

Loss and Damages in a Start Up Company

In the recent decision of Bergin J in the matter *Memorex Telex Pty Ltd v National Databank Ltd* [2002] NSWSC 1111 the basis for a claim of loss and damage for a start up company was considered.

This matter involved a dispute in relation to the provision of computer goods and consultancy services by Memorex. Memorex claimed an outstanding amount for the original installation of the system of \$336,444. The purchaser, National Databank cross-claimed for damages of \$2,376,620 which included a claim for \$2.2 million for estimated lost revenue due to the alleged inadequacies in the system.

Bergin J found that Memorex was clearly in breach of its agreement with National Databank in regard to completion dates and had a responsibility to correctly perform testing procedures. However, with regard to the alleged technical problems, on the basis of insufficient evidence to the contrary, Bergin J was not convinced the problems were anything other than minor.

On this basis judgment was entered for Memorex's claim in respect of the outstanding amount owed and on National Databank's cross-claim for liquidated damages of \$57,787 for the delivery delay. A further \$50,700 was also awarded to National Databank for reasonable costs to rectify the system and \$20,000 as an entitlement resulting from the loss of a few small users.

National Databank's accounting expert based his calculations of \$2.2 million loss of revenue on an assumption that there was a direct connection between the installation of the computer system and the reduction in the defendant's operating activities and resultant profitability. In the absence of a trading history, as this was a start up company, the alleged "reduction" was measured against the directors' forecasts included in the company's prospectus.

Bergin J did not accept National Databank's submission that customers failed to use the system because of the problems associated with it.

Extensive analysis was devoted to the issue of the profit forecasts and whether or not this was in fact an adequate measure by which to estimate damages for their losses.

His honour referred to *The Commonwealth v Amann Aviation Pty Ltd* (1991) 174 CLR 64, in particular the following portions of the judgment of Mason CJ and Dawson J at 80, 81 and 83 respectively:

The onus of proving damages sustained lies on a plaintiff and the amount of damages awarded will be commensurate with the plaintiff's expectation, objectively determined, rather than subjectively ascertained. That is to say, the plaintiff must prove, on the balance of probabilities, that his or her expectation of a certain outcome, as a result of performance of the contract, had a likelihood of attainment rather than being mere expectation.

*The expression "damages for loss of profits" should not be understood as carrying with it the implication that no damages are recoverable either in the case of a contract in which no net profit would have been generated or in the case of a contract in which the amount of profit cannot be demonstrated. If the performance of a contract would have resulted in a plaintiff, while not making a profit, nevertheless recovering costs incurred in the course of performing contractual obligations, then that plaintiff is entitled to recover damages in an amount equal to those costs in accordance with *Robinson v Harman*, as those costs would have been recovered had the contract been fully performed. Similarly, where it is not possible for a plaintiff to demonstrate whether or to what extent the performance of a contract would have resulted in a profit for the plaintiff, it will be open to a plaintiff to seek to recoup expenses incurred, damages in such a case being described as reliance damages or damages for wasted expenditure.*

(continued page 2)

Inside this Issue

- Loss and Damages in a Start Up Company
- Consolidations - Tax deductibility of valuations
- Division of Superannuation Benefits
- Proposed Negligence Law Reforms
- Recent Matters
- Forensic Accounting Standards



Munday Wilkinson

Our Aim

Munday Wilkinson is a boutique forensic accounting firm.

Russell Munday and Bruce Wilkinson together with Willy Bagg offer the legal profession, and others, quality service and technical proficiency commensurate with that of the Big 4.

At the same time we are able to provide a more personalised service as we operate in a framework that enables us to be very responsive to our clients while at the same time delivering a high quality service in a cost effective manner.

Our Services

Jointly we have over 75 years accounting experience and have extensive forensic accounting knowledge in:

- Business and company valuations
- Valuations of intellectual property
- Quantification of economic losses
- Fraud audits and investigations
- Loss of earnings assessments and reviews
- Family law investigations, valuations and tax advice on settlements
- Due diligence reviews
- Professional negligence matters concerning professional advisors
- Solvency reviews
- Expert determinations
- Expert witness services.

