

Due Diligence Procedures in the Commercial Litigation Economic Damages Analysis

Forensic accountants and other damages analysts (“analysts”) are often called on to perform consulting expert and testifying expert services with respect to commercial litigation disputes. In particular, those analysts are called on to measure the amount of damages suffered by the plaintiff in the dispute as a result of the wrongful actions of the defendant in the dispute. This discussion introduces the economic damages measurement methods that are typically applied by such analysts. This discussion focuses on the reasonable due diligence procedures that analyst perform related to such damages measurements. These due diligence procedures relate to the collection of—and assessment of—the data and the documents that the analyst relies on in the economic damages measurement process

A previous version of this discussion was published in the Spring 2013 issue of Insights. It was titled “Intangible Asset Economic Damages Due Diligence Procedures,” and it was originally authored by Robert F. Reilly, CPA.

INTRODUCTION

Industrial and commercial companies can become involved in commercial litigation disputes as either plaintiffs or defendants. This statement is true for companies participating in all industry sectors. Commercial litigation disputes could involve either breach of contract claims or tort claims. One common denominator in these disputes is that one party, usually the plaintiff, claims to have suffered economic damages due to the alleged wrongful actions of the other party, usually the defendant.

The plaintiff can ask the judicial finder of fact to award various types of nonmonetary remedies in the commercial litigation. These nonmonetary remedies could include an injunction of the wrongful action, a repossession of the taken property, the specific performance of a contract, a substitutional remedy (e.g., a new contract), and many others.

However, the plaintiff in the commercial litigation also typically asks for the award of monetary compensation as the remedy for the amount of

economic damages suffered. Therefore, a common question in most commercial litigation disputes is: What is the appropriate measurement of the damages suffered by the claimant/damaged party as a result of the wrongful actions of the defendant/damaging party?

Forensic accountants are often asked to measure the amount of economic damages in these commercial litigation disputes. For purposes of this discussion, a forensic accountant is simply an analyst who specializes in issues related to legal claims. Such issues may include the legal claims of fraud and misrepresentation, dissipation of corporate assets, and many other accounting-related matters.

In fact, the *Black’s Law Dictionary* (Deluxe Tenth Edition, page 764), defines forensic accounting as “The application of accounting principles to monetary issues that arise in courts, as in the apportionment of funds and of financial responsibilities upon a divorce or dissolution of a partnership.”

There are generally accepted forensic accounting methods and procedures related to the measurement of economic damages within a commercial litigation environment. This discussion summarizes these damages measurement methods including lost profits, reasonable royalty rate, lost business value, cost to cure, and other damages measurement methods.

However, before the forensic accountant begins the quantitative damages measurement, he or she will:

1. collect relevant data and documents and
2. perform reasonable due diligence procedures.

This discussion focuses on the due diligence procedures that the forensic accountant performs before actually measuring the amount of economic damages in the commercial litigation matter.

Forensic accountants and other damages analysts (hereinafter “analysts”) are often asked to identify and quantify economic damages in commercial litigation matters. These commercial litigation matters could relate to either:

1. breach of contract disputes or
2. tort disputes.

In these matters, the analyst could be retained to support the litigation positions of an individual or of an industrial or commercial company as either the plaintiff or the defendant in the dispute.

The analyst is typically retained by—and supervised by—the legal counsel for either the plaintiff or the defendant in the industrial and commercial industry dispute. The legal counsel will work, directly with—and provide legal instructions and directions to—the analyst. This statement is true whether the analyst will provide consulting expert services or testifying expert services.

In commercial litigation matters, the economic damages often relate to an alleged wrongful act committed either by—or against—the subject industrial or commercial company.

The breach of a contract claim could relate to an alleged breach of an employment agreement, a consulting agreement, a joint venture agreement, a materials supply agreement, a services supply agreement, a permit, a nonsolicitation agreement, a noncompetition agreement, a nondisclosure agreement, a stock (or business assets) purchase or sale agreement, a license, a franchise agreement, or some other contract right.

The tort claim could relate to intellectual property infringement, a breach of fiduciary duty, an expropriation, the tortious interference with a business opportunity, or some other tort-related claim.

The breach of fiduciary duty claim could relate to a commercial lender’s responsibility to the company debtor, the company board (or company management) responsibility to its shareholders, accounting fraud and misrepresentation issues, a fraud against the market claim, a controlling shareholder (the company owner/operator) responsibility to a non-controlling shareholder, a trustee responsibility to the trust beneficiaries, the government’s responsibility in a condemnation or eminent domain action, and the like.

Of course, industrial and commercial companies (and their owner/operators) could be involved in many other types of litigation—other than breach of contract or tort claims. Common examples of other types of litigation include taxation disputes, antitrust claims, SEC violations, other regulatory violations, employment discrimination claims, family law matters, and others.

While such matters are all serious, these types of legal disputes are slightly different from the commercial litigation matters that are the subject of this discussion, at least with regard to the forensic accountant due diligence issues.

ANALYST DUE DILIGENCE PROCEDURES

The due diligence procedures the forensic accountant performs in the commercial litigation damages measurement may be more difficult to perform than the due diligence procedures that another accountant may perform in a financial audit, a business valuation, a solvency analysis, or a merger and acquisition analysis. This is because the damages measurement is usually performed in a litigation or other contrarian environment.

