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On quantifying known unknowns

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"*…there are known knowns; these are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know*" Former US Defense Secretary Donald Rumsfeld.

One of the more demanding tasks a damages expert can be instructed to perform is the quantification of losses arising in the context of a newly-established business or project where little or no track record of past profits exists – and to persuade the Tribunal of the reasonableness of his approach and conclusions. If a business is expropriated, for example, before the owner has had the opportunity to generate (so he believes) extraordinarily large profits, how should an expert go about valuing the lost opportunity in the absence of a prior record of profitable operations? The same question arises in commercial arbitration, for instance, where a joint venture agreement or distribution contract is breached and/ or abruptly terminated shortly after signature, depriving the injured party of future profits which might be hard to determine in the absence of a sufficiently long record of profitable operations.

The overriding principle governing the recoverability of lost profits is whether they can be established with reasonable certainty. Claims for damages that are unduly speculative or uncertain have been and will likely continue to be rejected by Tribunals. In the alternative, instead of rejecting a claim outright, tribunals have sometimes only awarded the claimant the amount of its investment or its "sunk" or "wasted" costs.; Some commentators (and indeed some arbitrators) consider that limiting awards in this way unduly penalises the claimant whose business opportunity is curtailed through no fault of its own. To address this, tribunals have on occasion made a partial award of lost profits by amending some of the assumptions underpinning the Claimants loss model.

The purpose of this article is not to go over familiar legal ground but rather to set out some practical thoughts on how a damages expert might usefully assist a tribunal to determine, in the context of a start-up business or project, whether a wrongful act has prevented the injured party from realising a financial gain, and how to measure the amount of the loss given the inherent uncertainties. Many commentators have argued that the mere difficulty of proving that a gain would have arisen but for the wrongful act loss does not justify dismissing a claim out of hand as overly speculative or uncertain. In the real commercial and investment world, uncertainty over future revenue streams is a fact of life and there exists a well-established set of economic and financial models to measure the effect of uncertainty and risk on future cash flows.

Returning to the theme of start-up companies or businesses in a new industry, in the absence of a well-established operating history, what other reliable evidence could an expert review? How can the expert assist the tribunal in ensuring that an entrepreneur is not unfairly treated? Clearly, each case needs to be considered according to the individual facts and circumstances but I offer the following as potential alternative avenues of inquiry an expert might wish to consider where reviewing a long track-record is not a possibility:

• **Does the claimant have experience with similar projects?** – for example, if, as a result of a breach/ expropriation etc, a planned development is aborted, the lack of a trading record for that particular project might be less critical if the investor can point to past/ ongoing success with numerous similar projects (scale, geography). In its award in the matter of Vivendi v Argentina, for example, the Tribunal noted that a 'proven record of profitability of concessions it **(or indeed others)** had operated in similar circumstances' [emphasis added] might constitute sufficient proof for a claimant to demonstrate the likelihood of profitability of a new investment.

• **Does the claimant have a track-record of producing accurate forecasts?** – where the investor seeks to rely on its own business plans, forecasts, budgets etc as a guide to what would have happened but for the breach, this evidence may be more persuasive if previous financial projections for other projects can be shown in hindsight to have been consistently accurate and/ or reasonable.

• **Does the nature of the investment/ project render the claimant and its track-record less relevant?** – In some industries or project types, the need to demonstrate a prior operating history is of relatively little importance. To illustrate this point, consider an investor who acquires a gold exploration license for $10 million and invests a further $10 million in prospecting. After much time undertaking the usual exploration activities and striking gold(!), the investor hires a reputable third-party expert to produce a feasibility study on the discovered ore deposit. The investor is pleased with the expert's conclusion that the deposit is deemed economic. Assuming that expropriation occurs immediately after the feasibility study is received, meaning that there is no record of operating profits, is it right that the investor should only be compensated for the investment expenditure ($20 million) it has made? In reality, an ore deposit which has been independently assessed as economic will already have a readily defined market value; moreover, there exist independent studies and market data which can point to the likely costs of extracting the gold and selling it. Given the above, the lack of a record of operating profits (for the mine) is perhaps of relatively low importance.

• **Who else has relied on the claimant's business plans, projections etc?** – In the absence of actual trading history, some assurance over the reasonableness of a claimant's business plans, budgets, trading forecasts etc (on which the claim is partially or wholly based) may be gained by ascertaining whether others have relied on these. By way of example, a fund/ bank which provides finance/ seed capital will not normally do so unless it is comfortable (based on past experience of similar projects) that the economic returns the investor claims it will achieve look both reasonable and achievable. Similarly, the party in a joint-venture who breaches the agreement in some way may find it hard to dismiss as 'speculative' the business plan that the injured party relies on if this plan was jointly prepared and signed off by both parties

• **Is there macro economic data or other evidence to support (or indeed challenge) management's beliefs?** – an expert would be well advised to step back from the detail of the claim and consider 'big picture' issues i.e. to what extent (if any) does the claimant's assumed level of sales/ pricing/ profits etc look realistic given the relevant economic data, such as GDP, population spread, demographics etc.

Assuming that an expert is satisfied that a loss has arisen as a result of a wrongful act, his next task is usually to measure what that loss is. In general terms, the fact that he does not have the benefit of an established trading history to rely on for his valuation will often mean that he will need to be even more conservative in his approach than normal. In practical terms, depending on the nature and facts of the case, he may bear in mind one or more of the following non-exhaustive list:

• In order to reflect a lack of a track-record, it may be appropriate when discounting future cash flows to increase discount rates above those that might otherwise apply. If a company is new and management relatively inexperienced, it may be sensible to apply a high discount rate. Alternatively, the expert might adjust the projected future cash flows directly (downwards for cash inflows, upwards for outflows).
• In producing a valuation model, the expert should take care to be conservative in any assumptions or estimates that are made and draw the tribunal's attention to areas where reliance is made on such assumptions/ estimates.
• Where the matter involves a new industry and/ or where there is a general lack of data on comparable companies, an expert would be well advised to avoid creating alternative valuation concepts (some of the novel methods devised in the early 2000s to value internet start-up companies come to mind!).
• It will usually be appropriate to show the impact of using different scenarios or discount factors. Typically, an expert will model the outcome based on different scenarios (to show say low, base, high alternatives) using his chosen discount rate. It may also be appropriate (taking care to avoid double-counting) to show the sensitivity of his calculation to changes in the discount rate.
• Finally, one alternative that is often applied in the corporate finance work is the notion of "expected" value. Where there are a few key assumptions which are mutually exclusive, the expert may choose to model each, assign a probability to each, and derive an expected value. This approach is not always fully understood or welcomed since the expected value will not normally be the same as any of the underlying scenarios and thus nor reflect what might have come to pass but for the breach; tribunals may prefer to choose a given scenario rather than a blended result. To paraphrase Mr. Rumsfeld's immortal words, Tribunals prefer known unknowns to unknown unknowns.

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