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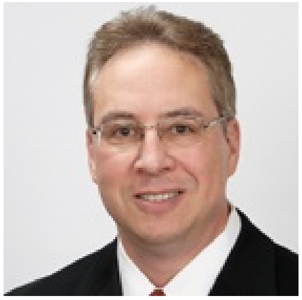
Duration Of Damages: Can Lost Profits Continue Forever?



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Law360, New York (March 11, 2013, 1:54 PM ET) -- If a business is financially harmed, but not ruined, by the acts of another party, it may seek damages based on some measure of lost profit. But for how long? While some aspects of a damages opinion may be accepted based on an expert's professional judgment, when it comes to the duration of damages, triers of fact will likely view the debate pre-armed with their own perceptions of how one recovers from "trauma." Consequently, an expert offering an opinion that financial harm will continue well into the future should consider the potential hesitancy of a judge or jury to award uncertain, long-term future damages. Failure to do so may reduce the degree of credibility given to an otherwise defensible damages analysis.

We have written about the incremental value associated with assuming damages into perpetuity vis-a-vis periods that are long-term but finite.[1] In our concluding remarks to that article, we posed the possibility that, "reasonably foreseeable mitigation options exercised by or available to the plaintiff, or lifespan limiting characteristics of the harmed entity, may cause the expert to conclude that damages are not reasonably expected to be long-lasting, let alone accrue forever." This article offers guidance as to inquiries an expert might undertake to identify and address that possibility.

Statistics on business longevity provides ample evidence of their impermanence. U.S. Census Bureau data shows that over 50 percent of businesses exit within five years of formation and more than two thirds exit within 10 years.[2] The National Federation of Independent Business' Education Foundation has reported that, over the lifetime of a business, 51 percent either break even or lose money.[3] A study of over 5,000 startups in Australia found that 64 percent "failed" (defined as discontinuance of ownership) over a 10-year period.[4] Recent well-known companies that have ceased operations include BearingPoint, Bethlehem Steel, Blockbuster Video, Borders, Circuit City, Enron, Hostess, Kodak, Tower Records and WorldCom.[5] Nearly 500 banks have failed since 2000.[6]

We note that “failing” or “exiting” does not necessarily mean bankruptcy: The NFIB study observed that many businesses cease because they were sold or merged into another company, while almost all of the failed banks were acquired by another bank. Nonetheless, the above data suggests that in considering the impact of a contract breach or a tortious act on the future earnings of a young business it may not be reasonable to automatically assume it will continue operations in its current form indefinitely.

What about established firms? If a company has been in business for 20 or 30 years, does that portend a similarly long future of operations? Perhaps, but empirical data to test that hypothesis is still being compiled. Census Bureau data of the type reported above has only been available since 1977. For establishments formed in that year, 70 percent, 59 percent and 55 percent of firms that survived 10 years of operation continued to operate for an additional 10, 15 and 20 years, respectively.

In contrast, when experts incorporate a “terminal value” in their lost profit analyses (it is usually added onto an initial five-year projection to reflect “thereafter”), they are implicitly assuming that the business will operate for at least 30 to 40 more years. In contrast, assuming a 15- to 20-year damages period results in significantly lower damages across a wide range of present value discount rates.[7] Thus, until a sufficient body of long-term firm survivorship data is available, it may be prudent to explore other sources for guidance in assessing the reasonableness of an assumption of damages lasting forever.

One source of insight is that of recognized authorities in the business community. At the 2012 World Economic Forum Annual Meeting, business leaders discussed the challenges facing companies. Among the consensus opinions expressed by panelists were the following:[8]

- Companies everywhere must fundamentally change the way they do business if they are to meet the challenges of 2012 and beyond.
- If a company continues to do what it has always been doing, it is going to be left behind.
- “We had about 100 great competitors in the 1990s. All but two are largely gone.” (John T. Chambers, chairman and CEO, Cisco, USA).
- The life span of companies that are unable to change is around 15 years.

Another source of insight is organizational behavior theory. Over the last 50 years[9] academics have studied the organization life cycle. The OLC uses a biological metaphor to describe and model the various stages of a business’s existence, starting with its birth and moving through growth, maturity, decline, and revival or death.[10] Some researchers have focused on a particular stage to uncover sequences of evolutionary (e.g., unhindered growth) and crisis (e.g., a growth roadblock) phases; the handling of which is thought to determine a company’s future prospects.[11] Others have analyzed ways a business may be able to prolong positive stages or delay negative ones.[12] Awareness of the issues being addressed by these researchers may spark ideas as to inquiries that will allow an expert to defend or rebut opinions offered regarding the duration of damages.

Examples of companies changing or adapting in order to survive are numerous. A striking case study is that of Nintendo. From its founding in 1889 to the early 1960s, the company was solely a producer of playing cards. A weakening market for its products prompted Nintendo to pursue other commercial ventures, eventually gaining traction in the then-growing arcade phenomena. From there, it moved into the home video game industry.[13] Today, in addition to its legacy playing card business, Nintendo Co. Ltd. is the world's largest video game company[14] and the majority owner of a Major League Baseball team.[15]

Along the continuum are firms that were once leaders in particular products, or invented a product segment, that had to exit those lines of business in order to survive. High-profile examples include Hewlett Packard Co. (electronic testing equipment), IBM Corp. (personal computers), Navistar International Corp. (agricultural machinery) and AT&T Inc. (the Bell System).

