

New businesses: Building the case for lost profits

By Steven Mizrach, CPA

Claims for damages from lost profits can arise in everything from shareholder disputes and insurance litigation to breach of contract, tortious interference, and intellectual property actions. Courts recognize that a plaintiff should not be precluded from recovering lost profits where the defendant's actions have prevented the plaintiff from establishing a track record.



The methods typically employed to calculate lost profits damages may prove tricky when the case involves a new or unestablished business. Financial experts can help you recover damages in the absence of the usual evidence.

Gaps for new businesses

Although damages calculations basically are the same for new and established businesses, less data is likely to be available and more assumptions are necessary. Lost profits calculations usually are based on two steps: 1) Determining the subject business's lost revenues, and 2) estimating lost profits.

Regardless of the method applied, the expert must weigh both future revenues and profit margins. To project future revenues, experts generally rely on data related to historical company performance, industry and general economic trends and forecasts, and company projections. With a new business, an expert may not find sufficient data to correlate with trend data or its product is so early in its development that the company hasn't yet made projections.

Determining profit margins presents similar difficulties. The process requires analysis of fixed and variable costs — usually studying historical company performance, industry profit margins, and internal forecasts based on projected revenues and cost structures. A new business may not have sufficient data for analysis, and, if it's offering a new product or service, an expert might not be able to locate comparable businesses. Projected revenue and cost structures also may be difficult to pin down.

Piecing together a picture

Attorneys for nascent businesses need not despair. Financial experts may be able to prepare some forecasts to build nonspeculative lost profits claims. An expert can rely on company projections for future revenues if the data allows him or her to calculate lost profits with "reasonable certainty."

An expert also might apply industry growth rate projections to existing company data to develop multiple sales projections with varied combinations of actual and projected data.

If the projections reach similar conclusions, the expert could cite those findings as evidence of lost revenues. From there, the expert can use company-specific data to develop cost structures by determining fixed and variable costs and the cost of goods sold.

If useful company-specific data is not available, experts can gather a wealth of information from outside sources. They can determine market share and penetration estimates by examining models and studies of new-product lifecycles and use that data to project revenues. Internal data and reports, industry forecasts and other sources can then be incorporated to formulate profit margins. Many governmental agencies, trade associations and research organizations issue regular reports with critical data — including expected demand, prices and cost structures — that can validate projections.

Discount rates figure prominently as well. The rate applied to lost profits must represent the risk related to the new business and specifically reflect the likelihood that the projected lost profits would be achieved “but for” the actions of the defendant.

All is not lost

Calculating lost profits for new businesses to a “reasonable certainty” may prove difficult and time-consuming, but it can be done in many cases. A qualified professional will provide you with a strong analysis that is capable of withstanding attack.

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