Best Practices Discussion

Understanding Your Projections in a Lost Profits Damages Analysis

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Financial projections are one of the (if not the) most important inputs when measuring lost profits in an economic damages measurement analysis. Often, the damages analyst ("analyst") is confronted with multiple conflicting sets of financial projections, financial projections with questionable credibility, or, in some cases, no financial projections at all. This discussion addresses some of the typical projection-related issues that the analyst is confronted with when conducting damages measurement analyses. This discussion also summarizes damages-related judicial decisions where the analyst successfully implemented and scrutinized financial projections in the damages analysis—and where the analyst was unsuccessful in doing so.

Introduction

A damages analyst ("analyst") may regularly rely on financial projections in damages measurements. These financial projections may have been prepared by a company's management team, by an industry expert, or (when necessary) by the analyst himself. When confronted with a damages measurement analysis involving financial projections, the analyst too often relies on projections at face value.

That is, the analyst may not sufficiently question the reasonableness, credibility, reliability, or applicability of the management-prepared financial projections.

Regardless of how well the remainder of a damages measurement analysis is performed, if the projections relied on lack of credibility to the finder of fact, the damages measurement analysis may be ruled inadmissible. For this reason, an analyst should adequately vet the financial projections that he or she relies on.

This discussion addresses analyst considerations when deciding which set of financial projections to rely on in a damages analysis. This discussion considers the questions the analyst should ask when provided with financial projections in a damages measurement, including (1) why the projections were prepared, (2) when the projections were prepared, and (3) whether the projections are sufficiently supported.

This discussion summarizes two damages-related judicial decisions where one party moved to have the opposing expert's testimony excluded based primarily on the underlying projections. One decision summarizes the actions the analyst took to successfully overcome a *Daubert* motion. The other decision illustrates how a lack of projection scrutiny led to an analyst's expert testimony and expert report being deemed inadmissible.

Background on Lost Profits Measurement Method

One generally accepted damages measurement method is the lost profits method. The lost profits

method measures the additional profits that the plaintiff would have realized but for the wrongful act of the defendant.

Four generally accepted methods applied to measure damages in a lost profit's analysis are as follows:

1. The before-and-after method
2. The yardstick method
3. The market model
4. The sales projections method

Before-and-After Method

A before-and-after method analysis seeks to measure damages by comparing the performance of a business before the wrongful act occurred and after the wrongful act occurred. In applying this method, credible projections prepared prior to the wrongful act may help to establish that a business anticipated achieving significantly different results than those realized after the wrongful act.

Alternatively, financial projections may help to establish that the results anticipated prior to the wrongful act did not deviate materially from the results realized after the wrongful act.

Yardstick Method

A yardstick method analysis relies on guideline company or guideline industry benchmarks to serve as a proxy for what results would have been achieved by a business but for the wrongful act.

When applying the yardstick method, the analyst should provide sufficient evidence that the selected guideline companies are reasonably similar to the subject business. Likewise, when relying on industry benchmarks, the analyst should prove that the industry data are both relevant and reliable.

Market Model

A market model analysis involves analyzing the plaintiff business's market share prior to the wrongful act, or what the plaintiff business's market share would have been but for the wrongful act. This information is then relied on to establish the lost profits that would have been realized but for the wrongful act.

Financial projections may be utilized to demonstrate what market share would have been realized but for the wrongful act. Additionally, financial projections are important in demonstrating the anticipated expansion or contraction of the relevant market.

Sales Projection Method

As the name implies, the sales projection method may require the greatest reliance on, and scrutiny of, financial projections. The sales projection method involves comparing company-specific projected results (based on circumstances that existed prior to the wrongful act, and, preferably, based on projections prepared prior to the litigation event) to the results realized or anticipated after the wrongful act.

Preferably, the financial projections relied on in the sales projection method were prepared in the ordinary course of business and for a purpose other than the subject litigation. Further, it is preferable that the financial projections relied on were prepared contemporaneously or closely prior to the wrongful act occurring.