This litigation environment adds at least two complications to the forensic analyst’s due diligence process.

First, there may be more documents for the analyst to review in a damages measurement analysis than in other types of financial analyses. These documents are principally litigation-related documents. Such documents include the litigation filings (e.g., the complaint, the answer, and any amendments to either), discovery documents (e.g., interrogatories and answers to interrogatories), and evidence documents (e.g., deposition transcripts and all of the documents produced in discovery).

Second, in the litigation environment, at least one party to the dispute is probably going to be less than fully cooperative with the analyst. The opposing litigant may produce only the specifically titled documents and data requested—and no more.

The analyst should not expect the opposing litigant to volunteer supplemental information, personal opinions, or data not prepared in the normal course of business. For purposes of this discussion, the opposing litigant is considered to be the party in opposition to the analyst's client.

Furthermore, in a litigation environment, the opposing litigant is not likely to suggest any damages theories or damages measurement methods to the analyst. In fact, the analyst should be suspect of any damages theories or damages measurement methods suggested by any party to the commercial litigation.

The analyst will typically perform reasonable due diligence procedures with regard to all documents and data obtained in the damages measurement analysis. To the extent that the analyst accepts certain data or documents without independent verification or documentation, that fact should be clearly disclosed in the analyst's expert report. To the extent that the analyst accepts a certain legal assumption or legal instruction, that fact should be clearly disclosed in the analyst's expert report.

First, this discussion considers the types of documents that the analyst may consider in the commercial litigation damages measurement analysis. Such documents may include the following:

1. Relevant legal claims documents
2. Relevant other legal documents
3. Relevant discovery documents

Second, this discussion considers the analyst's due diligence with regard to the legal claims, the causation or liability claims, and the damages claims.

Third, this discussion considers the analyst's due diligence procedures with regard to documents that may be considered to measure the following:

1. Lost profits
2. A reasonable royalty rate
3. Lost business value
4. Cost to cure



Fourth, this discussion considers the analyst's discussions with legal counsel with regard to the selection of—and application of—an economic damages measurement method.

Finally, this discussion considers the analyst's consideration of judicial precedent in the application of the economic damages measurement.

ANALYST DUE DILIGENCE OF THE RELEVANT LEGAL CLAIMS

The analyst is not the party's legal counsel. And, the responsibility of the analyst is to measure the amount of economic damages, if any, suffered by the damaged party. It is not the responsibility of the analyst to give legal advice in any form. A consulting expert may be considered to be part of the legal team. However, if the analyst is going to serve as a testifying expert, he or she should be—and should act—independent of the legal team.

That said, the analyst should be generally familiar with the legal claims made by both parties in the commercial litigation dispute. That is, the analyst should be generally familiar with the following:

1. What business, business ownership interest, or other property is claimed to have been damaged
2. Who is alleged to have caused the damages—and why
3. Who is alleged to have liability for the damages—and why

4. How the subject business interest is alleged to have become damaged
5. When the subject business interest is alleged to become damaged
6. What is the legal claim regarding the alleged economic damages (e.g., a breach of contract, a lender liability breach of fiduciary duty, a shareholder oppression breach of fiduciary duty, an infringement, some other type of tort, etc.)

In other words, from reading the litigation documents and/or from discussing the litigation claims with the client's legal counsel, the analyst should have a basic understanding of (allegedly) who did what to whom and when—and why the resulting damages are compensable under the law.

The complaint (or similar legal filing) summarizes the claimant's allegations, including the following:

1. The alleged wrongful actions of the respondent
2. What laws were allegedly violated as a result of those wrongful actions
3. What the claimant wants the judicial finder of fact to order the respondent to do in order to make the claimant whole (e.g., to specifically perform the contract, to pay an amount of compensatory damages, an injunction of the defendant to cease causing the damages)

The answer (or similar legal filing) presents the respondent's side of the story, including the following:

1. What allegations the respondent admits to
2. What allegations the respondent denies
3. What counterclaims, if any, the respondent has against the claimant
4. What defenses the respondent raises to justify its actions—or to claim that its actions are not wrongful, or illegal, or the cause for any economic damages to the claimant
5. What the respondent wants the judicial finder of fact to do (e.g., to dismiss the case)

The legal counsel will typically instruct the analyst to assume that the defendant's actions were wrongful (i.e., illegal). It is not up to the analyst to make that legal determination.

The analyst can be instructed to assume a fact like: Alpha Supplier Company breached its contract to supply goods and services to Beta Builders Corporation. The analyst can then measure the

amount of economic damages suffered by Beta Builders as a result of the Alpha Suppliers alleged wrongful action—that is, Alpha Suppliers alleged breach of the supply contract.

Whether Alpha's actions were, in fact, a breach of the contract or were otherwise illegal is a legal conclusion. That determination is a causation or a liability issue, not a damages issue. The legal counsel for both sides in this dispute may argue that issue as a matter of law. Also, both sides in the dispute may present a causation or a liability expert to testify with regard to such issues.

But the analyst should focus on the measurement of the economic damages—and not on who violated the law. Ultimately, the judicial finder of fact in the matter will make that legal determination.