We look forward to being given the opportunity to provide you and your clients with an independent, quality and effective forensic accounting service.

Loss and Damages in a Start Up Company

(continued)

The settled rule, both here and in England, is that mere difficulty in estimating damages does not relieve a court from the responsibility of estimating them as best it can. Indeed, in Jones v Schiffmann Menzies J. went so far as to say that the "assessment of damages ... does sometimes of necessity involve what is guesswork rather than estimation". Where precise evidence is not available the court must do the best it can. And uncertainty as to the profits to be derived from a business by reason of contingencies is not a reason for a court refusing to assess damages.

National Databank's proposed business activity was likened to that of Legalco, a direct competitor that commenced operations at approximately the same time as National Databank. This direct competition, together with evidence regarding insufficient market research, minimal marketing and poor advertising, led Bergen J to challenge many of the assumptions originally made in the company's prospectus. As a result he held that National Databank's failure to properly prepare for market entry was more probably than not the cause of its failure to thrive.

As a result National Databank was awarded damages for certain costs incurred but the claim for loss of revenue was disallowed. As a consequence National Databank was ordered to pay not only its own costs but also a proportion of Memorex's costs.

The case is also interesting in that it highlights the importance of being able to properly substantiate a claim for future loss of revenue.

Consolidations - Tax Deductibility of Valuations

Expenditure incurred in obtaining valuations in respect of the formation of a consolidated group or entities joining a consolidated group, as detailed in the Draft Taxation Ruling TD 2002/D12, will be deductible for income tax purposes in accordance with the tax related expense provision at s25-5 of the *Income Tax Assessment Act 1997*.

Market valuations are required under the consolidations regime primarily to determine the tax cost base of assets belonging to subsidiary members of the consolidated group.

Where expenditure was not incurred solely for the purpose of complying with the consolidations regime, an apportionment of the tax related expenses and other expenses would be required.



Division of Superannuation Benefits

On 28 December 2002 the *Family Law Legislation Amendment (Superannuation) Act 2001* commenced. This legislation allows divorced, or separated couples, to make binding agreements about their superannuation interests.

Superannuation interests can now be “flagged” or “split”, either before, during or after a marriage provided that a s79 property order or a s87 maintenance agreement under the *Family Law Act 1974* are not in place.

A “flagging” agreement prohibits a superannuation fund from making any payment to either party until the “flag” is lifted by court order or the parties’ agreement. Such an agreement can be used to defer a payment from being “split” until the member-spouse is close to retirement and the actual value of the superannuation interest would become known.

A “splitting” agreement will split superannuation interests as agreed by the parties or as ordered by the court. Once a superannuation interest has been split the non-member spouse can request to either be admitted as a member or to transfer their share of benefits to another superannuation fund. The split interest amount will be proportionately taken from the unrestricted non-preserved benefits, the restricted non-preserved benefits and the preserved benefits of the member-spouse.

Following the legislation to allow the division of superannuation interests upon the dissolution of a marriage the government has recently released a consultation paper “Splitting of Superannuation Contributions Between Couples”.

The consultation paper contemplates that from 1 July 2003 superannuation fund members will be able to make an irrevocable choice to split their personal and employer contributions with their married or de facto spouse by:

- **Prospective Split**
At the member’s request contributions will be split between the parties upon payment to the superannuation fund.
- **Annual Split**
After the end of the financial year the member can request the superannuation fund to split contributions received in the previous year.
- **Joint Accounts**
Opening a joint account that entitles both parties to 50% of the contributions and earnings therein.

The maximum split will be 50% of deducted employer contributions and 100% of undeducted contributions.

Proposed Negligence Law Reforms

The Assistant Treasurer, Senator Helen Coonan, recently released the final report of the Review of the Law of Negligence, this report being commissioned to develop a series of proposals to provide a principled approach to reforming the law of negligence.

The final report incorporates the findings of a report released in early September 2002 which primarily recommended a single Federal statute that would apply to any action or claim for personal injury or death resulting from negligence be it brought under the law of tort, contract, statute or any other entitlement.

