Measuring Business Interruption Losses and Other Commercial Damages

Second Edition

PATRICK A. GAUGHAN



Contents

Preface		XV
CHAPTER J	Introduction	1
	Development of the Field of Litigation Economics	1
	Development of the Field of Forensic Accounting	2
	Qualifications of an Economic Expert	4
	Qualifications of an Accounting Expert on Damages	. 7
	Interdisciplinary Nature of Commercial Damages Analysis	7
	Difference between Disciplines of Economics and Finance	10
	Finding a Damages Expert	10
	Critically Reviewing a Potential Expert's Curriculum Vitae	12
	Getting the Damages Expert on Board Early Enough	17
	Courts' Position on Experts on Economic Damages	18
	Standards for Admissibility of Expert Testimony	21
	Expert Reports	25
	Defense Expert as a Testifying Expert, Not Just a Consultant	28
	Quantitative Research Evidence on the Benefits of Calling a Defense Expert	30
	Treatment of the Relevant Case Law	31
	Legal Damage Principles	31
	Other Types of Damages Cases	37
	Summary	40
	References	41

•

CHAPTER 2	Economic Framework for the Lost Profits	
	Estimation Process	45
	Foundation for Damages Testimony	45
	Role of Assumptions in Damages Analysis	46
	Hearsay	47
	Approaches to Proving Damages	49
	Causality and Damages	54
	Using Demonstrative Evidence to Help the Client	
	Understand Its Losses or Lack of Losses	61
	Causality and Loss of Customers	62
	Graphical Sales Analysis and Causality	63
	Causality and the Special Case of Damages Resulting	
	from Adverse Publicity	65
	Length of Loss Period: Business Interruption Case	66
	Length of Loss Period: Plaintiff Goes Out of Business	71
	Length of Loss Period: Breach of Contract	72
	Methodological Framework	73
	Summary	75
	References	77

CHAPTER 3	Economic Analysis in Business Interruption	
	Loss Analysis	79
	Economic Fluctuations and the Volume of Litigation	79
	Macroeconomic Analysis	80
	Definition of a Recession	80
	Measuring Economic Growth and Performance	81
	Business Cycles and Economic Damages	89
	Using More Narrowly Defined Economic Aggregates	90
	Overstatement of Inflation Statistics	98
	Regional Economic Trends	100
	International Economic Analysis	104
	Macroeconomic and Regional Economic Analysis	
	and the Before and After Method	, 106
	Summary	107
	References	108

CHAPTER 4	Industry Analysis	111
	Sources of Industry Data	111
	New North American Industry Classification System	118
	Retaining an Industry Expert	125
	Conducting an Industry Analysis	126
	Relating Industry Growth to the Plaintiff's Growth	130
	Other Industry Factors	131
	Yardstick Approach and Industry Analysis	134
	Summary	138
	References	138
CHAPTER 5	Projecting Lost Revenues	141
	Projections versus Forecasts: Economic versus	
	Accounting Terminology	141
	Using Graphical Analysis as an Aid in the	
	Forecasting Process	142
	Methods of Projecting Lost Revenues	· 147
	Curve-Fitting Methods and Econometric Models	152
	Understanding Regression Output and Diagnostics	155
	Common Problems Affecting Regression Models	156
	Confidence in Forecasted Values	164
	Frequency of the Use of Econometric Techniques in Commercial Litigation	167
	Seasonality and the Forecasting Process	175
	Capacity Constraints and Forecasts	177
	Sensibility Check for the Forecasted Values	178
	Projecting Lost Sales for a New Business	179
	Projecting Losses for an Unestablished Business	184
	Summary	187
	Appendix	188
	References	196
CHAPTER 6	Cost Analysis and Profitability	199
	Presentation of Costs on the Company's	
	Financial Statements	199
	Measures of Costs	201