Until that legal determination is reached, the analyst may operate under a legal instruction to assume the following:

1. A breach of the supply contract occurred
2. The defendant's action (i.e., the alleged contract breach) was wrongful (illegal)

Accordingly, the analyst should be sufficiently informed regarding the allegations in the case in order to understand who is alleged to have done what to whom and when. That is, the analyst should understand what economic damages to what business interest he or she is being asked to measure.

ANALYST DUE DILIGENCE OF THE RELEVANT LEGAL DOCUMENTS

The analyst should be aware of any discovery requests that may affect the economic damages measurement. Such discovery requests may include requests for admission, interrogatories, and similar requests. Legal counsel may ask the analyst to help draft these discovery requests. Or, legal counsel may at least ask the analyst to provide a list of financial and operational data—and other types of documents—that the analyst would like to have to perform the damages measurement.

Of course, the analyst cannot force the clients' counsel to provide him or her with copies of all discovery requests and associated responses. Sometimes, legal counsel may decide that it is not appropriate for the analyst to have access to certain documents produced in the discovery documents.

All the analyst can do is explain to the client's counsel:

1. what type of information would be helpful to the damages measurement process and

2. what the analyst would do with such information, if it is obtained.

The analyst will be particularly interested in any legal filings that may directly affect the analyst. An example of such a filing would be a motion to exclude the analyst from testifying at trial or to limit the analyst's expert testimony in certain areas.

The analyst will also be interested in the counsel's filing of any disclosure regarding the analyst's expert opinions. That is, the analyst will typically be interested in how the legal counsel describes his or her damages measurement opinions and the bases for those damages measurement opinions.

ANALYST DUE DILIGENCE OF THE RELEVANT DISCOVERY DOCUMENTS

A lot of documents may be produced in the discovery phase of the commercial litigation. Legal counsel may not provide copies of all of these documents to the analyst. However, the analyst should have access to all discovery documents that affect the economic damages measurement.

In some situations, counsel may provide the analyst with password access to the counsel's cloud-based document server. That way, the analyst can sort through all of the discovery documents included in the counsel's database. With such access, the analyst can be relatively assured that he or she has access to all documents that may relate to the subject business interest economic damages.

Without that database access, the analyst may not know if the counsel is withholding documents that may have an undesirable impact on the economic damages measurement. Of course, even with password access to an automated data room, counsel can segregate discovery documents into the following categories:

1. Those documents that the analyst has access to
2. Those documents that the analyst does not have access to

Ultimately, the analyst may consider that incomplete, inconsistent, or obviously missing (e.g., based on gaps in the Bates numbers) documents may imply that legal counsel is not supplying all of the evidentiary documents related to the economic damages measurement. It is counsel's job to request evidentiary documents and to respond to document requests.

The analyst may help counsel to prepare such requests and to respond to such requests. However, the analyst has to decide if he or she has sufficient documents and data in order to perform the damages measurement analysis.

With regard to the subject business interest documents produced during the litigation discovery process, the analyst typically considers the following questions:

1. Are any of the documents obviously missing from within a series of documents? The series of documents could be periodic financial statements, project or research progress reports, production reports, sales reports, financial projections, etc.

A related question is: Are there any documents that are obviously just missing from the production (e.g., a copy of a relevant contract, license, permit, warranty, insurance policy, bond, trust indenture, loan covenant, shareholder agreement, etc.)?

2. Are any of the documents incomplete? Are pages of a document obviously missing? For example, the analyst can look for instances when a Xerox copy of a two-sided document only includes every other page. Are document exhibits or document appendixes obviously missing (in particular, are there memoranda or correspondence that refer to missing attachments)?
3. Are any of the produced documents contradictory? Do two (or more) different documents purport to be the same set of financial statements, financial projections, contracts, shareholder agreements, etc.? Do two (or more) different sets of correspondence (e.g., dated on the same or near dates) present two different descriptions regarding, say, the subject product or project?
4. Do any of the documents produced appear to be draft, incomplete, final, or revised versions of the purported document? Are the documents, or the associated transmittal correspondence, signed? Are the documents, or the associated transmittal correspondence, dated? Does any transmittal correspondence (or the documents itself) use terms like draft or final or revised or amended?
5. Were multiple documents produced in response to the same discovery request? Do the multiple documents present a consistent response or a contradictory response? Are the multiple documents needed to fully respond to the discovery request?

Or, is one document sufficient to respond to the discovery request (and all of the other documents are just superfluous or intended to obscure the essential document)?

6. Are the documents that were produced, in fact, responsive to the discovery request? Sometimes, the analyst (or the legal counsel) may request documents and data, and the analyst (or legal counsel) is disappointed in the response. The requested documents may simply not exist, or they may present data that are simply not useful to the analyst.

However, sometimes the documents produced simply do not respond to the stated discovery request. In fact, the document produced may simply represent subterfuge, produced to disguise the fact that the opposing litigant did not actually respond to the discovery request.

7. What are the effective dates of the documents and the data produced? For example, in litigation regarding a company valuation dispute, the analyst generally considers all information that was known or knowable as of the valuation date.

Subsequent (to the valuation date) information is typically only considered to the extent that such information confirms trends or projections that would have been known or knowable as of the company valuation date.

In contrast, in a the economic damages measurement, the analyst generally considers all information that is available up through a current (i.e., the analyst's expert report) date.

