



# BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

## Reliability of Business Plans To Support Lost Profits Damages

Tom Keith & Associates, Inc.  
Business & Real Estate Appraisers

Contacts:



Tom J. Keith, MAI, ASA, CBA  
tjk@keithvaluation.com



Thomas W. Bell, Associate  
twb@keithvaluation.com

(910) 323-3222

It is widely accepted business practice to employ some type of business plan, forecast, model, and/or budget to aid the entity in planning and control. In fact, many new businesses - as well as those that utilize some form of debt financing - are often required to provide such information to lenders in order to obtain financing. On the other hand, it is rare that these tools are prepared solely in anticipation of being used in litigation to show the business's lost profits. Unfortunately, this is exactly what usually happens when business is interrupted or damaged due to the act or omission of a third party. Courts are not uniform on the use of business plans, forecasts, models, and budgets to support damages and/or lost profits calculation. As such, an expert seeking to use such information as the basis for a damage calculation must exercise caution and carefully examine the underlying information, including the purpose, assumptions, intended users, form and method of preparation, convertibility, and reliability prior to use.

This article examines the use of business plans, forecasts, models, and/or budgets (hereinafter collectively referred to as "business plans" unless otherwise noted) as the basis for lost profit damage calculations. The use of a business plan as a model to calculate lost profits is not without potential hazards and risks for the damages expert. To illustrate the effectiveness and/or ineffectiveness in the use of business plans we focus in part on some informative recent cases that consider business plans as the basis for expert testimony.

Lost profit damages must be proven with "reasonable certainty." Due to the substantial use

of assumptions and forward looking projections, business plans present a unique challenge in determining whether or not they meet the "reasonably certain" standard. These plans are often called into question by opposing experts, who challenge the plan assumptions on a highly detailed level. The following is an analysis of several key issues regarding business plans and a survey of relevant cases on both sides of the issue. The key issues involved when basing lost profit calculations on business plans can significantly influence the success or failure of your case. This impact is demonstrated in the case examples discussed below.



### BUSINESS PLANS NOT SUPPORTIVE OF LOST PROFITS DAMAGES

#### (1) Failure to target specific lost profits

One scenario in which business plans can fail to provide reasonable certainty is when they are used to show a party's overall business losses while neglecting to zero in on the specific losses as a result of the alleged conduct.

In *Exel Transportation Services, Inc. v. Aim High Logistics Services, LLC*, 323 S.W.3d 224 (Tex.

App. 5th Dist. 2010), the Texas Court of Appeals overturned a jury's aggregate one million dollar damage award in favor of Aim High because the evidence of lost profits damages in the case was legally insufficient to support the award. Aim High's expert put forth three damage models, including one that incorporated Aim High's own five-year business plan and rate proposals for all of Aim High's accounts, not just the four accounts that were at issue. The losses under this model, dubbed the "blended" model, ranged from \$1.4 million to \$3.6 million. Aim High's expert did not consider that Aim High lost its largest customer (over 65% of its revenue) through no fault of Exel. Instead, Aim High presented testimony of blanket company-wide lost profits (including the large customer) based upon business plans, forecasts, and pricing models that did not focus only on the accounts in issue. As a result, the Texas Court of Appeals held that Aim High failed to present evidence establish[ing] any amount of lost profit damages with "reasonable certainty" and rendered a take-nothing judgment in favor of Aim High.

## **(2) Overly optimistic business plans may create a windfall**

New or startup business plans can sometimes be extremely optimistic and include material that is essentially a sales pitch in order to attract lenders, financiers, and other business partners. Overly optimistic business plans present a risk of unreliability when introduced in litigation.

