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POPULAR APPROACHES TO ESTIMATE LOST PROFITS

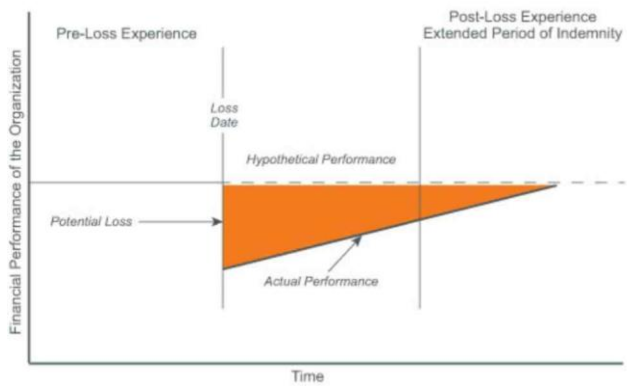
The quantification of losses related to a business interruption or loss of volume that follows a tort, breach of contract, covered cause of loss and any other event that leads to a claim requires an in depth analysis. The basic objective inherent in most, if not all, business interruption calculation models is to return the claimant to the financial position he or she would have been in had an event not occurred. The question that requires an answer in these cases is then what would have actually taken place if the event that triggered the loss had not occurred.

Even though models should be simple enough so that the trier of fact and other decision makers can understand the concepts, the loss calculation must incorporate pertinent elements, including the duty to mitigate damages, market trends, cause in fact (but-for) or proximate cause elements and a host of other considerations. Nonetheless, despite the complexities in the process of quantifying business interruption losses, the need to assess and address specific fact patterns, and the necessity to develop sound estimation models, there are four popular approaches to quantify the losses. This knowledge is of great use to both plaintiffs and defendants as well as to business owners, attorneys, insurance loss adjusters, accountants, and anyone involved in a claim related to business interruption losses.

Underlying Rationale

The underlying rationale behind most lost profits calculations rests on the premise that a wrongful act led to a reduction in profits. Once causation and other elements have been established, the controversy generally boils down to what is the amount of the plaintiff's loss. As a general rule, lost profits cases arise when an event causes a temporary or even permanent business interruption due a specific event or occurrence. For instance, a restaurant that closed for 3 months due to a fire will most likely suffer damages due to lost profits as it may not be able to service customers while the business is undergoing repairs.

To exemplify the issue, let's apply the rationale to a breach of contract claim, the cornerstone in one of the most common lost profits scenarios. Let's assume that D agreed to supply P flour for P's baking operation yet D breached the contract. P may be able to recover lost profits for the breach if it can prove the elements of the cause of action and the amount of damages with reasonable certainty (as opposed to absolute certainty). The scenario is illustrated in the following figure. P's profits for the periods before and after the breach are depicted in the following graph. The horizontal line represents the level of profits before the date of the breach (loss date) and what the profits would have been after that date but-for the breach. The orange triangle's hypotenuse (the lower line) represents the level of actual profits. As can be seen in the graph below, the objective in the lost profits calculation is, essentially, to quantify the profits in the orange triangle, which are basically the difference between the actual profits after the event and what the profits should have been had there been no breach.



Not all cases are as straightforward as the one depicted above as many different variables intertwine in every case. However, experts have developed models or approaches to address the quantification of lost profits. Here you will find the fundamental reasoning behind each of the basic approaches.

Before and After Method

The before and after method is known as a time series approach because it compares the profits before and after the event took place leading to the quantification of the lost profits. Essentially, the underlying idea behind this method is to use historical data to estimate performance during the period affected by the interruption. The difference between actual performance and the estimated performance without the event that led to the lost profits then approximates the amount of damages. This approach presumes sufficient data is available for each period to conduct the analysis and that the event causing the interruption is time specific.

Sales Projection Method

Under the sales projection method, the lost profit calculations emanate from a projection of sales under the assumption that the event that led to the damages did not take place. The difference between this method and the before and after method lies in the use of historical performance data; that is, under the sales projection method, sales are projected based on the circumstances that would have been present should the event had not happened whereas under the before and after method, sales during the loss period are estimated based on the historical trends.

Yardstick Approach

The yardstick method uses financial information of comparable companies to quantify lost sales, profits or even value. The results generated from the comparable companies' analysis are then compared to the company that suffered damages so that the difference between the comparable companies' relative performance and the subject company's performance comprises the foundation for the loss calculation. Factors to consider in selecting comparable companies include products, industry, size, location, and markets, among others. It must be noted that this methodology is generally appropriate when the subject company or business has a limited profit history or is new.

Market Share Method

Large companies that enjoy a significant market share in their businesses may use that percentage as a basis to quantify lost profits. The idea behind this method is to estimate the lost profits based on the market share that the company should have attained but for the event that caused a decrease (or absence of an increase) in business volume. Courts are generally reluctant to accept estimates based on market shares that the subject company has never attained and, therefore, the testifying expert must carefully develop and document his or her market share estimate.

It is a mistake to jump to the conclusion that the occurrence of a business related tort, breach of contract or insured event automatically leads to lost profits because in order to claim such losses they must be quantified with a reasonable degree of certainty. A qualified financial forensics consultant should therefore become an integral part of the litigation process so that efforts and resources are expended prudently. As such, feel free to contact JP Navarro, a forensic financial advisory advisor, expert witness and attorney at jpnavarro@nacpr.net for a consultation.

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