Determining Lost Profit v. Lost Business from the Financial Expert's Perspective

Until this past summer, the idea that YouTube might turn a substantial profit at long last may have been as improbable as Jon Stewart friending Glenn Beck on Facebook. But a federal judge's recent ruling in YouTube's favor in the 3-year-long copyright dispute with Viacom, the owner of such profitable brands as Paramount, Nickelodeon and Comedy Central, is a major victory in what some are calling a landmark copyright case.

The much-discussed suit revolved around Viacom's allegations that YouTube only became the Internet's most viewed video site by posting copyright-protected clips "stolen" from its shows. But in evoking a law that shields Internet services from claims of copyright infringement as long as the illegal content is removed, the Court noted that YouTube had removed about 100,000 videos the day after Viacom sent a mass takedown notice. If the Court in this case had agreed with Viacom, and ordered Google to pay the more than $ 1 billion in business damages the media conglomerate was seeking, the impact on YouTube's future profitability could have been considerable.

For a media conglomerate such as Viacom, however, copyright infringement on a site that might attract well over a billion visitors a day, could translate into lost revenue from DVD sales and rentals, worldwide TV syndication, and paid online distribution of their content. When copyrighted content is readily available for free on YouTube, for example, the Court may take into account what profits, if any, would have been generated by Viacom if not for the alleged copyright infringement. But is this a case of lost profits or lost business for a media conglomerate--or perhaps both?

In considering whether a case merits a claim for either or both, one must examine the facts and circumstance early in the litigation process to analyze the appropriate theory of recovery. The final determination can directly affect the appropriate damage calculations as well as the identification of proper claimants to the litigation. In some instances, the courts have allowed *both* lost profits and the decrease of the market value of the subject business; however, on some occasions, the court has allowed one or the other.

Whether business damages are calculated by the financial expert as lost profits or lost business, the objective is to restore the plaintiff to the position it would have been --"but-for" the defendant's actions that caused the damages. When calculating lost profits, damages are typically measured for a specific or limited period of time. In general, the loss is the difference between what the business would have produced during the loss period, minus what it actually did produce during this same time frame. All the business's expenses are taken into consideration in both the "what would have happened" and "what did happen" scenarios.

Case law and statutes dictate what a plaintiff needs in order to demonstrate lost profits. It is the financial expert's task to employ both a scientific and artistic interpretation of the facts and circumstances that will eventually tell a detailed, accurate story.

The approach to determine lost profits is multi-faceted and generally requires the following 6 steps:

1. Calculate lost earnings by comparing profit history before and after a damaging event,

2. Understand the subject company's cost structure,

3. Examine the calculated expenses for reasonableness,

4. Determine causation (i.e. consider possible reasons for drop in sales),

5. Examine how things such as economic conditions, marketplace demands and government regulations have impacted a sales loss,

6. Present detailed information to support the assumed revenue, expense, and growth rates.

As an experienced practitioner, the steps of assessing lost profits can be simply stated; but more often than not, the process itself requires meticulous attention to detail and a sharp eye for any contradictory information. Often, one needs to step back to inquire about issues that arise during this endeavor. Three that come to mind are as follows:

1. What influence does an immature line of business affect the overall operations of the entity?

2. How does a poor performing sector influence the results?

3. How influential should projections and forecasts that materially differ from historical results be, and how should they be utilized?

The financial expert knows that *the credibility relevant to projected income*—and anticipated expenses—is absolutely critical in supporting a lost profits claim. The analyst works methodically from business plans, market surveys, income projections, and other evidence of projected revenues to estimate future receipts. One may use data from industry sources, comparable companies, market data or any other source that may help in predicting a company's financial results. It is imperative that the expert acquires in-depth knowledge of the subject company early in the process: its products, markets and competition, and the market forces to which it is subject.

In a case when an entire business is destroyed, the analyst's task is still to determine the lost future cash flow. But in contrast to a lost profits case, the loss is now permanent. Just as in the lost profit calculation, the expert considers all of the subject company's expenses in the "what would have happened" vs. "what did happen" scenarios. The fair market value of the subject company is determined based on the assumption that an earnings stream will continue into perpetuity.

So when the attorney considers whether a plaintiff may recover both lost profits *and* lost value, I can tell you of an important exception: when a business operates for a certain amount of time and then closes as a direct result of the defendant's behavior, thereby incurring a period of lost profits followed by lost business. In this case, the courts have found no "double-counting" of the plaintiff's allowable recovery.

Simply summarized, how does a lost profits case differ from a lost business case? Lost profits are usually measured over a specific time period (e.g. the estimated time it will take the plaintiff to restore "normal" profits).With lost business value, profits are projected into perpetuity. A lost profits analysis views a business from the perspective of a plaintiff; a business valuation views the business from the "hypothetical buyer's" perspective.

Drawing from the analyst's skills in finance, accounting and economics, the financial expert—reasonable and objective-- can distill complex data into an understandable, accessible communication that can prove invaluable to the litigation team.

This past August, Viacom filed an appeal in the U.S. Circuit Court of Appeals for the Second Circuit in New York; any decision, however, is likely several years away. Did YouTube build its business, in part, at Viacom's expense, thus depriving the media conglomerate of significant revenue? Could YouTube have done more to keep illegal content off its site with the help of copyright detection tools it later developed after its sale to Google? Will Jon Stewart ever have Glenn Beck on his show? And could a clip still find its way on YouTube? Stay tuned.