In *Agranoff v. Miller*, 791 A.2d 880 (Del. Ch. 2001), the court was tasked with determining the valuation of certain warrants for Express Messenger Service, Inc. ("EMS"), an express delivery and courier service. The court noted that EMS enjoyed relatively strong revenue in the late 1990s but its ability "to derive profits from its revenues was less impressive." (781 A.2d at 882) The parties submitted testimony of two highly regarded and experienced experts in business valuation, both admitting that the projections (both revenue and profit) for EMS as presented in its business plans were "wildly unreliable and overly optimistic." (*Id.*) Both experts attempted to perform a valuation of EMS while substituting other, more reliable data for the overly optimistic projections. The court determined that the valuations were still highly speculative because of the optimistic projections and embarked on performing its own valuation. The court chose to primarily use an analysis of comparable companies to formulate a valuation while using certain reliable aspects of each expert's methodology. Nonetheless, the court declined to base a valuation on the "wildly unreliable and overly optimistic" business plan projections.

## **(3) No comparison to similar businesses**

Use of business plans that include comparisons to similar businesses or the industry may provide enhanced reliability. On the other hand, where there is no comparison or consideration of similar businesses, the opponent is likely to attack a business plan by showing that it is not in line with other similar businesses. Attempting to establish lost profits

by a business plan alone without any comparison to similar businesses or the industry may prove to be highly detrimental.

In *Mid-American Bio Ag, Ltd. v. Wieland & Sons Lumber Co.*, 2010 WL 3662305 (Iowa Ct. App. Sept. 22, 2010), the plaintiffs were attempting to start a mushroom farm operation and had gathered substantial information and prepared a business plan for the new venture. The plan was full of projections but failed to make any comparison to the industry or even a comparable business. The trial court refused to admit the business plan as evidence of damages. The Court of Appeals affirmed this decision, stating:

The proffered business plan is full of projections, but lacks any link to past experience or a comparable business. The evidence offered in the offer of proof [which included the business plan] does not provide the jury with any basis for determining what, if any, damages might have been suffered. ... Even if damages are assumed, there is no "reasonable basis from which the amount can be inferred or approximated."

## **(4) Inefficient business operation**

Courts can sometimes disallow all or parts of a business plan from being admitted as evidence (and thus precluded from serving as a basis for lost profits) where unexplained or personal expenses and inefficient operations have made the business plan and projections unreliable. Additionally, assuming a business plan is admitted as evidence, a jury may conclude that these same concerns preclude reliability of the plan.

In *Old Well Water, Inc. v. Collegiate Distributing, Inc.*, 150 N.C. App. 717, 565 S.E.2d 112 (2002) (memorandum affirmance), Collegiate Distributing ("Collegiate") was incorporated to distribute bottled water products affiliated with various colleges and universities. Since Collegiate did not have a financial history, the trial court allowed Collegiate's business plan to be used to establish projections made by Collegiate but disallowed the plan's use as direct evidence of lost profits. The court reiterated the "reasonable certainty" standard for lost profits and noted that where "an estimate of anticipated profits does not provide an adequate factual basis for a jury to ascertain the measure or damages, the trial court is permitted to exclude evidence of lost profits if it is based on mere speculation." The Court of Appeals (in an unpublished opinion) affirmed a nominal jury verdict of \$1.00 in favor of Collegiate and its key person, noting that the jury was free to determine that Collegiate's business plan was unreliable because Collegiate was inefficiently run and its operating costs and expenses were often attributable to personal expenses of its key person.

## **(5) The "hope" of success present in a business plan is insufficient**

Nearly all for-profit business plans, especially for new business ventures, will provide a plan for financial success. A business plan expressing a desire for success, even when that success is realistic, may not be reasonably certain enough to establish lost profits.

## IRS Outlines Factors that Influence Marketability of Closely-held Company Interests

On August 22, 2011, the Internal Revenue Service released the “Discount for Lack of Marketability Job Aid for IRS Valuation Professionals.” The document was intended to provide information to IRS Valuation Analysts when considering the Discount for Lack of Marketability. A copy of the official IRS release of this document is available at <http://www.irs.gov/pub/irs-utl/dlom.pdf>

The 107-page detailed study gives an in-depth presentation on IRS views concerning almost all of the current DLOM models, databases and studies. Most of these reviews include background, summary, areas of focus, strengths, weaknesses, important parameters, prevalence in professional practice and court-case coverage and citations.