Senator Coonan claimed the 61 recommendations in the final report had the potential to significantly reform the legal system underlying medical negligence, public liability and professional indemnity claims and to provide a platform for national consistency.

Foreseeability of Risk

- Defendants should only be responsible for a risk that is not insignificant;

Contributory Negligence

- Allowing courts to find that a plaintiff who contributed to his or her own injury can be held 100 per cent responsible;

Public Authorities

- Providing a limited defence for public authorities where they have taken a decision on policy grounds not to perform a specific public function, such as a road inspection;

Mental Harm

- Changing negligence law so that plaintiffs who suffer a physical injury can only claim for consequential psychiatric harm if they have suffered a recognised mental illness;

Limitations on Legal Costs

- Abolishing orders for legal costs when the award of damages is less than \$30,000 and limiting legal costs to \$2,500 in cases where the award of damages is between \$30,000 and \$50,000;

Caps and Thresholds

- A cap for general damages payouts of \$250,000;
- Thresholds to remove small claims from the system;
- A cap for loss of earnings of twice average full time adult ordinary time earnings.



Recent Matters

Munday Wilkinson, Chartered & Forensic Accountants continue to be involved in a wide variety of matters. Matters since our last newsletter include:

- Preparation of a valuation and goodwill assessment of an Australian subsidiary company owned by a multi-national telecommunications company to determine the extent, if any, of goodwill impairment as required by the United States accounting standards FASB 141 and 142.
- Review of several Professional Negligence claims against accountants on behalf of the solicitors for the insurers.
- Valuation of large complex group of private entities with sales in excess of \$150 million per year with cash reserves of \$25 million and no material distributions, or benefits to the owners during the last 8 years.
- Investigation of dispute between beneficiaries of a deceased estate as to the ownership and operation of a business that had been conducted by the deceased father and his son. Based on our investigations and analysis of financial material we were able to provide the only existing evidence as to the basis upon which the business was conducted and who owned the assets.
- Valuation of numerous other businesses including: an office supply business, a legal practice, a plant hire business, a coffee supplies distributor, a grip (equipment supplier for film making), supplier of electrical heating systems, executive recruitment agency;
- Providing our opinion as to the assessment of the loss incurred as a result of alleged misrepresentations made by the management of a shopping centre.
- Taking of account for a joint venture between a developer and builder in dispute over the project to construct 5 residential units

Disclaimer

Although all care has been taken in preparing "MW Forensic", no responsibility is accepted by Munday Wilkinson Pty Ltd for any errors or omissions. Professional advice should be sought before applying the information to particular circumstances.

Forensic Accounting Standards

The Institute of Chartered Accountants in Australia, together with the Australian Society of Certified Practising Accountants have approved the new accounting statement APS 11 Statement of Forensic Accounting Standards", and related Guidance Note "GN 2 – Forensic Accounting".

These documents set standards of conduct for forensic accountants, requiring:

- non acceptance of engagements where a conflict of interest may exist for the member or firm;
- acceptance of engagements only where the member has sufficient knowledge, experience and expertise;
- reasonable professional care be taken in the provision of forensic accounting services;
- confidentiality of information acquired;
- the member not to be associated with a report or expression of opinion where it is known that it contains incorrect or misleading information or omits material information;
- adequate training and supervision of staff;
- proper documentation of each assignment; and
- fees charged when acting as an expert witness not to be based on, or dependant upon, the outcome or size of the award.

Copies of APS 11 and GN 2 can be found at The Institute of Chartered Accountants website www.icaa.org.au

Further Information

If you would like further information regarding this newsletter or our services, please contact either Russell Munday, Bruce Wilkinson or Willy Bagg at:

Munday Wilkinson
Chartered & Forensic Accountants
Level 10, 470 Collins Street
Melbourne, Victoria, 3000.

Telephone: 9621 1622
Facsimile: 9621 1522
Email: advice@mwforensic.com.au
Web: www.mwforensic.com.au