

## Defining the Difference #99



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## EVALUATING DAMAGES IN COMMERCIAL LITIGATION AND INSURANCE CLAIMS EARLY INTERVENTION AND ASSISTANCE



Damage claims may be based on unreasonable business and financial assumptions. It is important to look at the assumptions used in formulating a damage model as well as to review all the calculations involved. An expert business analysis can determine whether use of the model is relevant and appropriate to the actual situation in dispute, and can also illuminate issues pertaining to all parties involved that impact causation and liability. This month's bulletin describes a past [H.S. Grace & Company, Inc.](#) (HSG) business-based analysis and testimony assignment in which HSG was requested to evaluate plaintiff's business valuation damage model in a complex energy financial transaction.

### **Allegations of the Plaintiff**

Plaintiff, a minority shareholder in one of the defendants, and defendant companies (HSG Clients) had jointly developed an energy project. The project had a single sales contract to a third party, which had been the subject of arbitration with the third party purchaser. The arbitration was settled and a new five year contract was entered. The proceeds of the settlement were used to pay off a portion of the outstanding debt on the project and one of the defendants was substituted as the lender for the remaining balance. Plaintiff, minority shareholder, sued defendants alleging that the refinancing was inappropriate and that the arbitration settlement proceeds should have been distributed rather than used to pay off a portion of the loan. Plaintiff also requested that defendants be required to buy out its interest in the project, and plaintiff's expert submitted a valuation model valuing the plaintiff's interest in the project.

### **Business-based Analysis**

The HSG team consisted of several former CFOs and senior executives of energy-related firms, banks and other companies. Utilizing their extensive experience with

financing arrangements and in forecasting and budgeting, they examined the business assumptions used by plaintiff's valuation expert to project future free cash flows and determined that the assumptions used were inconsistent with the facts in the case and resulted in a valuation that grossly overstated the value of the energy venture at the time. HSG's analysis showed:

**First, both the assumptions and the calculations within the model were incorrect.**

Plaintiff's expert used historical sales from the project to project future cash flows. However, the new sales contract, which replaced the contract which was the subject of the arbitration, had no commitment to purchase minimum quantities, and recent quantities purchased were far below the amounts used in plaintiff's expert's valuation projections. Further, this contract was also in arbitration at the time since the purchaser was contending it had overpaid under the new contract and was demanding both a refund and a reduction of future payments.

Plaintiff's expert over time doubled revenues from the project, but projected few, if any, cost increases, effectively doubling future net income from historical levels. Yet, the revenues in the valuation were from a contract that was to terminate in 5 years. This contract was the sole revenue-generating contract from the project. It was highly uncertain whether there would be revenues from the project beyond that point in time - yet plaintiff's expert essentially projected revenues into perpetuity by using a terminal value. (Plaintiff's expert also used yet another inconsistent termination point for the new contract in a separate opinion in the report).

**Second, and far more importantly, the model did not apply to what had occurred.**

The HSG team established that what had occurred was a lender substitution and not a reorganization of the partnership which could have called for distributions to the partners. The majority shareholder substituted for the remaining bank lenders after the arbitration proceeds were distributed, an action which was permitted by the documents and falls within customary and normal business practices. When questioned about the arrangement in his deposition, Stephen Grace was able to cite major projects in which he had been personally involved in which the majority equity holder was also the majority, or sole, lender.

## **Results**

When presented with the information developed in the HSG business analysis, Plaintiff's counsel, a well-known plaintiff's law firm, shortly thereafter delayed the trial, and subsequently resigned from the case. Later the Plaintiff raised new disputed issues with subsequent counsel, but the allegations in the original plaintiff scenario were not pursued further.

If you would like to know more about this case, or about the kinds of business-based analysis of claims and damages that can be obtained from H.S. Grace and Company, you are invited to contact members of our group, Al Fenichel, Charles Fischer, Steve Grace, and H. Stephen Grace, Jr. at (713) 572-6800.

H. S. Grace & Company, Inc. (HSG) is a litigation support and consulting firm established in 1993 that works with in-house counsel, outside counsel, insurance carriers and corporate attorneys, as well as company boards and senior management. HSG specializes in assisting clients both before and during litigation in

analyzing and assessing the validity of claims involving representations and warranties, directors and officers responsibilities, financial reporting, business judgment, merger and acquisition disputes and other complex issues. The firm provides expert testimony from our detailed analyses of the business decisions and actions, issues reports of how the actions of all parties involved affect causation and evaluation of damages and provides guidance to support settlement strategies and negotiations. HSG has approximately 30 consultants, including experienced testifying experts, who have had significant experience as senior

executives (e.g., CEOs, COOs, CFOs, SVPs, Treasurers, technical professionals and board members), many of whom hold advanced degrees and professional certifications. Our experienced team members look deeply into claims and allegations to determine not only what happened, but how and why, to speak authoritatively about appropriate business practices, and to assist clients in achieving favorable outcomes. HSG has represented banks and other financial institutions, real estate partnerships, energy companies, pharmaceutical firms, healthcare companies, insurance carriers, retailers, technology companies and others in a broad array of complex commercial litigation.

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