Included in the Job Aid is a list of factors that can have an influence on marketability which are presented below. A prominent Tax Court case set forth factors for consideration of DLOM. The Mandelbaum Factors were set out in *Mandelbaum v. Comm.*, TC Memo 1995-255 (1995), with the opinion written by Judge Laro. The factors and the analysis that go with them are considered by many valuers to form a good conceptual basis for thinking about and quantifying DLOM. Some common factors that have been identified in various studies as impacting marketability are listed below and are modeled after the Mandelbaum factors.

The first set of factors relate to the characteristics of the subject company. The second set of factors relate to the characteristics of the subject interest.

### Factors Influencing Marketability Identified\*

#### SUBJECT COMPANY FACTORS

- Value of subject corporation’s privately traded securities vs. its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation’s public and private stock)
- Dividend-paying (or distribution) ability and history
- Dividend yield
- Attractiveness of subject business
- Attractiveness of subject industry
- Prospects for a sale or public offering of the company
- Number of identifiable buyers

- Attributes of controlling shareholder, if any
- Availability of access to information or reliability of that information
- Management
- Earnings levels
- Revenue levels
- Book to market value ratios
- Information requirements
- Ownership concentration effects
- Financial condition
- Percent of shares held by insiders
- Percent of shares held by institutions
- Percent of independent directors
- Listing on a major exchange
- Active vs. passive investors
- Registration costs

- Availability of hedging opportunities
- Market capitalization rank
- Business risk

#### SUBJECT INTEREST FACTORS

- Restrictive transfer provisions
- Length of the restriction period
- Length of expected holding period
- Offering size as a % of total shares outstanding
- Registered vs. unregistered
- General economic conditions
- Prevailing stock market conditions
- Volatility of stock

\*IRS DLOM Job Aid, pp. 6-7.

In *Ramco Oil & Gas Ltd. v. Anglo-Dutch (Tenge) LLC*, 207 S.W.3d 801 (Tex. App. 14th Dist. 2006), the parties presented a dispute over interests in a foreign oil and gas field that included extensive expert testimony as to lost profits damages. The Plaintiffs claimed that they would have earned over \$640 million in profits from the acquisition of an oil field but for the Defendants’ actions. The Plaintiff’s experts based their lost profits damages on business plans and numerous assumptions about events (such as acquisitions, licensing, financing, operations, etc.) that would have to come to fruition in order for the

business to be profitable. The Court held (207 S.W.3d at 824-25):

In sum, to realize Van Dyke’s “dream and business plan,” Plaintiffs first would have needed to obtain approval from Tenge Development. Then, despite the lack of profitable production from the Tenge field in the past, Plaintiffs would have had to convince a third-party lender to put millions of dollars at risk, without compromising Plaintiffs’ equity stake and right to all of the profits in the event of success. Plaintiffs’ lost profits calculations are not based on a business that already was established and making a profit when the contract

was breached. The fervent hope of Brickhill and Schaefer [Plaintiff's experts] for Plaintiffs' success in obtaining financing, buying the Kazakhtenge interests, and producing and marketing oil and gas from the Tenge field under Schaefer's production plan is not enough to warrant recovery of lost profits.

The Court concluded that "Plaintiffs' proof of lost profits is largely speculative, dependent on uncertain and changing market conditions, and based on risky business opportunities and the success of an unproven enterprise. Thus, it is insufficient for recovery." (*Id.*)

## **BUSINESS PLANS SUPPORTIVE OF LOST PROFITS**

### **(1) Use of other corroborative factors along with business plans**

Business plans usually have elements of uncertainty because of their forward-looking nature. However, consideration of other details used in conjunction with a business plan can bolster the plan over the "reasonably certain" standard.

