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Presented by Stout, Causey & Horning, P.A.

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COURT CASE ABSTRACT

Lawyers and Appraisers Alike Should Beware the Overly Litigious Client

***Davison v. Margolin Winer & Evans, LLP,* 2007 N.Y. Misc. LEXIS 816 (March 8, 2007)**

Some litigants simply won't give up the fight—and they can be the most difficult clients, because their resistance often extends to paying professional fees or, in the worst case, suing their professionals for malpractice.

When goodwill turns to bad

Two physicians sought judicial dissolution for their large medical practice. Their shareholder agreement provided for arbitration, and the first issue that one doctor (the plaintiff) contested was whether the goodwill of a cardiac scanning department was a divisible asset. The arbitrator held that it was, so the doctors each obtained an appraiser (per the shareholder agreement), one valuing the goodwill at $1 million—the other (plaintiff's) at $3,600.

Given this wide variance, the shareholder agreement obligated the doctors to choose a neutral and binding third appraiser. They couldn't agree on one, so the arbitrator chose Margolin Winer & Evans, LLP (defendant). The doctors signed an agreement that the defendant's appraisal would be "final and binding." In its report, defendant valued the scanning practice goodwill at $1 million. The arbitrator adopted the value and issued his award. Plaintiff moved to vacate or modify the award, based in part on an allegedly flawed appraisal. The court denied the motion, and confirmed the arbitrator's award.

After losing these battles, the plaintiff sued the defendant for malpractice, resurrecting the claims from his previous litigation: that the appraisers had failed to consider certain relevant factors and had based the report on management interviews instead of "sworn testimony;" and that the calculation of goodwill contained errors in methodology and math.

Defendant moved to dismiss, claiming collateral estoppel; that is, the plaintiff had already tried to win these arguments, first in arbitration, then on appeal. In effect, his complaint was largely a "rehash" of all his prior complaints, for which he was given ample time and opportunity to litigate, with no success.

The Court agreed. "This action is nothing more than a collateral attack on the arbitration award and the orders granted by the [trial court]." It dismissed the plaintiff's complaint—hopefully for the last time.

COURT CASE ABSTRACT

Lost Profits Calculations Must Reflect 'Real World'

***Rose Acre Farms, Inc. v. United States*, 2007 U.S. Claims LEXIS 47 (February 22, 2007)**

Perhaps you shouldn't count chickens before they hatch, but you can count eggs after they break—or so claimed one of the largest U.S. producers after losing millions of eggs due

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to the imposition of federal regulations intended to halt the spread of salmonella.

Three outbreaks lead to quarantine

When an incidence of salmonella was traced back to one of the plaintiff's Midwest chicken farms, the U.S. government enacted emergency regulations restricting the interstate sale of contaminated eggs and limiting permissible sales to liquefied, pasteurized eggs. When three subsequent outbreaks were linked to plaintiff's farms, the government put them under quarantine.

Historically, the plaintiff had sold over 97% of its production as "table eggs," the familiar raw eggs in their shells. The quarantine forced it to divert nearly 700 million eggs as the cheaper "breaker eggs" used in pasteurized liquids such as cake mixes. To minimize its losses, plaintiff built a breaker plant for $6 million and expanded production from another plant; it also spent considerable funds cleaning its farms until 21 months later, when the restrictions were lifted.

To recover its losses, plaintiff claimed that the government regulations constituted an impermissible taking of private property and asserted $21 million in damages. At trial, the U.S. Court of Claims awarded plaintiff $6.2 million, but the government's appeal caused it to reconsider damages in light of several legal factors: the severity of the regulations' economic impact on the plaintiff; the extent to which they interfered with its investment expectations; and the purpose of the government's action.

Diminution in return versus diminution in value

To determine economic severity, plaintiff's expert asserted that "diminution in return" (also known as diminished profit) was the correct approach, as opposed to "diminution in value" (diminished revenue). To simply look at the asset values would ignore the plaintiff's costs, profit margins, and other going concern aspects. Moreover, a diminution in value only measures the loss at a specific point in time rather than during the entire 21-month quarantine.

The Court agreed with the plaintiff's approach and its formula for measuring diminution in return:

$$\frac{\text{“but for” revenue} - \text{actual revenue}}{\text{“but for” revenue} - \text{average total cost}}$$

"But for" revenue is the average price per dozen at which the plaintiff would have sold its table eggs absent the regulations, while "actual revenue" is the price at which it sold them on the breaker market. The "average total cost" is the total operating and production cost per dozen eggs at the farms during the quarantine. Applying this formula, the plaintiff had suffered a 219.2% diminution in return, equivalent to losing 100% of profits over three years.

The government tried to argue that plaintiff's approach overstated its losses. By subtracting the costs that the plaintiff could have avoided by shutting down its quarantined farms, it had suffered only a 45.4% loss—not severe enough to comprise a taking.

Loss calculation must reflect reality

But "[s]ubtracting the incremental costs from the total revenue for all three farms inaccurately prejudices the results," the Court said, and "simply does not reflect reality." In the real world, the plaintiff had mitigated its losses by selling breaker eggs and building a breaker facility. Adopting the government's calculations "would essentially punish plaintiff" for attempting to alleviate the impact of the regulations, something the courts and case law do not encourage.