When applying the sales projection method, the credibility of the analyst's damages measurement analysis may be closely correlated with the credibility of the financial projections relied on. For this reason, the analyst may take care to scrutinize the underlying financial projections.

Although financial projections may play an important role in each of these lost profits measurement methods, this discussion is particularly applicable to the sales projection method.

Selecting Different Scenario Projections

During the regular course of business, a company's management team often prepares multiple sets of financial projections to incorporate differing levels of growth, profitability, and other factors. These financial projections may come in the form of worst-case scenario, best-case scenario, and base-case scenario.

However, multiple projections may also be prepared to incorporate different potential future events, with a similar likelihood of achieving each scenario.

The relevance of a certain set of financial projections may be dependent on a future outcome such as the approval of a drug or a decision to move forward with an acquisition or major capital project. In this case, if the event does not occur, an individual set of projections could be rendered irrelevant.

Generally, if one set of financial projections was prepared as the "most likely" or "base case," this set will be the most supportable in a litigation analysis. The base-case scenario set of projections may also provide the analyst with the most accurate picture

of what results the business anticipated achieving if business continued as usual, without the damages event occurring.

However, the base-case set of financial projections is not always the most applicable to the damages measurement analysis. Management may prepare a set of projections that are predicated on achieving some future result. This result may be directly related to the alleged wrongful act.

For example, management may prepare a set of financial projections that anticipate the successful implementation of a product. If the alleged wrongful act hindered the business' ability to successfully implement the product, it may be the most relevant set of financial projections for the damages analysis. This may be the case even if the projections do not represent the base-case scenario. The analyst should, however, consider the risk of achieving the projected results absent the alleged wrongful act.

The analyst may take care not to rely on a projection scenario that is predicated on circumstances unrelated to the alleged wrongful act. The case of *Exel Transportation Services, Inc. v. Aim High Logistics Services, LLC*,[1] provides an example of this scenario. In this litigation, Aim High Logistics Services, LLC ("Aim High" or "plaintiff"), alleged that Exel Transportation Services, Inc., breached their contract causing Aim High to suffer a loss of profits.

In conducting his lost profits measurement analysis, the plaintiff's analyst relied on financial projections that reflected a company-wide loss of profits. The most significant factor contributing to the loss of profits in the plaintiff analyst's financial projections was the Aim High loss of its largest customer (accounting for approximately two-thirds of company revenue).

However, the loss of this customer was not a result of the alleged wrongful act and, therefore, the financial projections were not applicable to determine the lost profits attributable to the wrongful act.

Based on this information, the Texas Court of Appeals held that the evidence was insufficient to support an award of lost profits damages and overturned a jury's previous damages award.

The analyst may be provided with a set of projections that are overly optimistic or dependent on an uncertain event occurring. This is often the case when the subject company is a start-up business without historical proven results.

Generally, lost profits damages measurements should be proven with "reasonable certainty." When confronted with a start-up business, the only projections available may represent the best-case scenario. Management may have no reason for modeling a scenario where the business is not successful, in which case all available financial projections may have a lower likelihood of being realized.

In this scenario, the analyst may either decide to alter the projections to represent a more likely outcome, discount the cash flow based on a higher risk-adjusted discount rate, or reject the projections altogether.

Of these three options, discounting the projected cash flow using a higher risk-adjusted discount rate to account for the higher risk of achieving the level of cash flow present in the projections may be the most practical and supportable option.

Why Were the Projections Prepared?

In the regular course of business, financial projections may be prepared for a variety of reasons. These reasons include the following:

1. Regular budgeting and planning purposes
2. Decision making regarding major capital investments
3. Decision making regarding potential acquisitions or divestitures

4. Bank decision making in relation to financing or covenant compliance
5. Attracting investors such as venture capital firms
6. Break-even analysis
7. Internal liquidity analysis

The reason for which a set of financial projections was prepared will largely determine if they are applicable for use in a damages measurement analysis.

Generally, financial projections prepared for actual decision-making purposes may carry more weight than those prepared in a "back of the envelope" manner. If company management prepares internal projections to decide whether to move forward with an actual capital investment, business acquisition, or business divestiture, it is more likely that the projections were made in good faith with significant research and analysis backing them up.

