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BUSINESS LAW ALERT

Current Financial Matters Regarding Business Litigation

When One Business ‘Steals’ Another, Its Net Profits Can Provide Basis for Damages

Electronic Funds Solution, LLC, v. Murphy, 2009 WL 1717383 (Cal. App. 4 Dist.)(June 19, 2009)(unpublished)

It’s the high school garage band story all over again in this case—the band mysteriously dissolves, only to re-form an almost identical group with a different bass player. Here, three partners designed a company to help commercial establishments electronically recover funds from customers’ bank accounts after their checks bounced. Within a few months, the company had over 50 clients and licensing agreements with suppliers.

Within nine months, however, two of the partners decided to oust the third. They changed the locks on the office, removed his electronic access, appropriated his mail, and stopped forwarding calls. They also converted company funds and entered into new customer contracts without his knowledge or consent; and they renamed the company, telling customers that nothing else had changed. The former partner sued (a big difference from high school).

It doesn’t pay to mislead the court. During discovery, the plaintiffs asked for specific emails and electronic data, but the defendants claimed that a virus had completely destroyed their computer files. On examining the computers, the plaintiffs’ IT expert determined that the defendants had copied the hard drives to an external source and then erased them. After the defendants refused to turn over the copied data, the plaintiffs asked the court for terminating sanctions, including a default judgment and damages. Finding the defendants’ discovery violations willful and egregious, the trial court granted \$8 million in actual damages and assessed an additional \$16 million in punitive damages.

The appellate court overturned the award, however, because it was erroneously based on the market value of the company rather than its net lost profits. On remand, the trial court assessed over \$67 million in total damages (\$10 million in lost profits) and the defendants appealed (again); the court was not entirely sympathetic.

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The appropriate method for estimating losses for a start-up business. Net lost profits are “gains made from sales after deducting the value of the labor, materials rents, and all expenses, together with the interest of the capital employed,” the court said. Recognizing that start-ups are a special circumstance in which a court is allowed more latitude in estimating damages, the court went to say that this is particularly so when the “difficulty in estimation arises from the defendant’s bad faith.”

In calculating compensatory damages at trial, the plaintiffs’ expert used financial data from the successor company to determine total damages of approximately \$40.6 million. But because the plaintiffs’ amended complaint requested only \$10 million in damages, the trial court entered this amount as a default judgment and then added substantial punitive damages and penalties to reach a total assessment of over \$67 million.

On this second appeal, the defendants challenged the use of their data to compute the plaintiffs’ lost profits. However, when the defendants “stole” the original company—its business methods, office, computer system, and customers—their successor company provided an appropriate “surrogate” for estimating the lost profits of the plaintiffs’ original enterprise, the court held.

“We conclude the methodology used to calculate compensatory damages appropriately determined net profits,” the court said, and it confirmed the \$10 million award of compensatory damages. The punitive damages were struck as excessive.