The regulations also interfered with the plaintiff's investment-backed expectations, and while the purpose of the government's action—to halt the spread of salmonella—weighed in its favor, ultimately the Court decided that the impact on the plaintiff was so severe "that it is only equitable the public should shoulder a portion of the weight." By counting its eggs after they broke, the plaintiff was awarded over $5 million in damages, plus interest.

COURT CASE ABSTRACT

Three New Cases Examine Valuation of Goodwill in Medical Practices

***Keane v. Lowcountry Pediatrics*, 2007 S.C. App. LEXIS 6 (January 29, 2007); *Bunkers v. Bunkers*, 2007 Ohio App. LEXIS 523 (February 9, 2007); *Nowzaradan v. Nowzaradan*, 2007 Tex. App. LEXIS 1021 (February 8, 2007)**

Goodwill valuation continues to cause legal headaches, as three recent cases dissect the issue, all in the context of medical practices. The first considers applying the rule regarding valuing goodwill in marital dissolutions to

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partnership dissolutions. The second questions the distinction between enterprise and personal goodwill in divorce. The last confirms that when both valuation experts follow state law regarding goodwill valuation, they help create a solid court record, resistant to appeal.

Should goodwill be included in partnership dissolutions?
In Keane, a group of five South Carolina physicians couldn't agree how to split up their professional association. At a shareholders meeting, the three senior physicians voted to exclude an individual physician's goodwill from any appraisal, while, predictably, the two junior physicians voted to include goodwill.

Having won the vote, the senior shareholders offered to buy out the juniors based on an appraisal valuing their stockholder equity at $69,000, excluding goodwill. But unable to resolve their differences, the senior doctors finally changed the locks on the practice, changed its name, and distributed the tangible assets to the juniors, including their pro rata share of accounts receivable and rents.

The junior physicians sued for judicial dissolution, obtaining an expert appraisal of the partnership at $1.3 million, including tangible and fixed assets of approximately $443,000 and individual physician goodwill of $918,000. The trial court adopted this valuation, awarding the junior doctors their interests in the intangibles without further distribution, as they'd already received their share of the tangibles.

The senior physicians appealed, arguing that the trial court should have excluded goodwill. In a case of first impression, the South Carolina appeals court agreed, applying the standard in divorce and also conversion cases. Individual goodwill "attached solely to the professional, not to the association," and is not transferable or divisible. The trial testimony by the junior physicians' expert supported this decision, as he included the physicians' reputations in his goodwill value. If the senior doctors were to depart, "a large portion of the intangible value would go away," he conceded, and "that value would be hard to arrive at" because it was more speculative than scientific.

Partners in a professional association could still include personal goodwill in buy-sell or other contracts, the Court noted, but as these shareholders evidenced no such agreement, the junior physicians received no further award.

Ohio considers joining the majority view
The majority of U.S. jurisdictions now distinguish enterprise from personal goodwill in divorce actions. Family law practitioners can expect more cases to challenge the standard in the minority states, as the Bunkers case attests.

The husband owned a solo orthodontic practice, valued by his expert using the capitalization of earnings approach, using the past five years of earnings. (The opinion doesn't state the ultimate conclusion of value.) The wife's expert posited a fair market value standard and used only the most recent year's earnings to reach a value of over $2 million. The trial court adopted the wife's valuation standard but used the husband's five-year capitalization of earnings, adjusting the husband's income downward and applying a 10% "marketability discount" (which really reflected transactions costs upon sale). The court also applied a 42.41% pre-tax rate of return to the weighted average and concluded that the practice had a fair market value of just over $1 million.

The husband appealed, claiming that the value impermissibly included personal goodwill and urged the court to adopt the majority rule. But the Ohio Court of Appeals declined, relying on "thorough" precedent determining that all goodwill of a solo practitioner was subject to equitable division in divorce. The court rejected the argument that "goodwill is synonymous with future earnings" (where the court also awards spousal support); or that by valuing it, a court is improperly valuing a medical degree.

Texas stays true
The Nowzaradan case reads more like an episode of Dallas, involving a doctor-husband who filed a bad faith bankruptcy on the fourth day of his divorce trial. He obstructed the judicial process by withholding financial documents and failing to comply with court orders, creating havoc as well as heartburn. But just like a TV drama, at trial the bad guy lost: The court awarded the wife 70% of the marital estate, while the doctor received 30%--little more than the value of his surgery clinic.

On appeal, the husband contended that the valuation erroneously included professional goodwill. Although his expert had valued the clinic at $240,000 and the wife's expert at $1.2 million (income approach) and $550,000 (asset approach), the wide divergence was due more to the husband's many failures to comply with discovery. Both experts applied accepted methodologies and the appropriate state standard, distinguishing the clinic's commercial goodwill from any personal goodwill. Both experts had also assigned a specific value to personal goodwill and excluded it from their ultimate conclusions. The trial court reconciled the opinions by valuing the practice at $850,000. The appeals court affirmed both the decision and the good work by the appraisers in what appeared to be a very difficult case.

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