H.S. Grace & Company, Inc.

# Defining the Difference # 68 – July 2013

## DEFENDING DAMAGE CLAIMS IN COMPLEX

## COMMERCIAL LITIGATION – VALUATION MODELS

As discussed in our last Defining the Difference, damage claims made by plaintiffs in complex commercial litigation may be based on unreasonable business and financial assumptions. For that reason it is important to look behind the assumptions used in formulating the damage model to the underlying facts on which the claim is based. The following H.S. Grace & Company, Inc. (HSG) expert witness assignment in which HSG was requested to evaluate plaintiff's business valuation damage model in a complex energy financial transaction demonstrates how a careful and thorough analysis of the business assumptions underlying the model can show that the damage calculation is flawed.

**Allegations**

Plaintiff, a minority shareholder in one of the defendants, and defendant companies 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 payoff 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 payoff a portion of the loan. Plaintiff also requested that defendants be required to buyout its interest in the project, and plaintiff's expert submitted a valuation model valuing the plaintiff's interest in the project.

**Analysis**

The HSG team consisted of several former CFOs and senior executives of both energy-related and other companies. Utilizing their extensive experience as CFO's with financing arrangements and in forecasting and budgeting, HSG 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:

- 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.

- 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).

**Results**
The Plaintiff has chosen not to pursue the matter.

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**Representative Issues Examined**

- Lender Liability
- D&O
- Corporate Split-off
- Family Trust
- Health Care
- Professional Services
- Intellectual Property
- International Structured Finance Transaction
- Fraud
- Pension Fund Investments
- SEC White Collar Defense
- Stock Option Backdating
- Oil & Gas
- Real Estate
- Fiduciary Issues
- Contract Dispute
- Fund Management
- Market Timing Allegations
- Financial Derivatives
- Portfolio Management
- Special Purpose Corporation

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