That is, the analyst may rely on the so-called "book of wisdom" to complete the damages measurement analysis. In a commercial litigation matter, the finder of fact wants to know what really happened. So the analyst can consider (a) information known as of the damages event date and (b) information that becomes available up to the date of the trial.

In the damages analysis, the analyst may perform the damages measurement as of either (a) the damages event date or (b) a current (i.e., analyst's expert report) date. In both cases, the damages estimate is brought forward (from the damages event date or from the current expert report date) up to the date of the trial—typically by the application of a prejudgment interest rate.

8. Were the documents that were produced prepared contemporaneously (i.e., a prelitigation filing) or prepared in response to the litigation discovery request? This question does not imply that documents prepared in response to discovery requests (or otherwise prepared after litigation is filed) are necessarily unreliable.

As explained previously, many industrial or commercial companies may not maintain separate financial or operational data regarding the particular asset, property, or business interest that was damaged. This is because there may be few (if any) financial accounting, taxation, or regulatory reasons for the company to assemble such business-interest-specific data.

Nonetheless, the analyst may be interested in whether the documents produced:

- a. were prepared historically and in the normal course of the company business operations or
 - b. were prepared recently and in specific response to the litigation discovery request.
9. Were the produced documents ever relied on by parties independent of the litigation (or were they prepared solely for the purpose of the litigation)? This question does not imply that all contemporaneously prepared documents are somehow not credible or not reliable.

However, the analyst may be particularly interested in documents that were relied on by parties (e.g., company executives, company stockholders, contract counterparties, auditors, taxing authorities, investors, joint venturers, bonding agencies, regulatory authorities, bankers, etc.) at the time that the documents were originally prepared.

This consideration may be particularly relevant for financial projections or other prospective financial information related to the asset, property, or business interest subject to the damages.

10. Were the documents ever reviewed by parties independent of the litigation (or were they prepared solely for the purposes of the litigation)? As mentioned above, the company may not prepare contemporaneous financial or operational documentation regarding the individual asset, property, or business interest that was damaged. This is because there is often no reason to prepare such documentation.

The analyst may be particularly interested in subject business interest documents that were historically reviewed by independent auditors or by other independent parties.

THE BASIS FOR THE CAUSATION OR LIABILITY CLAIMS

The damages analyst is typically not also the causation analyst—or the liability analyst. In the damages measurement, the damages analyst will typically assume that there is causation, based on a legal instruction from the client's counsel.

Typically, the damages analyst will not also serve as the causation expert unless the causes of the damages are clearly within the expertise of the damages analyst. Such causation-related expertise may include, for example, fraudulent or misrepresented financial statements, improperly prepared income tax returns, or other causation factors to which the forensic accountant can claim expertise.

Typically, either a fact witness or another expert witness will testify as to the causation issues or liability issues at the trial. The causation expert may be an engineer, and industry specialist, or any other third-party specialist who can explain how the damages event occurred.

And, the causation expert should explain why the defendant's wrongful action would cause damages to the claimant. The liability expert, if different from the causation expert, should be able to explain why the defendant is legally responsible for the wrongful action.

The liability expert may (or may not) be an attorney.

Typically, the analyst working for the plaintiff's counsel relies on a series of legal instructions like the following:

1. The defendant performed a certain act (e.g., a tort or a breach of contract).
2. The defendant's act was wrongful (i.e., illegal).
3. The wrongful act caused the plaintiff to suffer damages.



It is then up to the damages analyst to:

1. select the appropriate damages measurement method and
2. measure the amount of economic damages suffered by the claimant (if any) as a result of the assumed wrongful act.

Typically, the damages analyst working for the defendant's counsel may receive a different set of instructions than the analyst working for plaintiff's counsel. That is, the defendant's analyst may be instructed by the defendant's counsel to assume the following:

1. The defendant did not perform the alleged act.
2. If the defendant did perform the alleged act, that act was not wrongful—that is, it was not illegal.
3. If the alleged act was illegal, the act did not cause the damages, if any, that were suffered by the plaintiff.

Alternatively, the defendant's analyst could be instructed by counsel to assume that the defendant did cause the plaintiff to suffer any economic damages. Then, it would be up to the analyst to measure the amount of the damages (if any) caused by the alleged wrongful actions.

In any event, the damages expert is typically not the causation expert. And, the damages analyst will typically not reach an expert opinion as to causation. Rather, the damages analyst will work

under a legal instruction regarding the assumption that there was (or was not) causation. That is, the analyst will measure the amount of the damages suffered by the claimant “assuming” the defendant wrongfully caused those damages.

While the damages expert is not the causation expert, the analyst should develop a basic understanding of the causation expert’s opinion. That is, the analyst can explain why (assuming the defendant’s wrongful action caused the damages) that action resulted in the claimant’s damages.

This way, the analyst can identify and measure economic damages that are consistent with the causation expert’s opinions. And, the analyst can avoid damages measurement methods that are inconsistent with the causation expert’s opinions.

THE BASIS FOR THE DAMAGES CLAIMS

The analyst will not prepare the plaintiff’s complaint or the defendant’s answer in the commercial litigation. However, the analyst should be generally aware of each party’s respective claims in the complaint and the answer (including any amended complaints and amended answers).