Alternatively, company management may prepare "back of the envelope" projections when tossing around ideas. These projections may have never been intended for actual decision-making purposes and may lack thorough research and analysis.

Financial projections prepared to attract investors may be overly optimistic or represent a best-case scenario. In the case of start-up firms, investors will likely take company management's projections with a grain of salt, and potentially apply a high discount rate to the projections when making investment decisions.

If the analyst naively accepts this type of projection and applies a discount rate more appropriate for a base-case scenario, he or she may overestimate the damages amount and lose credibility in the eyes of the finder of fact.

Alternatively, financial projections prepared for bank loan purposes or internal liquidity analysis may be overly conservative and represent a worst-case scenario. The projections may not represent in any way what management expects future results to be, but rather may be used to determine how bad things can get without causing financial distress.

If the analyst relies on this type of projection without making appropriate adjustments, it may lead to a challenge by opposing counsel and cause the entire damages measurement analysis to be disregarded by the finder of fact.

Finally, financial projections may be prepared by company management specifically for damages litigation. This may be required when relevant projections prepared prior to the litigation event are not available. However, when projections are prepared exclusively for litigation purposes, they will come under increased scrutiny by the finder of fact.

When financial projections are prepared exclusively for litigation purposes, it is important that the analyst confirm that the projections are credible and reasonable through comparison to historical results, comparison to publicly available industry and market data, discussion with the person(s) who prepared the projections, and/or analysis of the underlying assumptions and information relied upon to prepare the financial projections.

When Were the Projections Prepared?

Financial projections that are prepared prior to any litigation event are often viewed as more trustworthy than projections created subsequent to the litigation event. Whether or not it is true, the finder of fact may question whether projections prepared after the litigation event occurred are unbiased and reliable.

Alternatively, if company management prepared a set of internal projections prior to the anticipation of any litigation event, they would have no reason to bias the results one way or the other.

Even if the post-litigation projections are not created to purposely influence the damages measurement one way or the other, they may still unintentionally incorporate information that was not known or knowable prior to the litigation event.

In *Agranoff v. Miller*,[2] the Court of Chancery in the State of Delaware (the "Chancery Court") gave a rebuke to the plaintiff expert's projection adjustments based on information obtained after the valuation date. When provided with financial projections that the plaintiff expert and defendant expert agreed were overly optimistic, the plaintiff expert (Lee) "purported to base a DCF analysis on a substantial negative revision of those projections that he came up with after discussions with EMS managers after the valuation date. That is, Lee discussed the projections for the years following 1998 with managers who knew what the actual results of those later years were."

The Chancery Court went on to state, "I refuse to give any weight to this technique and therefore to Lee's DCF analysis. The possibility of hindsight bias and other cognitive distortions seems untenably high. . . . Suppose there was an interview with Sir George Martin from 1962 in which he opined as to how many number one songs he thought

would be released by his new proteges, the Beatles." One can infer the direction that the rest of this analogy took.

Post-litigation financial projections are nevertheless commonly prepared by damages analysts and other parties. This may be necessary and helpful under certain circumstances. Analysts may examine the appropriateness of altering or creating projections after a litigation event has occurred, and only do so for valid reasons and with sufficient supporting information.

Are the Projections Sufficiently Supported?

After receiving management projections, the analyst may vet the projections for reliability, credibility, and reasonableness. By conducting this vetting process, the analyst not only ensures that the analysis is more accurate and complete, but also is in a position to defend the use of the subject projections when questioned by opposing counsel or the finder of fact.

One way to consider the credibility of financial projections is to compare them to the subject company's historical results. If a company's past sales and profits are in line with the projected results, it will be much easier to substantiate the credibility of the projections.

Additionally, the analyst can review past financial projections prepared by the same management team to verify if the projections are reliable. If the subject management team has a history of consistently underperforming or overperforming the projections that they compile, the subject projections relied on in the damages measurement analysis may be less reliable, either in reality or perception.

