COVID-19 Has Broad Impact On Lost-Profit Determinations

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by Neil Ashton and Michael Yachnik

COVID-19 has caused a significant disruption to business operations around the world, which—as we have seen widely publicized—has the potential to result in a corresponding wave of litigation and arbitration involving claims for lost profits.

But what about claims for lost profits where the breach is related not to COVID-19, but other factors? In many jurisdictions, the claimant must be able to show that the amount of any loss can be estimated with reasonable certainty.

Even in normal times this can be difficult, but it is made significantly more challenging due to the pervasive effects of the pandemic.

In this article we focus on these challenges in the context of claims that arise for reasons other than COVID-19, but where the pandemic has implications for the loss suffered, i.e., where the loss period extends into March 2020 and beyond.

Overview of Lost Profit Calculations

Typically, lost profits are calculated by assessing the difference between: the but-for scenario—the profits that the party would have earned but-for the

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alleged breaches; and the actual scenario—the profits that the claimant expects to earn after taking into account the alleged breaches.

The profits in each scenario are assessed for a discrete period, the loss period, usually ending when the profits in the actual scenario return to the levels they would have reached, but for the breach.

The loss period will often encompass historical losses—i.e., losses up to the date at which the assessment is being made—and future losses extending beyond the assessment date.

Ordinarily, future losses are discounted back to the assessment date using a discount rate that reflects the time value of money and the riskiness of the profit streams.

Impact of COVID-19 on the But-For and Actual Scenarios

Financial estimates in the but-for scenario are usually calculated using forecasts developed before the time of the breach.

However, particularly for breaches that occurred prior to the pandemic, such forecasts are now likely to be unreliable and alternative measures should be considered.

One appropriate starting point may be to take a yardstick approach to look at industry trends or specific company comparators.

In theory, an appropriate analysis of a good comparator company that has been impacted by the effect of COVID-19, but not by the matters complained of by the claimant, will provide a potentially reliable indicator of the subject company's likely but-for performance—adjusting as need be if the claimant would have been particularly well or ill-placed to deal with the new market conditions compared to the chosen comparator.

However, the market share of the company before COVID-19 should also be considered and necessary adjustments made if there have been significant changes in market share during the pandemic.

For example, this could be due to a loss of competitors or the gain in market share of certain competitors who were better placed to adjust to the impact of the pandemic.

For breaches that occurred pre-pandemic, COVID-19 may shorten the period of loss if the effect of the virus means that the claimant would not have been able to operate at a greater level of profitability than in the actual scenario—and regardless of the breach.

For example, an industrial manufacturing business recently brought a claim for lost profits as a result of events in 2019 that had an ongoing impact on the production and sales capacity of the business.

In this instance, the effect of the pandemic on demand from late in the first quarter of 2020 was such that it entirely eclipsed any ongoing impact of the events giving rise to the original claim, i.e., the reduced actual financial performance of the business after this time was due entirely to the virus and was no different than if the original breach had never occurred.

By the same token, there are scenarios and industries where the effect of COVID-19 may lead to a potential increase in the quantum of loss of profits.

Consider an accommodation-based business, which had previously suffered a period of loss as a result of alleged building defects within one of its properties.

The pandemic significantly extended the period of loss because, in the but-for scenario, it was contended that full capacity would have been reached before the beginning of pandemic-related restrictions but, in fact, as a consequence of the defects the relevant accommodation was only part full at that time, and growth in occupancy has taken much longer to materialize than previously anticipated.

Another particularly challenging area in the current environment is the assessment of any future element of revenues in the actual scenario, i.e., the likely level of actual performance beyond the date of assessment. This is significantly more difficult now than in a pre-pandemic world due to the continuing uncertainties that businesses face.

Estimations of future financial performance will in many cases be constantly changing due to shifting government mandates such as regional and national lockdowns, travel restrictions, and social distancing requirements.

For example, many businesses in the U.K. saw revenues gradually return to some level of normality over the summer when restrictions were lifted.

Assessing future earnings during these months would likely result in higher estimated future earnings than if considering future earnings in the fall, when many parts of the country had returned to a second period of lockdown. Therefore, the date of assessment is key.

More generally, given that the impact of the pandemic is likely to be long-lasting, it is difficult to predict when business revenues will begin to stabilize.

This makes it all the more challenging to confidently calculate lost profits for claims that are currently proceeding. At the very least, however, businesses can help themselves by identifying and recording impacts on revenue and the consequent changes in likely budgeted performance on a timely basis.

Overall in the actual scenario, it is important that the effect of the breach is isolated from the impact of COVID-19—or any other factors unrelated to the alleged breach—as the defendant party should not be held liable for losses not attributable to its breach.

This requires a careful analysis of any performance fluctuations and their root cause. Where such reasons are not related to the breach, they should then also be reflected in the but-for scenario.

Other Lost Profit Considerations

As with all lost profit calculations, once the value of lost revenue has been established, the value of saved costs must also be assessed and subtracted from the lost revenue in order to identify the value of lost profits.

This involves an analysis of costs to determine which are fixed and which are variable; only incremental costs—i.e., additional costs that would have to be incurred to generate the claimed lost revenue—should be deducted in arriving at lost profits.

Just as with revenue, the value of saved costs needs to be properly analyzed in light of the pandemic; it is not appropriate to simply apply historical averages or forecast data prepared pre-pandemic.

This is because unit costs may have changed substantially as a result of the pandemic and, as such, should be reassessed.

For example, industries such as hospitality may now have significantly higher costs associated with complying with hygiene and cleaning requirements.

Further, new COVID-19-specific expenses must be identified. These could be directly related costs such as purchasing equipment to allow employees to work from home or implementing measures to ensure social distancing is enforced in the workplace; alternatively, they may be more indirect in nature if, for example, costs in the supply chain have increased.

Either way, as for revenue, business should seek to identify and record these cost impacts and integrate them in their budgets in as timely a manner as possible.

Government financial assistance during the pandemic is yet another factor to consider: If a claimant business has benefited from such assistance, it will be important to consider this aid and any differences between the actual and but-for scenarios.

Finally, as COVID-19 is likely to have an impact on the risk-free rate and on entity-specific risk premiums—e.g., country risk, financing risk and forecasting risk—any discount rates calculated pre-pandemic may not be a reliable guide to the likely level of discount to be applied in the current environment.

How Can Counsel and Claimants Prepare?

Now more than ever, the need to produce relevant documentation is critical. Claimants should retain budgets, forecasts and other financial documents as well as correspondence with suppliers and customers, especially if it relates to cancelled orders.

Due to the ever-changing nature and duration of the restrictions placed on businesses, calculations of lost profits may need to be updated multiple times pretrial with supplemental disclosures and reports presented.

Counsel should ensure that there is agreement around the necessary financial data and implement a process to provide that data in a timely manner, especially given potential constraints in relation to remote working and the ability of the parties' teams to conduct necessary investigations.

Legal teams should also consider presenting multiple damages scenarios so that the court or tribunal can consider and select the most relevant scenario(s) at the date of judgment or award.

Conclusion

While lost profits will continue to be assessed conceptually using the same principles as before, in practice the COVID-19 pandemic is already adding new complexities to damages calculations.

It is rare for a single issue to be so pervasive and have such a significant impact on so many different business and industries at the same time.

Therefore, it is critical that challenges such as the timing of the assessment and the reliability of forecasts and other financial information are proactively addressed when presenting damages assessments to courts and tribunals.

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