In *Gullwing Int'l Motors, Ltd. v. Ostermeier*, 2009 WL 2961939 (Cal. Ct. App. 2nd Dist., 2009) (unpublished; not citable), the plaintiff built and sold replica Mercedes Benz Gullwing vehicles. He subsequently sold the right to Defendant, with a transition period where the production and selling would be moved to a new entity. Plaintiff's expert relied on a strategic business plan for the new venture as well as interviews with the primary person responsible for creating the plan. The expert also analyzed various documents, assumptions and other details regarding profitability present in the plan and concluded that the projections were achievable and that there was "quite a profit in them." On appeal, the court noted that the expert had thoroughly analyzed the business plan along with other factors such as the plaintiff's experience, the market, data on profitability of building replica automobiles, and interviews with the creator of the business plan. The court determined that the projections contained in the plan were reasonably achievable and affirmed the lost profits damages.

### **(2) Pre-litigation plans more reliable**

Business plans and projections created prior to any litigation generally carry more weight in a lost profit context than those created subsequent to the litigation. The reason is simple: pre-litigation plans possess greater indicia of trustworthiness and reliability due to the fact that they are not yet affected by the litigation. They provide a pure look at what the business owners expected to achieve. It should be noted that this only applies to projections created by the harmed business and/or its owners and agents. Post-litigation projections are routinely created by experts and others to assist with the case.

In *Super-Valu Stores, Inc. v. Peterson*, 506 So.2d 317 (Ala. 1987), the Alabama Supreme Court dealt with a claim that Super-Valu stores had

interfered with Hardin & Co. Warehouse Market's ("Hardin") exclusive right to operate a certain type of grocery store in Oxford, Alabama. Hardin introduced evidence of its lost profits in the form of Super-Valu's own projections "produced in its normal course of business long before this dispute arose." (506 So. 2d at 330). In affirming the award of lost profits to Hardin, the court stated (506 So. 2d at 330):

In considering claims by unestablished or new businesses for lost profits, courts have consistently given special deference to a party's pre-dispute projections of anticipated profits. As one court succinctly noted, pre-dispute projections are "no mere 'interested guess' prepared with an eye on litigation. Instead, they [are] ... the product of deliberation by experienced businessmen charting their future course." *Autowest, Inc. v. Peugeot, Inc.*, 434 F.2d 556, 566 (2d Cir.1970) (affirming profits award for new business).

The courts have shown even more deference in a situation, such as exists in the present action, where plaintiff's proof of lost profits is based on pre-dispute projections prepared by the defendant. For example, in a closely analogous case, a substantial verdict for lost profits was upheld where plaintiff's proof was based upon the defendant's "projected profit-and-loss statement" for plaintiff's anticipated second year of operation as one of defendant's distributors. *Computer Systems Eng'g, Inc. v. Qantel Corp.*, 740 F.2d 59, 66 (1st Cir.1984). Similarly, lost profits have been awarded based on sales "projections, prepared by the defendant's market expert, [that] were not put together with an eye to litigation." *Perma Research & Dev. Co. v. Singer Co.*, 402 F.Supp. 881, 898-902 (S.D.N.Y.1975), aff'd, 542 F.2d 111 (2d Cir.1976), cert. denied, 429 U.S. 987, 97 S.Ct. 507, 50 L.Ed.2d 598 (1976).

## **CONCLUSION**

The overriding factor in almost all lost profits cases is whether the lost profits can be proven with "reasonable certainty." The methods for showing reasonable certainty are far-ranging because every lost profits case is unique and incorporates different factors, assumptions, and characteristics from the next. Case law such as that analyzed above provides useful guidance on situations where lost profits have been upheld or denied based on business plans. The litigant or expert seeking to prove lost profits damages based on business plans should consult an attorney and have some understanding of case law on the subject in his/her jurisdiction.

*By Ralph Q. Summerford, CPA, ABV, CFE, CIRA, CFF  
Jeffrey Windham, J.D., CFE  
Forensic/Strategic Solutions, PC, Birmingham, AL*

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