Another way to consider if financial projections are reasonable is to compare them to industry and market data. The analyst will have a stronger case in supporting a set of projections if they have independently scrutinized the underlying data through comparison to publicly available information.

To achieve this objective, the analyst may consider the following data sources:

1. Information regarding competitor companies or other industry participants
2. Published research and analysis regarding industry growth expectations and trends
3. Discussions with third-party industry experts
4. Market share data for the industry

The analyst may also conduct the necessary research to understand the underlying assumptions and information relied on to prepare the financial projections. This may be achieved by conducting interviews with the person(s) who prepared the projections, as well as requesting and reviewing the information that the person(s) relied on to prepare the projections.

Additionally, the analyst may consider the appropriateness and credibility of the person(s) who prepared the subject financial projections. This can be achieved through direct interviews with relevant members of the company management team or industry experts, and research into the credentials of those who prepared the financial projections.

It may be important to verify that the person(s) who prepared the subject financial projections had extensive knowledge regarding the relevant business or product line.

Overcoming a *Daubert* Challenge

In the case of *Aetna, Inc. v. Blue Cross Blue Shield of Michigan*,[3] Aetna, Inc. ("Aetna"), alleged that Blue Cross Blue Shield of Michigan ("Blue Cross") engaged in anticompetitive practices that caused financial damages to Aetna. Blue Cross was seeking to exclude the Aetna damages analyst on the basis of reliability.

Blue Cross alleged that the analyst based his conclusions on (1) projections that were fundamentally flawed and inconsistent with actual data, (2)

damages that were unreliable and speculative based on the number of years projected, and (3) incorrect assumptions regarding the damages actually caused.

In defending its damages analyst and the projections that his lost profits measurement was based on, Aetna argued that the projections were prepared in the ordinary course of business. Further, Aetna argued that the projections were based on analysis by business experts in each relevant business unit who used extensive information from various sources, including third-party data and consultant's reports.

Additionally, Aetna noted that the financial projections were created prior to the damages event and that they were validated through multiple acquisitions.

Aetna argued that its analyst did not naively rely on the ordinary course of business projections, but rather conducted a thorough investigation of the processes and methodology underlying the projections, including a detailed review of relevant documents and numerous conversations with the individuals who developed the projections.

Aetna claimed that its analyst checked the reliability of the financial projections and found that Aetna met and exceeded its projections prior to the damages event.

Blue Cross argued that the most relevant financial projections were those prepared after the alleged damages event occurred based on a change in circumstances. Aetna countered that projections prepared before the alleged damages event are more relevant because the revised projections incorporated the decreased profit resulting from the alleged damages event.

Blue Cross argued that the Aetna analyst's use of financial projections nine years into the future were not relevant because Aetna did not prepare projections for a period greater than three years. Aetna responded that case law does not support the argument that damages should be capped at the duration of financial projections.

Aetna also asserted that the extended projections were not just made up by the analyst, but rather based on assumptions he made from available information after analyzing relevant data.

After considering the arguments put forth by Blue Cross and Aetna, the U.S. District Court (the "District Court"), found that the Aetna analyst's model was reliable.

The District Court stated that damages need not be determined with mathematical certainty, and that the level of detail in the projections does not exclude the reliability of the model used. Therefore, the District Court denied the Blue Cross motions to exclude the Aetna expert's testimony.

This decision touches on a number of the financial projection considerations discussed above. This decision highlights the importance of relying on financial projections that were prepared:

1. in the regular course of business,
2. in the appropriate time period (i.e., prior to the damages event),
3. via a rigorous process by qualified experts including third-party data, and
4. for a relevant purpose (i.e., for actual acquisition decision making purposes).

This decision further highlights the importance of the analyst vetting projections, including:

1. understanding the underlying methodology,
2. reviewing relevant documents and information,
3. interviewing the people who prepared the projections, and
4. comparing the projections to actual results that occurred prior to the damages event.

Succumbing to a *Daubert* Challenge

In the case of *Bruno v. Bozzuto's, Inc.*,[4] the owner of a supermarket ("Bruno" or "plaintiff") brought action against a wholesale supplier ("Bozzuto" or "defendant") for breach of contract. The defendant challenged that the plaintiff's expert report was based entirely on unverified data and, therefore, not admissible.