This awareness is necessary in order for the analyst to develop a general understanding of each party’s claims in the commercial litigation. This way, the analyst can perform an economic damages measurement that is consistent with (and not contrary to) the legal claims of the client’s counsel.

Based on this general understanding of the legal claims in the commercial litigation, the analyst may prepare a damages measurement that is consistent with (and not contradictory to) the following:

1. The damages event described in the legal filings
2. The damages time periods (i.e., the first damages event through the last damages event) described in the legal filings
3. The business interest that was subject to damages as described in the legal filings
4. The type of the damages suffered, as described in the legal filings

With regard to this last point, for example, the analyst may decide not to measure damages based on a reasonable royalty rate if the legal filings described the damages event as resulting in either of the following:

1. Lost project revenue

2. Expenditures required to cure (i.e., recreation cost) the damaged project

In other words, the above description of the damages event would lead the analyst to apply a damages measurement method other than the reasonable royalty method.

LOST PROFITS DOCUMENTS

Typically, the analyst will not select the damages measurement method until he or she:

1. assembles all relevant documents and
2. performs all reasonable due diligence procedures.

Nonetheless, in order to consider any of the lost profits measures of economic damages, the analyst will have to gather and review relevant data and documents. These data and documents can be obtained at the following points in the litigation:

1. During the litigation discovery process
2. During the analyst’s fieldwork and investigation
3. During the analyst’s industry, guideline company, or comparable transaction research

Since the analyst may not have selected the damages measurement method at this stage of the due diligence process, the analyst should be mindful of all generally accepted lost-profits-related damages measurement methods.

These lost-profits-related damages measurement methods typically include the following:

1. The projections/but-for method
2. The before and after method
3. The yardstick method

For each of these lost-profits-related measurement methods, the analyst will want to assemble and review both financial and operational data regarding the asset, property, or business interest subject to damages.

In fact, the analyst typically assembles and reviews documents and data related to three time periods:

1. Historical data (i.e., prior to the damages event date)
2. Current data (i.e., around the time of the damages event date)

3. Prospective data (i.e., prospective financial information after the time of the damages event date)

The analyst may review these data in order to ascertain whether the lost profits measurements are consistent with the following:

1. The damaged company historical results of operations
2. The damaged company production capacity constraints or other constraints
3. The damaged company's industry historical trends and projected outlook

In particular, the analyst may compare the company's historical financial projections to its historical results of operations. This comparison may help the analyst to assess whether the company has a track record of accurately projecting either of the following:

1. The business entity results of operations
2. The damaged asset, property, or business interest results of operations

Virtually all of the lost profits damages measurement methods involve some sort of "but for" analyses. That is, the analyst compares (1) the damaged company actual results of operations to (2) the damaged company hypothetical results of operations "but for" the wrongful action to the subject asset, property, or business interest.

Regardless of who the analyst is working for in the assignment, he or she will likely encounter one or more sets of but for financial projections. The but for financial projections may be prepared by the damaged company owner/operator.

Or, the but for financial projections may be prepared by another analyst working on the same matter. And, that other analyst could be a concurring analyst (i.e., working for the same client as the analyst) or an opposing analyst (i.e., working for a contrarian party in the dispute).

In any event, before relying on such financial projections, the analyst should subject the but for financial projections to reasonable due diligence procedures. These analyst due diligence procedures may include consideration of the following:

1. Whether the financial projection variables are internally consistent with each other
2. Whether the financial projections can be reconciled to historical results of operations
3. Whether the financial projections are mathematically correct (e.g., the projected balance sheet does balance)

4. Whether the financial projections can be reconciled with the appropriate industry trends
5. Whether the financial projections can be reconciled with a recognized independent benchmark
6. Whether the financial projections contemplate the correct dates related to the dispute (e.g., the damages date, the mitigation date, the end of damages date)
7. Whether the financial projections consider the plaintiff's mitigation efforts
8. Whether the financial projections consider the defendant's damages correction efforts
9. Whether the financial projections consider any maintenance expense or other required investment related to the damaged asset, property, or business interest
10. Whether the financial projections consider the expenses related to correcting the damaged asset, property, or business interest damages caused by the wrongful act

REASONABLE ROYALTY RATE DOCUMENTS

As an alternative to estimating lost profits as a measure of the economic damages, the analyst could conclude a reasonable royalty rate. A reasonable royalty rate is more commonly concluded in, say, intellectual property infringement (and other tort) claims than in breach of contract claims. Nonetheless, a reasonable royalty rate could be one measure of damages related to any economic damages event.

The calculation of a reasonable royalty rate is based on the theory that the arm's-length negotiation of the parties could have avoided the litigation of the parties. Let's assume that the defendant wrongfully used (or otherwise damaged) the plaintiff company's intellectual property.

This estimation of the reasonable royalty rate assumes the defendant should have approached the plaintiff prior to the damages event. Hypothetically, the parties would have negotiated a fair, arm's-length license agreement for the use of the intellectual property.

Operating within this hypothetical license agreement, the defendant would have lawfully used the intellectual property. The defendant would have paid the plaintiff a fair license payment for this use license. So, the plaintiff would not have been damaged by the actions of the defendant.

