definition, is not adapted to the situation. The margin on direct costs is the one that we believe to be most appropriate for the situation. Our analysis thus divides the amount of damages demanded from our client by seven.

**Different valuation techniques**

Damages are often based on the valuation of an activity or business. The valuation process then involves implementing proven methods that are segmented according to the following approaches:
- Intrinsic approach: thus named because it relies upon the specific performance of the business or activity to be appraised. Within this category, the method most frequently used is the discounted cash flows (DCF) method.
- Analogical approach: this involves appraising a company by comparing it to “comparable” companies (in terms of business area, performance, growth profile) whose value is known either because they are traded on a market or because they were the subject of a recent transaction.

Since the mid-1970s, the *Autorité des Marchés Financiers* (AMF - the French Financial Market Authority, formerly COB) has recommended that valuation be conducted according to the multi-criteria principle, i.e. they compare several relevant valuation methods. This recommendation was reaffirmed in 2005 by a group of experts who worked at the request of the AMF to improve independent financial valuation.