Evaluation of business losses as damages

The valuation of a small business is often difficult, particularly if the business shows a loss on its income taxes

By Nathaniel Leeds

Did your economist just destroy your case?

This article is the third in a series that will serve as a reference for lawyers who need to scrutinize an economist's report but do not feel comfortable with the impenetrable tables of numbers. The impetus for these articles was our frustration that many of the reports prepared for our firm were sloppy and filled with errors. The first and second of the three articles appeared in October and December issues, and addressed valuation of present value, personal consumption, and household services.

Many lawyers do not like math and numbers. But, we are not serving our clients if we are not mastering these skills and scrutinizing the numbers with the same precision that we examine a police officer's determination of fault.

This article addresses what is likely the most complicated of the topics addressed in this series: business losses. Our experience is that the majority of clients who run small businesses overestimate the value of their businesses, and – consequently – overestimate their losses. The goal of a business-loss evaluation is to control client expectations and make sure we can describe the business loss in a defensible way.

The courts are crowded with people arguing over valuing everything from the income-stream of a mom-and-pop corner store to a market advantage in the sale of complicated technology. Rather than try to cover the whole field, this article is an overview of issues that affect the valuation of small businesses with limited fixed assets and debt financing – beyond that, you should be working with experts early. Here are some of the basic questions we ask when looking at a business loss claim.

Question 1: Lost profits or increased expenses?

There are two ways of talking about business losses: either profits went down, or expenses went up.

When looking at a profitable business it is relatively easy to quantify how much money the business was making before the business owner's injury or death; and then look at how much it was making afterward. Subtract, and you have a defensible business loss.

However, if the business is not profitable, or not very profitable, looking at profits can undervalue your client's loss. Just

because a business is not profitable does not mean that there is no business loss. We recently settled a case where the defendant conceded that our client had suffered a significant loss in her restaurant business even though the client's restaurant was losing money and for sale at the time she was injured.

Here are three ways to think about capturing increased business expenses when there are no lost profits:

(1) Key-employee replacement costs

The owners of unprofitable businesses still work, and often work very hard. That work they did for the business had value – otherwise, why were they doing it? The hard part is capturing the value of that work at the unprofitable business. When there are other employees (or family member owners), we have looked at additional staff costs and the increased hours that family members are putting into the business after the business owner's injury.

Although more difficult, sometimes you can look at the average wage for what the injured party did and argue that the benefit to the business of their work was "at least" what they would have been able to receive on the open market. The argument is that those services rendered prior to the injury had value and business rational, otherwise why were they working at their unprofitable business?

(2) Increased demise

Sometimes the injury of a key employee is the last nail in the coffin of a struggling business. The rapid demise of a business can create its own additional losses. There is a significant difference between the timely dissolution and sale of an ongoing business concern versus a "fire sale" price precipitated by an unexpected injury. A look at cash flow can uncover the difference. If a business had income of $50,000, against expenses of $75,000 it is losing $25,000 a year. But, when the injury happens, the income goes from $50,000 to $0, and expenses may stay the same.

Also, if the business is a type that is regularly bought and sold (restaurants, bars, livery services, insurance brokerages), there are business brokers (they hold real estate licenses in California) who can assist in describing the difference between the value of an ongoing business that can wait for a good buyer and one that has ceased operation and needs to take the first offer.

(3) Unavoidable fixed costs and unrealized expenses

Even if the business can be shuttered easily, that does not mean that the expenses of the business can be avoided. Sometimes there are lease obligations, or equipment rentals that cannot be avoided and are a business loss.

It is worth looking at pre-injury business investments into projects that were abandoned because of the client's injury. For example, sometimes investments in promotional materials, insurance, licenses, remodels and the like are all investments that the business anticipated recouping, before the injury. After all, boxes of holiday cards and calendars are of no use to a closed business.

Keep in mind that many people are emotionally invested in their businesses. My belief is that jurors understand this and are willing to compensate an injured client who needs to keep their business on life support while they are recovering from an injury – even if it is expensive to keep the business limping along.

Question 2: Is the income in cash?

The easiest companies to look at are those that make a profit in cash. But, a surprising number of businesses are profitable even though they do not generate any cash for their owners.

We once looked at a wrongful death case that involved a bookkeeper who had carefully set up his bookkeeping business to generate tax losses to offset his rental income – he also just liked going into the office. Looking at the family's finances in their entirety, the business was profitable – in tax avoidance – but on its own, it looked extremely unprofitable.

Another type of business that generates value, but might not generate cash flow is the rental business. Many landlords are in the business as part of a long-term strategy to acquire property, even if there is no income coming out of the business.

