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Hypothetical or real value?

Ryder & Anor v Frohlich & Anor
[2006] NSWSC 833

The classic test of value is directed towards a consideration of how “hypothetical” buyers and sellers would act. In applying such a test, can it be relevant that there may be no actual market for the thing being valued?

In June 2000 Nicholas Frohlich and Peter Ryder created the Coastal Magma Diversified Performance Fund (the Fund), an “absolute return investment fund”.

After only eight months in operation and having only made losses, Ryder took up full time employment with Salomon Barney Smith. As a result of his departure, Frohlich had to work 80 hours per week in an attempt to make the Fund successful.

Approximately one year later, after the business started to turn around and become of some value, Ryder sought his share.

In earlier judgments, the NSW Supreme Court had held, *inter alia*, that:

- There had been a partnership between Ryder and Frohlich
- A fundamental term of that partnership was that each partner would contribute equally in terms of time and effort
- Ryder’s departure in March 2001 caused the dissolution of the partnership

This judgment dealt with the quantification of damages. Associate Justice McLaughlin considered:

- 1) The nature and value of the partnership assets
- 2) Whether Ryder was owed money in relation to the value of those assets

Ryder’s expert valued the partnership’s business at \$320,635. Frohlich’s expert valued it in a range between \$Nil and \$17,700 (both positive values derived by adopting a funds-under-management methodology).

Associate Justice McLaughlin found that, because the only material asset of the partnership was a contractual right to undertake the operational management of the Fund on behalf of the Fund’s responsible entity, and because that contractual right ceased when Ryder abandoned the partnership, the value of the partnership assets was \$Nil. This, he said, meant that he did not need to consider the evidence of each party’s expert valuer.



However, foreshadowing a potential appeal, Associate Justice McLaughlin commented on this evidence.

He agreed with Frohlich's expert that the partnership business was not worth more than \$17,700. In doing so, he found that the Fund's reported accumulated losses of \$78,816 by March 2001 did not allow for the partners' salaries which, on his assessment, approximated an annual cost of \$500,000.

Associate Justice McLaughlin also commented that, **in circumstances such as these, it is important for a valuer to consider whether or not there is a market for the product or interest being valued.** He found that there was no basis for Ryder's expert to prepare his valuation, as he did, on the assumption there would be a buyer.

Significance:

Each expert in this case was required to address his task by applying the classical test of value, that being:

... to determine the fair market value of the business on the basis of what a hypothetical prudent purchaser, who was a willing but not anxious buyer, will be prepared to pay to a vendor, who is a willing but not anxious seller, in circumstances where both buyer and seller are fully informed of all the operational and financial details.

In *Spencer v The Commonwealth of Australia* [1907] HCA 70, Griffith C.J. said that **the test of value did not require an assessment of what could be obtained for an asset on a given day** but rather required an assessment of the hypothetical situation of what a purchaser would have to offer to induce a vendor who is "willing but not desirous" to sell.

At first blush, the approach suggested by Associate Justice McLaughlin appears to be at odds with this statement. However, if his comments relate to the inability to sell the business because the expected net cash flow from the business (after allowing for costs of management) would render it of no value, the same practical result arises.



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