In contrast to the prior decision discussion, the motion was granted and the U.S. District Court (the "District Court") granted in full the defendant's *Daubert* motion to exclude the plaintiff's expert reports and expert testimony.

The defendant alleged, and the District Court agreed, that the plaintiff expert's analysis was based entirely on unverified data and thus was unrealizable and not admissible to establish damages.

The initial iteration of the plaintiff's expert report lacked the benefit of historical financial information. This was due to the fact that the plaintiff destroyed all historical financial information related to the subject supermarket shortly before filing the litigation. This lack of historical data hindered the damages expert's ability to verify and scrutinize the projected results based on a comparison to actual results.

The plaintiff's analyst relied on unverified secondhand data. These data were from a pro forma sales projection created internally by the defendant.

The defendant argued that the pro forma grossly overstated the sales that were actually realized by the plaintiff's supermarket and, therefore, the defendant had internally rejected the pro forma figures as unreliable prior to the litigation event.

Further, the defendant contended that the pro forma was created to conduct a break-even loan analysis, and not to project actual sales or potential contract damages.

The plaintiff's analyst relied on the pro forma without making any revisions or conducting any independent verification of the numbers. The plaintiff's expert admitted that he did not speak with anyone at Bozzuto's and did not conduct any independent review of Bruno's books and records.

The plaintiff's analyst also admitted that he did not know the exact methodology used to create the projections. Rather, the plaintiff's analyst naively relied on Buzzuto's management (who had prepared the projections) as being experts in the field, and the analyst performed no further verification of the financial projection accuracy, reliability, or relevance.

After completing the initial expert report, documents surfaced that provided historical financial information for the supermarket. This information showed that the actual sales realized by the supermarket shortly prior to the alleged damages event were significantly less than the base for the pro forma.

However, the plaintiff's analyst ignored this new information and continued to rely on the inflated numbers from the pro forma in his revised expert report. The pro forma utilized a constant growth rate applied to a base level of sales. By relying on a base level of sales that clearly did not reflect reality, the defendant alleged that the resulting damages measurement was significantly overstated.

Based on these factors, the District Court granted the defendant's *Daubert* motion to exclude the plaintiff's expert reports and expert testimony.

This decision touches on a number of financial projection considerations discussed above. This decision highlights the importance of:

1. comparing projections to historical results,
2. verifying projections through market data and trends,
3. analyzing the documents relied on to prepare projections,
4. discussing projections with the people who prepared them,
5. understanding the underlying methodology used to create projections,
6. understanding the purpose for which projections were created,
7. assessing the reasonableness of projections, and
8. revising analyses based on the introduction of new relevant information.

Summary and Conclusion

The difference between a credible damages measurement analysis and an inadmissible analysis can hinge entirely on the underlying projections. When applying the lost profits measurement method, the analyst may take care when deciding (1) which set of projections to rely on, (2) whether to alter a set of projections, and (3) whether to create their own set of projections.

The analyst should conduct sufficient due diligence in order to assess whether the subject financial projections are:

1. reasonable,
2. credible,
3. reliable, and
4. appropriate for the subject damages measurement analysis.

The analyst should understand the projections that they rely on in a damages measurement analysis, and vet the underlying assumptions and information appropriately. This procedure includes understanding:

1. the differences between conflicting scenario projections,
2. why the projections were prepared, and
3. when the projections were prepared.

Notes:

1. Exel Transportation Services, Inc. v. Aim High Logistics Services, LLC, 323 S.W.3d 224 (Tex. App. 2010).
2. Agranoff v. Miller, 791 A.2d 880 (Del. Ch. 2001).
3. Aetna, Inc. v. Blue Cross Blue Shield of Michigan, No. 11-15346, 2015 WL 1497826 (E.D. Mich. Mar. 31, 2015).
4. Bruno v. Bozzuto's, Inc., 311 F.R.D. 124 (M.D. Pa. 2015).

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