In theory, in order to make the plaintiff whole after the damages event, the defendant should pay the plaintiff the arm's-length royalty that would have been agreed upon by the plaintiff in an arm's-length negotiation.

In such an analysis, the principal task of the analyst is to estimate this hypothetical arm's-length royalty rate. A description of the specific methods for estimating such a royalty rate (e.g., comparable uncontrolled transactions method, residual profit split method, comparable profit margin method, etc.) is beyond the scope of this discussion. However, the analyst typically performs reasonable due diligence procedures with regard to the assemblage of data used to conclude a reasonable royalty rate.

To estimate a reasonable royalty rate, the analyst typically gathers data from various sources, including the following:

1. The company owner/operator, such as historical financial statements and prospective financial statements
2. Guideline publicly traded companies, such as historical financial statements
3. The subject industry financial reporting services, such as industry average levels of profitability (which may be defined at various income levels)
4. Databases regarding intellectual property license agreements, such as online databases that report arm's-length royalty rates
5. The subject intellectual property, such as the historical development cost, a current replacement cost, or a current value estimate

When the analyst confirms that the data are objective and credible, all of these data sources can be used to extract a reasonable royalty rate. For example, the analyst could apply the profit split method to the company's historical or projected income measures in order to estimate a royalty rate. The profit split percentage is often based on the analyst's functional analysis of the intellectual property (vis-à-vis all of the company's other tangible and intangible assets).

Likewise, the analyst could estimate a royalty rate by comparing the company's profit margin to the guideline companies' profit margins. To the extent that the company earns an excess profit margin and that excess profit margin is attributable to the subject intellectual property, the analyst may assign some portion of that excess profit margin as a reasonable royalty rate.

The same type of excess profit margin analysis can be performed by comparing the company owner/operator profit margin to a published industry average profit margin. To the extent that the company owner/operator earns an excess profit margin and that excess margin is attributable to the subject intellectual property, the analyst may assign some portion of that excess profit margin as a reasonable royalty rate.

The analyst can search various databases to identify and select comparable uncontrolled transaction ("CUT") royalty rate evidence. Typically, the analyst will search for arm's-length license transactions involving similar intellectual property that are used in the same or similar industries.

After selecting a sample of CUT license agreements, the analyst may adjust the CUT data to make the transactional data more comparable to the subject intellectual property. The analyst selects the royalty rate appropriate to the intellectual property based on the adjusted CUT data.

In the CUT selection process, the analyst typically considers several factors regarding the subject intellectual property (compared to the CUT intellectual property), including the following:

1. Relative age
2. Relative size of the market/industry sector
3. Relative growth rate of the market/industry sector
4. Relative competitive position of the subject intellectual property and of the subject company

When extracting the intellectual property royalty rate from the selected/adjusted CUT license data, the analyst typically considers several factors regarding the subject intellectual property (compared to the CUT intellectual property), including the following:

1. Relative growth rates
2. Relative profit margins
3. Relative returns on investment

Alternatively, the analyst can also calculate a reasonable royalty rate by reference to some intellectual property value indication.

Using this method, first, the analyst starts with a current value estimate for the subject intellectual property. Typically, this value indication may be based on a cost approach valuation analysis (e.g., the replacement cost new less depreciation method). This is because if data were available to use the income approach or the market approach to

value the subject intellectual property, the analyst could use, for example, a profit split/residual profit method or CUT data to estimate the reasonable royalty rate.

Second, the analyst multiplies the subject intellectual property value by a fair rate of return of and on the intellectual property. This multiplication product indicates the amount of license income required to produce this rate of return. Third, the analyst divides the calculated license income by the amount of the company's revenue. This calculation produces an indication of a fair royalty rate (expressed as a percent of revenue).

The analyst may consider all of the above-indicated data and documents to conclude a fair royalty rate damages measurement in an intellectual property infringement damages analysis.

COST TO CURE DOCUMENTS

As an alternative to estimating lost profits or a reasonable royalty rate, the analyst may calculate a cost to cure as an estimate of the subject asset, property, or business interest damages. The cost to cure often quantifies the loss in the subject asset, property, or business interest value due to the defendant's alleged wrongful action.

If the loss in the subject asset, property, or business interest value is the only type of damages suffered by the subject company, then the cost to cure may also be measured as the loss in business value for the company.

Finally, if the subject asset, property, or business interest was destroyed as a result of the defendant's wrongful act, then the cost to cure could be estimated as the cost to create a *de novo* (replacement) asset, property, or business interest.

This damages measurement method concludes the amount of expenditures required to restore the asset, property, or business interest to the condition it was in before the damages event occurred. Of course, this cost to cure the damages includes both direct costs and indirect costs related to restoring the asset, property, or business interest.

In addition, the cost to cure method typically includes an opportunity cost component. This opportunity cost generally relates to lost profits suffered by the company during the time period between the damages event and the final curing of the project, asset, or business interest.

