



FORENSIC PERSPECTIVE



CASE
IN
POINT

Start-up Companies: Damage Claims

New businesses alleging injury due to actions of others sometimes face challenges in claiming damages due to the company's lack of historical performance data. Some Courts have denied claims from these businesses ruling that the claims are speculative and that they are based on uncertainties that make it impossible to meet the "reasonable degree of certainty" test. Some recent cases have, however, allowed recovery subject to plaintiffs meeting certain evidentiary requirements.

Start-up Companies can recover lost profits if they show proof with reasonable certainty

In *Bevill Co. v. Sprint/United Mgmt. Co.*¹ the plaintiff sued for damages in a breach of contract suit claiming that the Defendant wrongfully terminated a Master Services Agreement (MSA). The 2000 Agreement provided that Bevill would sell dial-up internet access to soldiers living in barracks of military bases where Sprint provided telecommunication services. In its defense, Sprint stated that it terminated the contract because Bevill failed to meet the subscription targets agreed upon in the MSA.

Although the District Court took into account the fact that Bevill was a start-up company, it did not rely solely on Bevill's historical failure to make a profit in determining damages. In its ruling, which was upheld by the Court of Appeals, the District Court noted that its decision to deny claimed damages was based entirely on Bevill's failure to prove damages, with some reasonable level of certainty, at trial. From the evidence presented, the Court found that Bevill:

- Did not show that it could make a profit under the agreement.
- Had financial practices which showed a lack of attention to detail, such that it would not become profitable.
- Was selling dial-up connectivity at a time when the service was losing popularity to faster services like DSL. [Court ruled that Bevill could not compare its profitability to Sprint which was providing DSL internet access]

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"Stolen" company's profits used as basis for damages

Two partners ousted a third partner from a bounced-checks recovery business they had started. The two renamed the company, changed locks on the office doors and removed the other partners electronic access while continuing business and representing to customers that nothing had changed. The ejected partner sued on his own behalf and that of the original company claiming lost profits. During discovery, the defendants refused to make available electronic data requested by plaintiff. Although the defendants claimed that a virus had completely destroyed the requested data, the trial court in *Electronic Funds Solution, LLC. V. Murphy*² found that the discovery violations were willful and egregious.

Plaintiff's expert used financial data from the successor company estimating \$41 million in lost profits over 5 years. The court noted that in addition to the general difficulty in demonstrating lost profits for start-up companies, the estimation in this case was made more difficult by the defendants' bad faith in failing to produce all documents requested. The court thus found that the successor company provided an appropriate "surrogate" to estimate the plaintiff's original company's profits. The Court of Appeals, however, only awarded \$10 million in damages, the maximum requested in the plaintiff's amended complaint.

(continued on next page)

Start-up Companies: Damage Claims (cont'd)

Court reverses Jury's \$10 million lost value award for lack of evidence

In *M&A Technology v. iValue Group, Inc.*,³ the iValue founder sued M&A for damages after he was terminated by the computer-networking company that had hired him to raise equity investment. In return, M&A was to house iValue's servers and web assets and use its domain name "explore.com" to attract web-hosting clients. M&G said that they terminated the iValue founder after they traced several forged checks to him. The iValue servers were shut down and their hard drives wiped clean on the same day of the termination. The cause of the server wipe-out was disputed. M&A claimed it was a result of a power failure while the iValue founder said it was deliberate.

At the time of termination, iValue had not launched the "one-stop-shop" for outdoor gear and travel intended to be hosted at the explore.com website. It did not have any capital, customers or products. Nevertheless, iValue argued that but for the defendant's destruction of the servers the company would have become a highly profitable e-commerce business. iValue's valuation expert presented three valuation methods to prove the company's lost value.

1. *Income Approach* - \$2.5 million
2. *Market Approach* – Between \$6.7 and \$7.1 million
3. *Cost Approach* – Software and hardware at \$0.4 million and e-commerce platform at \$1.8 million. In support of the latter, he referenced Amazon.com and Buy.com with platforms that cost about \$10 million to build.

The court ruled that iValue did not establish that it could make money in the near future.

The jury agreed with iValue's argument and awarded the company \$3 million in lost value and \$6 million in punitive damages plus interest and penalties for a total \$10 million in damages.

M&A appealed claiming that the damages presented relied on assumptions which were speculative since iValue was new and unproven. The Court of Appeals agreed with M&A and reversed the judgment ruling that the damages award was not justified. The court ruled that iValue did not establish that it could make money in the near future. At the time of breach, the company was trying to raise working capital. It did not have customers, distribution contacts, employees or office space. Likewise, there was no evidence to support the cost estimates for the software, hardware and e-commerce platform. The court ruled that a comparison between iValue's e-commerce platform and Amazon.com's was not a logical comparison.

¹ 304 Fed. Appx. 674; 2008 U.S. App. LEXIS 26367

² 2009 WL 1717383 (Cal. App. 4 Dist.)

³ 2009 WL 2456289 (Tex. App.-El Paso)

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FRAUD CORNER

White-Collar Crime: 12-Step Path

How do the Madoffs, Skillings and Stanfords transition from respected executives to criminals? According to recent research published in the *International Journal of Business Governance and Ethics*,¹ white-collar criminals go through 12 steps when committing a crime:

- STEP 1: Perpetrator is hired into a position of power
- STEP 2: Personality and circumstances affect the perpetrator in such a way that he realizes authority
- STEP 3: "Drivers" ignore or condone certain actions that have been taken
- STEP 4: Passive participants recognize an opportunity
- STEP 5: The perpetrator draws some reluctant participants into the crime
- STEP 6: Distrust develops between the people involved
- STEP 7: The perpetrator recognizes that the co-conspirators are in a vulnerable position and begins to exploit this position
- STEP 8: Bullying and pressuring tactics become rampant as illegal goals are pursued
- STEP 9: Perpetrator becomes greedy and more brazen taking bigger risks while seeking more lucrative exploits
- STEP 10: A paradox as the participants' values and their behavior come into obvious conflict
- STEP 11: A whistleblower steps up and marks the perpetrator's downfall
- STEP 12: The perpetrator is blamed for the crime at which point he either denies everything or admits guilt and seeks forgiveness

¹ A 12-Step Process of White Collar Crime, *International Journal of Business Governance and Ethics*, 2010, 5, 14-25

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