,

Profit Margins and Profitability	201
Appropriate Measure of Profitability for a Lost	
Profits Analysis	201
Burden of Proof for Demonstrating Costs	207
Fixed versus Variable Costs	207
Using Regression Analysis to Estimate Costs as	
Opposed to More Basic Methods	210
Pitfalls of Using Regression Analysis to Measure	
Incremental Costs	211
Possible Nonlinear Nature of Total Costs	211
Limitations of Using Unadjusted Accounting Data	
for Measuring Incremental Costs	215
Treatment of Overhead Costs	218
Must a Plaintiff Be a Profitable Business to	
Recover Damages?	223
Mitigation of Damages	224
Cash Flows versus Net Income: Effects on the	
Discounting Process	230
Recasted Profits	231
Firm-Specific Financial Analysis	237
Cross-Sectional versus Time Series Analysis	239
Summary	239
References	240
Time Value of Money Considerations	2/2

CHAPIEK /	Time value of Money Considerations	243
	Determination of Interest Rates	244
	Types of Interest Rates	244
	Financial Markets: Money Market versus	
	Capital Market	245
	Money Market Securities and Interest Rates	245
	Capital Market	247
	Real versus Nominal Interest Rates	248
	Determinants of Interest Rates	252
	Prejudgment Losses	- 258
	Components of the Cost of Capital	260
	Discounting Projected Future Profits	267

OTTAD

	Common Errors Made in Discounting by	
	Damages "Experts"	273
	Summary	279
	References	280
CHAPTER 8	Business Valuations	285
	Legal Standard for Business Valuations in Business Interruption and Business Failure Lawsuits	285
	Lost Profits versus Lost Business Value	287
	Business Valuation Framework	289
	Theoretical Value of a Business	290
	Public versus Private Companies	291
1	Business Valuation Parameters	292
	Revenue Ruling 59-60 and Factors to Consider	
	in Valuation	292
	Valuation Concepts	295
	Most Commonly Used Valuation Methods	298
	Capitalization of Earnings	302
	Comparable Multiples	303
	Adjustments and Discounts	307
	Summary	312
	References	313
CHAPTER 9	Intellectual Property	315
	Patents	315
	Computation of Damages for Patent Infringement	318
	Legal Requirements Necessary to Prove Lost Profits	318
	Lost Profits Due to Price Erosion	322
	Lost Profits Due to Changing Cost Conditions	325
	Royalty Arrangements	326
	Copyrights	333
	Measurement of Damages for Copyright Infringement	336
	Trademarks	339
	Trade Secrets	345
	Summary	347
	References	349

CHAPTER 10	Securities-Related Damages	353
	Key Securities Laws	353
	Damages in Securities Litigation	358
	Fraud-on-the-Market	359
	Comparable Index Approach	364
	Event Study Approach	367
	Broker Raiding Cases	378
	Merger-Related Damages	383
	History of Mergers in the United States	384
	Client-Broker Claims	388
	Churning	390
	Appendix 10A: Case Study: In Re Computer	
	Associátes International, Inc.	397
	References	404
CHAPTER 11	Antitrust	407
	Antitrust Laws	408
	Antitrust Enforcement	411
	Economics of Monopoly	411
	Changing Pattern of Antitrust Enforcement	416
	Antitrust and the New Economy	421
	Monopolization and Attempts at Monopolization	421
	Market Definition and Microeconomic Analysis	426
	Market Power	426
	Measures of Market Concentration	428
	Common Types of Antitrust Cases	430
	Summary	442
	References	443
CHAPTER 12	Economics of Punitive Damages	447
	Evolving Position of the U.S. Supreme Court	
	on Punitive Damages	447
	Frequency of Punitive Damages	450
	Frequency of Punitive Damages and the Shadow	
	Effect of Punitive Damages	451
	Purposes of Punitive Damages	452

Punishment of Corporations and Corporate	
Governance	453
Spillover Effects and Punishment of Corporations	454
Deterrence Theory and the Changing	
Litigation Environment	465
Deterrence and Regulatory Processes	467
Typical Financial Measures Used in the Determination	
of Punitive Damages	470
Net Worth	472
Market Capitalization	474
Uncertain Litigation Environment	480
Summary -	483
References	484

7

Index

1

489

.