

# Penalty from the Spot of the Foul – Financial Experts in Litigation



**SPEAKERS**

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## FINANCIAL EXPERTS IN LITIGATION

### Introduction

- Typical litigation settings where a financial expert is needed:
  - *Damages calculations involving lost profits or lost value of a business or its assets*
  - *Contentious shareholder buyouts aka shareholder divorce*
  - *Shareholder oppression*



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## FINANCIAL EXPERTS IN LITIGATION

### Introduction

- Partnership between attorney and financial expert
- Expert must maintain independence and objectivity
- Role of financial expert must be determined at the inception of an engagement
  - *Consulting expert or independent (testifying) expert*



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## FINANCIAL EXPERTS IN LITIGATION

### *Types of Experts*

- Consulting expert:
  - *Assists attorney with various pre-trial matters*
  - *Work is protected by applicable work product doctrine*
- Testifying expert:
  - *Expected to provide testimony regarding his/her conclusions or opinions*
  - *Work is discoverable under federal and most state Rules of Civil Procedure*



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## FINANCIAL EXPERTS IN LITIGATION

### *Expert Admissibility*

- Experts must comply with professional standards, as well as applicable case law and evidentiary standards related to admissibility of testimony
- Financial expert must:
  - *Establish that he/she has requisite knowledge, skill, training and experience in his/her field of practice*
  - *Provide the facts, assumptions, information and other considerations relied upon when reaching his/her conclusion*
  - *Provide the methodology employed in reaching his/her conclusion*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profit Determinations*

- Plaintiff must demonstrate three key elements to enable recovery of lost profits:
  - *Lost profits were directly caused by opposing parties' wrongful actions*
  - *Lost profits were a foreseeable consequence of the defendant's wrongful conduct*
  - *Lost profits can be determined and proven with reasonable certainty*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Calculating lost profits
  - *Lost profits calculated as the amount necessary to place injured party in a position that he/she would have been in had the injury or incident not occurred*
  - *Net lost profits = lost revenues – avoided costs*
  - *Approach and method used for calculation selected based on specific facts and circumstances of the case*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Calculating damages
  - *Damages calculation requires analysis of many elements*
  - *Calculations should not be based on speculation; reasonable, reliable factors must be considered*
  - *Sufficient support and documentation should be provided*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Considerations
  - *Plaintiff must prove acts of defendant caused damages to the plaintiff (must be material factor in the cause)*
  - *Experts should also consider other factors that may have contributed to cause of plaintiff's loss*
  - *Failure to address relevant factors can cause expert to fail to meet "reasonable certainty" standard*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Period of recovery
  - *Start date: the date on which the harmful act occurred*
  - *End date: the point at which the plaintiff's operations return to "normal"*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Approaches used to calculate lost profits
  - *One-model approach: calculation of only the increment lost revenues and related avoided costs*
  - *Two-model approach: taking the difference of the net profits the business would have attained "but for" the damaging event, and the actual financial results attained over the given period*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Methods used to determine lost revenues and profits
  - *Before-and-After Method*
  - *Yardstick Method*
  - *Sales Projection Method*
  - *Market Model*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Before-and-After Method
  - *Also referred to “book ends” method*
  - *Compares performance of business before the alleged actions and after the effects of damaging event are over*
  - *Underlying theory is “but for” the defendant’s action, plaintiff would have experienced similar revenues and profits after the event as experienced before the event*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Before-and-After Method
  - *Best applied to established business with historical track record of profitability*
  - *Defendant can also use the method to illustrate that the plaintiff did not suffer any harm*
  - *Expert must also consider other factors that may have contributed to harm or loss*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Yardstick Method
  - *Also known as “benchmark” method*
  - *Uses guideline company/industry measures to determine what the revenues and profits of the affected company would have been if the damaging event had not occurred*
  - *Can use outside companies and/or proxies from within the company*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- **Yardstick Method**

- *Expert must prove that the subject business is sufficiently similar to the guideline company/industry used for comparison*
- *Expert must also consider other factors that may have contributed to harm or loss*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- **Sales Projection Method**

- *Utilizes company-specific forecasts, preferably prepared in the ordinary course of business prior to the damaging event*
- *Method allows expert to more easily incorporate the effect other factors might have had on revenues and profits*
- *Can be difficult to identify and measure these “other” effects and/or support the underlying projections of the business*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Market Model
  - *Expert uses plaintiff's market share prior to the alleged act to determine lost revenues*
  - *Most frequently used in patent infringement cases*
  - *Expert must define the market of the company and analyze the subject business' historical sales, as well as the performance of its competitors*



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## LOST PROFITS DAMAGES CLAIMS

### Lost Profits Determinations

- Calculation of avoided costs
  - *Analyze the cost structure of the business to determine the cost drivers and other factors that impact costs directly tied to revenue*
  - *Generally costs are classified into five categories:*
    - Cost of goods sold
    - Direct costs
    - Indirect costs
    - Overhead costs
    - Other expenses
  - *Also separated into "fixed" versus "variable" costs*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Discounting of future lost profits to present value
  - *Appropriate discount rates must be determined by considering:*
    - Time value of money
    - Risk
  - *Critical for financial expert to determine whether an “ex ante,” “ex post,” or hybrid methodology is appropriate*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