In order to estimate the cost to cure, the analyst will typically review data and documents related to the following:

1. The original costs to create the asset, property, or business interest
2. The current costs to replace the asset, property, or business interest
3. The current costs to restore the asset, property, or business interest from its damaged condition to its pre-damaged condition
4. The impact of the damages event (e.g., lost revenue, customers, profits, consumer awareness, first to market industry position; increased expenditures related to maintenance, R&D, selling, and promotion; legal and other litigation-related expenses)
5. The opportunity cost during the time to cure the asset, property, or business interest (e.g., any lost economic benefits associated with any project, asset, or business interest diminished capacity)

LOST BUSINESS VALUE DOCUMENTS

Essentially, the lost business value damages measurement method compares the difference in the damaged subject company value (1) before the damages event to (2) after the damages event. This damages measurement formula is typically presented as:

- Company business enterprise value before the damages event
- Company business enterprise value after the damages event
- = Lost business value due to the damages event

Typically the value of the damaged company is measured at a total business enterprise—or marketable, controlling ownership interest basis—level of value. At that level of value, typically, fair value is the same as fair market value. That is, shareholder-level value adjustments (such as a discount for lack of marketability or a discount for lack of control) do not apply to this damages measurement method.

Typically, the analyst can apply any generally accepted business valuation approaches and methods to this lost business value analysis. These generally accepted business valuation approaches and methods include the following:

- Income approach
 - Discounted cash flow method
 - Direct capitalization method

- Market approach
 - Guideline publicly traded company method
 - Guideline merged and acquired company method
 - Backsolve method
- Asset-based approach
 - Adjusted net asset value method
 - Asset accumulation method

In the due diligence process, the analyst will gather and review all of the documents and data that will be useful to value the subject company both before and after the damages event. These documents and data may include the following:

1. Historical financial statements
2. Historical income tax returns
3. Financial budgets, plans, and projections—prepared as of each valuation date
4. Historical financial budgets, plans, and projections—prepared as of each damages-related historical financial statement date
5. Operational budgets, plans, and projections—prepared as of each damages-related valuation date
6. List of all investment projects in progress—as of each damages-related valuation date
7. Corporate documents (e.g., articles of incorporation, bylaws)
8. Shareholder agreements
9. Banking covenants and outstanding debt interest rates and repayment schedules
10. Listing of key employees (particularly employees with employment contracts)
11. Listing of owned or leased real estate
12. Listing of owned or licensed intellectual property
13. Listing of any pending litigation claims
14. Listing of any pending client or customer proposals outstanding
15. Descriptions of any recent offers to buy the company

In particular, the analyst will focus on any documents or data that may be used to support the changes in any business valuation variables in (1) the “before” damages event valuation analysis compared to (2) the “after” damages event valuation analysis.

DAMAGES MITIGATION DOCUMENTS

The analyst will typically consider the effects of the plaintiff’s mitigation efforts on the measurement of economic damages. When the plaintiff’s business interest is damaged due to the defendant’s alleged wrongful acts, the plaintiff still has the obligation to mitigate the effects of the damages. That is, the plaintiff has the obligation to perform reasonable efforts to minimize the amount of the damages suffered.

These mitigation efforts often involve the damaged party attempting to do the following:

1. Develop a new (replacement) asset, property, or business interest
2. Enter into replacement contracts, agreements, licenses, permits, franchises, relationships, etc.
3. Find new client/customers, suppliers, employees, etc.
4. Inform the public about (and, therefore, counteract) the wrongful actions with regard to the plaintiff’s patents, trademarks, copyrights, or related intellectual property
5. Enforce all other nondisclosure, noncompetition, nonsolicitation, and other available contractual remedies

Therefore, the analyst typically obtains data and documents related to any mitigation efforts related to the claimed economic damages, including the following:

1. Description of any efforts that the plaintiff made in mitigation
2. Timing of any efforts that the plaintiff made in mitigation
3. Expenditures that the plaintiff made in the mitigation efforts
4. Financial impact of the plaintiff’s mitigation efforts on reducing the amount of the economic damages
5. Date at which the economic damages were fully mitigated (or mitigated as much as it is possible to do)

The analyst typically considers any mitigation documents and data in the application of the lost profits, reasonable royalty, cost to cure, or lost business value damages measurements.

ANALYST CONFERENCES WITH COUNSEL REGARDING DAMAGES MEASUREMENT METHODS

The analyst may perform due diligence by conferring with the client's legal counsel before selecting or implementing a damages measurement method. In some instances, damages measurement methods are allowed (or are not allowed) by statutory authority, judicial precedent, or administrative ruling.

As mentioned above, the damages analyst is not the client's counsel. That is, the analyst should receive legal directions and instructions from counsel regarding such matters.

The analyst is not responsible for researching the law or reaching legal conclusions regarding legally appropriate (or inappropriate) damages measurement methods. To the extent there is such statutory, judicial, or regulatory guidance regarding the measurement method, the client's counsel should provide legal instructions or directions to the analyst.

In such instances, it is the responsibility of counsel to provide legal instructions or directions to the analyst. It does not impair the analyst's independence to receive and rely on legal instructions or directions from the client's counsel. To the extent that counsel does not provide legal instructions or directions, the analyst should feel free to discuss the proposed damages measurement method with counsel.

If counsel does not object to the analyst's proposed damages measurement method as a legal matter, then the analyst may assume that there are no legal roadblocks to the proposed measurement method. To the extent that there is a legal concern about the proposed damages measurement methods, it is the responsibility of counsel to instruct the analyst regarding how to handle such a legal concern.