There are also other businesses that do not generate income, but provide property, or other ancillary benefits to their proprietors. For example, a hobby vineyard in Napa might not be profitable, per se, but allows its proprietor to defray some of the costs of owning a vacation home. If they are no longer there to supervise the vines, the income necessary to keep the vacation home can disappear. Even more modest businesses – such as livery services – can often provide their proprietors with a car.

Before discounting the possibility of non-cash income as the province of the wealthy and particularly crafty, it is useful to take stock of the number of "business" vehicles that are on the roadway during the weekend. I recently saw a nice new Porsche SUV with tasteful reference to its owner's plumbing business on the side – a pretty good non-cash benefit.

Question 3: When does the money come in, and what part is from future repeat business?

The easiest businesses to look at are those – like retail stores – that make money on each transaction at the time of the transaction. As readers of this magazine are well aware, there are plenty of businesses that do not work on this model.

It is often the case that income is spread over many years and may come in long after the business owner's work is done. For example, insurance brokers often earn a percentage of the premium paid every year the insured buys the insurance. Because many people do not change their insurance from year to year, a sale by a broker in Year 1 often means income in Years 2, 3, 4, 5.

The same can be true for many professionals (doctors, dentists, business

lawyers, and accountants) who expect income from future follow-ups; and car dealerships, who expect business from "regularly scheduled maintenance."

What this means is that an interruption to the business in Year 1, can cost your client in Years 2, 3, 4, and 5. Ask your clients how much of their income is passive (like the insurance broker who gets a check each year when you renew your policy), and how much of it is repeat customers. Some simple modeling can reveal that a loss this year is multiplied in lost business for years to come.

Question 4: Do the tax returns reflect reality?

One of the more peculiar features of our advanced economy is that businesses are permitted to keep two sets of books: one for the purposes of taxes (cash accounting), and the other for their investors (accrual accounting under Generally Accepted Accounting Principles − GAAP). A cynic would say that this dual system allows companies to lie to their investors, telling them that they are wildly profitable while at the same time telling the IRS that they do not have any reportable income.

There are plenty of tax preparers who have creatively found ways of making all of their client's income disappear from the tax returns. Whatever you think of the ethics, it is a reality that is evident in most small-business tax returns.

It can be hard to have your client explain that, even though they told the IRS they were not profitable, they had a significant income. The way around this problem is to look, in detail, at what business expenses (tax deductions) are unavoidable when the business is not operating and argue that those expenses were a legitimate business expense before the injury and will be a legitimate expense going forward.

The home-office deduction offers a useful example. If pre-injury your client was taking a generous home-office deduction but since the accident they are no longer in business, it does not mean they should move out of their home; accordingly, the tax deduction should not be considered in looking at their pre-injury income. Similar arguments can be made with respect to cars, business meals, and many other expenses that the IRS generously allows people to characterize as business expenses.

We had one economist on the stand in a recent trial who had subtracted the home-office expenses from our client's pre-injury income. Under cross he was forced to explain the implication of this analysis: that if our client had claimed her home office deduction before, that she should move now that she was not in business – needless to say, telling an injured person they should leave their home was not a position which resonated with the jurors.

Question 5: What impact do business cycles have on your client's business?

Many businesses are cyclical. If your client was in a very cyclical business, like real estate or construction, it is important to distinguish their loss-related income variance due to business cycles that affected everyone. A real estate agent who sold a lot of houses in 2006 and 2007 cannot claim that they suffered a significant income loss because they were going to repeat those good years in 2008, 2009, and 2010.

In some industries, such as real estate, you can find benchmarks and figure out what type of slow-down was typical, and then compare it to what your client did. Other times, the best information about the cycle is available in the business itself. We worked with a woman who ran her own brokerage: After her injury her own sales suffered, but the sales of the other agents in her brokerage stayed constant. By superimposing her income against that of her other agents, the pattern of her loss was clear.

The same phenomenon can be true in businesses you would not immediately think were cyclical, or seasonal. I litigated a business dispute case against a bar in Cotati that claimed that their summer-slump was my client's fault – that was until we looked at the Sonoma State school calendar.

Finally: Look for an appointment calendar

I recently had the uncomfortable experience of needing to drop a wage-loss claim on the eve of trial when, during trial preparation at my client's house, I came across my client's "personal" calendar. Although she honestly believed her business had suffered, once we had digitized her calendar and charted it on a spreadsheet, the pattern was the opposite: She had been working longer hours and seeing more clients at the time of trial than she ever had before her injury. She was in pain, and work was hard, so she assumed her business was suffering, but when we dug into her calendar we could not support that claim.

The lesson was simple: small business people are often too busy running their businesses to understand the value of their businesses. So, you need to. If you do not dig into their books and understand the dynamics of their business better than they do, you may either undervalue their loss or mistakenly overestimate it.

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