- Taxes and damages
  - *Lost profits damages generally taxable as ordinary income to the party receiving the damages payment*
  - *Calculations typically prepared on a pre-tax basis*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

#### ▪ Mitigation

- *Expert must consider whether revenues and/or profits earned subsequent to the damaging event are a mitigation of the damages caused by the defendant, thereby reducing damages, or are profits that would have been earned regardless of the event*
- *Plaintiff generally cannot recover damages that were foreseeable and could have been avoided by reasonable efforts, without causing undue expense or risk*



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## LOST PROFITS DAMAGES CLAIMS

### *Lost Profits Determinations*

#### ▪ Mitigation

- *Plaintiff's ability to mitigate is dependent upon:*
  - Financial ability to mitigate;
  - Cost to mitigate as compared to economic damages suffered by plaintiff;
  - Technical barriers to mitigation;
  - Market barriers to mitigation;
  - Supply-oriented barriers to mitigation; and
  - Timing issues impacting mitigation of damages.



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## SHAREHOLDER DIVORCE & OPPRESSION

### ***Causes of Shareholder Divorce***

- Personal use of business assets/income
- Personal behaviors of a civil or criminal nature
- Use of business to advocate personal interests
- Financial success/distress in the business
- Shareholder/equity owner freeze out



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## SHAREHOLDER DIVORCE & OPPRESSION

### ***Shareholder Divorce Resolution Alternatives***

- Single Equity Owner Buy Out
  - *Most common alternative*
  - *Exiting owner receives valuable consideration on investment*
  - *Remaining shareholders no longer need to deal with him/her*
  - *Issues: valuation and payment*



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## SHAREHOLDER DIVORCE & OPPRESSION

### *Shareholder Divorce Resolution Alternatives*

- Sale of Business
  - *Extreme, but sometimes the only option*
  - *Completed transaction is negotiated by third parties*
  - *Can be achieved in a taxable transaction or tax-free basis*



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## SHAREHOLDER DIVORCE & OPPRESSION

### *Shareholder Divorce Resolution Alternatives*

- Arbitration
  - *Goal is to push to quick resolution without high cost*
  - *Can be voluntary or mandatory; binding or non-binding*
  - *Clauses directing arbitration often contained in governing documents*
- Mediation



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## SHAREHOLDER DIVORCE & OPPRESSION

### **Shareholder Divorce Resolution Alternatives**

- Resolution in Court
  - *Courts do not want to address disputes among business owners*
  - *Few tools available for resolution*
  - *Only become involved in limited situations*
  - *Courts can appoint a custodian to run the business in place of the individuals involved in the dispute (not common)*



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## SHAREHOLDER DIVORCE & OPPRESSION

### **Role of Independent Financial Specialist**

- Type of dispute influences assignment(s) requested of specialist
- Specialist should have clear understanding of dispute
- Role of specialist can include
  - *Business valuation expert*
  - *Forensic accounting expert*
  - *Consulting and/or other support services*



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## SHAREHOLDER DIVORCE & OPPRESSION

### *Valuation Issues*

- Valuation poses one of the most critical issues
- Failure to consider nuances can create issues
- Lack of a quality valuation can prove to be a costly misstep
- Critical to engage a qualified valuation expert



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## SHAREHOLDER DIVORCE & OPPRESSION

### *Valuation Issues*

- Purpose of valuation
- Existence of a buy-sell agreement
- Valuation date
- Premise of value
- Standard of value (*often most material issue relating to value*)
- Valuation adjustments



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## SHAREHOLDER DIVORCE & OPPRESSION

### Valuation Issues

- Fair Value vs. Fair Market Value Standard
  - Most states (including PA) use fair value to resolve shareholder disputes
  - Defined in the Revised Model Business Corporation Act
  - Some courts do not equate fair value to fair market value



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## SHAREHOLDER DIVORCE & OPPRESSION

### Valuation Issues

- Fair Value vs. Fair Market Value Standard

Fair Value	Fair Market Value
Not always a willing buyer	Willing buyer
Not a willing seller	Willing seller
Buyer not always compelled; seller under compulsion	Neither under compulsion
The impact of the proposed transaction is not considered; the “fairness” to the seller is a possible consideration	Assumes a typical hypothetical buyer and seller
A concept of “fairness” to the seller, considering the inability to keep the stock	A price equitable to both



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## SHAREHOLDER DIVORCE & OPPRESSION

### Valuation Issues

- Valuation adjustments
  - *Driven by:*
    - Specific investment characteristics
    - Required standard of value
    - Methodologies applied



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## SHAREHOLDER DIVORCE & OPPRESSION

### Valuation Issues

- Valuation adjustments
  - *Buy-sell agreement may speak to the standard of value which will impact application of discounts*
  - *Absent governing documents, state statutes will provide authority*
  - *Application of discounts in a fair value context*



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## QUESTIONS?

***Thank you for your attention!***

- Please contact the presenters directly if you need assistance:
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