If the analyst's proposed damages measurement method is not permitted by statute or precedent, it is the responsibility of counsel to instruct the analyst to select another measurement method.

With regard to selecting the appropriate damages measurement method, it is not appropriate for counsel to otherwise substitute his or her professional judgment for that of the analyst. And, it is certainly not appropriate for counsel to recommend a damages measurement method just to allow the analyst to reach a greater or lesser damages conclusion.

However, it is perfectly reasonable for the analyst to confer with the client's counsel with regard to the

analyst's proposed damages measurement method. It is perfectly reasonable for counsel to instruct the analyst as to which damages measurement methods are allowable from a legal perspective. And, it is perfectly reasonable for counsel to instruct the analyst as to which damages measurement methods are not allowable from a legal perspective.

ANALYST RELIANCE ON JUDICIAL PRECEDENT

Unless he or she is a licensed attorney and is acting in that role, the analyst should not perform (or rely on his or her own) legal research. To the extent that judicial precedent may inform the analyst with regard to a damages measurement method and related analytical decisions, counsel should do the following:

1. Research and select those relevant judicial decisions
2. Provide those relevant judicial decisions to the analyst
3. Explain those relevant judicial decisions to the analyst

To the extent that the analyst has any questions at all about the applications or implications of the judicial precedent to the subject damages measurement analysis, the analyst should confer with counsel.

The prosecution or defense of the commercial litigation is a team effort, involving several professional disciplines. Counsel should rely on the analyst for damages measurement expertise. Likewise, the analyst should rely on counsel for legal expertise.

Accordingly, counsel should provide the analyst with copies of (or summaries of) any relevant judicial decisions. The analyst should not assume that he or she has either the experience or the expertise to identify—or interpret—such relevant judicial precedent.

To the extent that counsel provides the analyst with judicial decisions, the analyst should review that precedent with counsel in order to obtain an understanding of the following:

1. The relevant legal concepts involved in the judicial decision
2. The allowable (or not allowable) damages measurement methods
3. The procedural adjustments allowed (or required) by the court for income taxes, prejudgment interest, mitigation efforts, time period over which damages may be considered, and other methodology considerations

“[T]he analyst should not attempt to extract specific damages measurement variables from . . . judicial decisions.”

In contrast, the analyst should not expect to extract quantitative damages measurement variables from judicial precedent. In other words, the analyst should not review the judicial decisions with the objective of extracting growth rates, discount rates, capitalization rates, income tax rates, royalty rates, profit split percentages, and so forth.

The analyst should not use judicial precedent as a source of damages measurement variables for the following reasons:

1. The facts and circumstances of each judicial decision are unique to that particular case.
2. Such damages measurement variables change over time, with corresponding changes in capital market and other economic conditions.
3. Each litigant company is different.
4. Each litigant company's industry is different.
5. The particular court in a particular judicial decision may have reached a poorly reasoned decision (which should not be duplicated).

Accordingly, the analyst may consider legal instructions and judicial precedent as a source of measurement methodology guidance. The analyst should not look to legal instructions or judicial precedent as the source of quantitative damages measurement variables.

SUMMARY AND CONCLUSION

Industrial and commercial companies can become involved in commercial litigation disputes as either plaintiffs or defendants. In such disputes, the plaintiff often claims that it suffered economic damages as a result of the wrongful actions of the defendant.

Forensic accountants and other damages analysts are often retained in such disputes to measure the damages that the claimant suffered as a result of the wrongful actions of the respondent.

Analysts preparing such commercial litigation damages measurements have to perform reasonable due diligence procedures with respect to the documents and data they rely on.

With regard to the commercial litigation damages measurement, the analyst should perform due diligence procedures related to the following:

1. The relevant legal claims in the litigation
2. The relevant legal documents in the litigation
3. The relevant discovery documents in the litigation
4. The basis for the causation or liability claims
5. The basis for the economic damages claims

First, the analyst should have a basic understanding of the breach of contract, tort, or other claims in the subject litigation matter. That way, the analyst can assemble and assess the relevant legal claim documents, litigation discovery documents, subject company (and owner/operator) documents, and subject industry documents.

Second, the analyst should have a basic understanding of the alleged causation issues as well as the economic damages issues in the claim. That way, the analyst can collect and review data and documents that may be used in various damages measurement methods. These damages measurement methods may include lost profits, reasonable royalty rate, cost to restore, and lost business value damages measurements.

As part of the damages measurement analysis, the analyst also considers the relevant documents and data related to the plaintiff's mitigation efforts.

Finally, the analyst may confer with the client's counsel about the selection of the damages measurement method. Counsel may provide the analyst with a legal instruction and legal directions as to which damages measurement methods are legally permissible—and which damages measurement methods are not legally permissible—in the relevant jurisdiction.

During the commercial litigation process, counsel may also provide copies of relevant judicial precedent to the analyst. Such legal research is the counsel's responsibility. Because it is not within the scope of the analyst's experience, such legal research is not the analyst's responsibility.

The analyst may confer with the client's counsel related to any questions regarding the relevant judicial decisions. In any event, the analyst may review the judicial decisions in order to obtain judicial guidance on the acceptance (or lack thereof) of damages measurement methods. However, the analyst should not attempt to extract specific damages measurement variables from such judicial decisions.