At the other end of the spectrum are firms that, according to a recent article, were once "leaders in their industries, but are no longer and likely will never be again," including JCPenney, Barnes & Noble and Sprint Nextel. "Almost all have lost money recently. Each has had a drop in share price of over 50% in the last five years. Each has powerful competitors who have built market share or moats around their businesses that are nearly impossible to overcome."[16]

Examples such as the above can be used to both support and attack the reasonableness of an assumption of long-term or perpetuity damages. Thus, an expert should endeavor to find the tipping point between "reasonable" and "questionable" as it relates to the duration of damages. To that end, OLC research may provide useful guidance and insights.

One avenue of inquiry is organizational flexibility: As the subject industry or market evolved over time, has the company adapted so as to keep its existing customers or substitute new customers, or has it settled for more of a niche profile or reduced market share? Examples include commoditization of a product or service, support needs evolving from local to regional/national in scope, and preference changes from specialty providers to "one stop" shops.

If flexibility can be demonstrated, the expert can more persuasively argue that if the harm is long-term, the financial impact is also likely to be long term. If not, the expert may need to perform market analyses to identify when the next evolutionary challenge in the industry will likely take place, and this may inform the duration of damages. If a company has not had the opportunity to demonstrate its flexibility during its lifetime but such challenges are foreseeable, the expert can consider drawing conclusions from proxy measures of the firm's flexibility or default to a damages period consistent with what the facts and circumstances can reasonably support.

Another avenue of inquiry focuses on company management: To what extent are management's knowledge, skill and good will durable, concentrated, scalable, and transferable? Durability can relate to health (think Steve Jobs) or to potential flight risk. Concentration considers where the know-how, talent or Rolodex resides. Scalability relates to the company's ability to grow or to add complementary offerings. Transferability can encompass succession planning or the salability of the company to third parties; for small family-owned businesses there may be risk that the heirs may possess valuable complementary skills but not the drive, vision or relationships of the founder.

As with organizational flexibility, demonstrated success in meeting management challenges can be cited by an expert as support for a longer damages period (if warranted by the duration of the harm) or, if lacking, may restrict damages to a period consistent with the available facts and circumstances.

The information described above may be gathered by legal counsel through discovery. The expert can assist by suggesting questions or document requests, either to compile relevant information or to set the stage for adopting a key assumption (i.e., an inquiry for relevant information was requested but not provided). By incorporating into the damages analysis case facts as well as real world evidence to support appropriate boundaries on the duration of damages, the damages expert can make great strides in establishing credibility and justifying the reasonableness of the analysis.

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[1] Bosco, Rodney J., “What is the Value of ‘Forever’?: Choosing Between Long-Term Mitigation and a Perpetual Damages Period”, Financial Valuation and Litigation Expert, Issue 28, December 2010/January 2011, pp. 9-13.

[2] The Business Dynamics Statistics database is a public use data set of annual aggregate statistics describing establishment openings and closings, firm startups, job creation and destruction by firm size, age, industrial sector, and state. Based on data in the “Firm Age Table” www.census.gov/ces/dataproducts/bds/

[3] Wells Fargo/NFIB Series on Business Starts and Stops, November 1999, p. 20.

[4] Watson, John and Everett, Jim E., “Do Small Businesses have High Failure Rates: Evidence from Australian Retailers“, Journal of Small Business Management, October 1996, pp. 45-62.

[5] http://en.wikipedia.org/wiki/List_of_business_failures

[6] http://www.fdic.gov/bank/individual/failed/banklist.html

[7] Bosco, pp. 9-13.

[8] Davos-Klosters, “To Survive, Companies Must Constantly Reinvent Themselves, Become Socially Responsible,” World Economic Forum News Release, Jan. 25, 2012.

[9] Haire, Mason, Modern Organization Theory, 1959.

[10] Quinn, R., and K. Cameron, "Organizational Life Cycles and Shifting Criteria of Effectiveness: Some Preliminary Evidence." Management Science, January 1983.

[11] Greiner, L., "Evolution and Revolution as Organizations Grow," Harvard Business Review. July-August 1972.

[12] See, for example, Adler, Karen R. and Swiercz, Paul M., “Taming the Performance Bell Curve,” Training & Development, October 1997, pp. 33-38.

[13] http://www.nintendo.co.uk/Corporate/Nintendo-History/Nintendo-History-625945.html

[14] Based on Revenue. See http://www.softwaretop100.org/gaming-company-top-25

[15] http://www.forbes.com/lists/2008/33/biz_baseball08_Seattle-Mariners_331202.html

[16] Nine Great American Companies That Will Never Recover: 24/7 Wall St., Aug. 4, 2012. http://247wallst.com/2012/08/01/nine-great-american-companies-which-will-never-recover