VALUATION Trends
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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.

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 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

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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.

Two Economic Damages Cases Dismissed for Lack of Reliable Valuation Evidence

***Gordon Partners v. Blumenthal,* 2007 U.S. Dist. LEXIS 9110 (February 9, 2007); *AccuWeb v. Foley & Lardner,* 2007 Wisc. App. LEXIS 61 (January 31, 2007)**

Two recent cases demonstrate what happens when plaintiffs fail to provide diligent, well-prepared valuation testimony to support their loss causation analysis—and what happens when the defense does.

Securities claims require reliable market study

The *Gordon* plaintiffs were hedge fund partners who had invested most of the fund's assets in NTL, Inc., with whom the partners had personal as well as business ties. At the start of 2000, an NTL share was worth over $100, and the hedge fund's entire investment was worth $30 million.

Within eight months, the NTL price declined to $44, and by May of 2001, to $31. Even so, the Gordon founder admitted he would not have sold NTL until its price dropped to $27.50 in mid-May. But at that time, the company announced a 32% increase in quarterly EBITDA and stated it was "on track" to reach its financial goals. The plaintiffs alleged that NTL made similar misleading statements through a major acquisition and attempted restructuring,

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despite knowing that both were plagued with serious problems. NTL stock dropped to an "all-time low" of $1.50 in September 2001, and bankruptcy followed in April 2002, wiping out all of the hedge fund holdings.

Alleging fraud and misrepresentation against NTL and its individual members (the defendants), the *Gordon* plaintiffs sought damages amounting to over $16 million for the period January 2000 through April 2002, calculated by relying on the price they paid for NTL stock as of August 2000.

The plaintiffs did not submit an expert report—but the defendants did. Their expert testified that plaintiffs' damage calculations lacked "any reliable basis" because they failed to adjust for market, industry, and company-specific factors that affected NTL's price during the loss period but that were unrelated to any alleged fraud, including a "marked decline" in the telecommunications industry.

Moreover, defendants' expert conducted a comprehensive, chronological assessment of public information available about NTL during the loss period, using regression analysis to study the material effect of each major report and finding few significant price reactions related to these publicized risks.

The plaintiffs called such analysis "an academic exercise" and "nonsense." In response, defendants asserted that the courts require "reliable principles and methods" to exclude unrelated price declines from any estimate of damages. The plaintiffs had merely booked all such declines into their measure of damages, and the Court agreed, dismissing all of their claims.

Fair market value of patent requires proof

In the second case, attorneys for plaintiff AccuWeb apparently allowed a technology patent to expire in 1995 by failing to pay a maintenance fee; AccuWeb sued, alleging legal malpractice and damages based on: (i) the loss of a potential sale of the company due to the loss of the patent; (ii) the loss of the fair market value of the patent; and (iii) the diminution of the future resale value of the business.

The attorneys filed for summary judgment on all claims based on a lack of causation as well as failure to prove damages with a "reasonable degree" of certainty. The appeals court agreed there was insufficient proof tying the lapse of the patent with the loss of the potential sale, which apparently failed due to general economic conditions.

As to the loss of the patent itself, AccuWeb claimed "uncontroverted" proof of its fair market value, but failed to explain what that value was or how a trier of fact could determine the amount. "More fundamentally," the Court said, "AccuWeb has not by way of testimony or affidavit demonstrated it has suffered any damages simply because the…patent lapsed."

AccuWeb did submit an expert report attempting to show its diminished value. The expert calculated damages as the difference between the value of the company's assets with the patent ($5 million to $10 million under the market approach, $6 million to $18 million under the income approach) and its value without the patent ($1.7 million to $3 million) on the date of the valuation report in November 2002. But the Court found that the expert should have valued the patent as of the lapse date in 1995. (The dissent disagreed, arguing that the date of the *report* had no bearing on damages, which could be measured on an ongoing basis up until the date of trial.)

Further, the expert assumed that without the patent, future competitors would be able to introduce similar technologies impacting AccuWeb's value, but the Court found this speculative. No competitors had in fact exploited the unpatented technology, and AccuWeb was unable to point to any who might with "reasonable" certainty.

Finally, a 1997 valuation of the company (two years after the patent lapse) had estimated its worth between $8.5 million and $11.5 million, with a "strategic value" of up to $22 million. These values fit within the expert's "undamaged" valuation as of 2002, and AccuWeb did not adequately reconcile the asserted damaged values to the 1997 appraisal. Though the dissent argued that the expert report raised a material dispute, the majority summarily dismissed all claims.

BV Appraiser Challenged Under Daubert *for Reliance On Third-Party Reports*

***In re Greater Southeast Community Hospital Corp.,* 2007 Bankr. LEXIS 1 (January 2, 2007)**

It's been nearly five years since Greater Southeast Community Hospital Corp. (GSCH) filed for Chapter

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11 protection. In 2004, the Bankruptcy Court for the District of Columbia confirmed the debtor's reorganization plan, by which the "Reorganized Debtors" succeeded to the operations and the pre-confirmation creditors succeeded to a Liquidating Trust. But the bankruptcy battles didn't end, and in 2005, nearly a third of the Court's published opinions (five out of sixteen) were related to the GSCH litigation—for which the Trustee received $1 million to cover some of the expense, including this most recent adversarial proceeding.

The Judge (Teel), who has presided over the GSHC bankruptcy since the beginning, provides none of the facts but only the disposition of this latest hearing, in which the defendants (various hospital entities) sought to preclude the expert for the plaintiff (the Trustee) from testifying at trial pursuant to the Federal Rules of Evidence and the U.S. Supreme Court standards set forth in the *Daubert* and *Kumho Tire* decisions.

When may valuation specialists rely on third-party appraisals?

Specifically, defendants claimed the expert was neither qualified nor independent, as he'd relied on third-party appraisals to prepare a net asset valuation, and because his income approaches were allegedly biased and based on flawed methodologies.

But a review of his "extensive" background in business valuation quickly led the Court to qualify the expert as capable of offering "expert net asset valuation and solvency opinions." And though the expert had apparently conceded his lack of qualification to perform real estate or equipment appraisals, all he needed to show was the "requisite knowledge, skill, experience, training, or education to competently render a net asset valuation opinion based on the opinions of others." It is permissible for BV analysts to rely on third-party reports, the Court said, "so long as those appraisals are of the type experts in the field of business valuation would reasonably rely on."

Allegations of bias more troubling

The defendants also complained that since the expert had acted as a "virtual member" of the Trust's legal team by recommending the adversarial suit, he was "biased and cannot be trusted to offer an objective and reliable expert opinion." The Court simply deferred these allegations to trial, when they would factor into the weight of the expert's opinion, not its credibility.

However, the defendants had also accused the expert of "selective reliance on data favorable to the Trust's litigation position." In particular, when valuing the improved real estate, he had excluded the one appraisal that contradicted the Trust's claims. This "self-serving determination" of reliability constituted an "impermissible weighing of the evidence," according to defendants, sufficient to warrant its exclusion.

The Court permitted the Trust to offer the expert report, but added this warning:

> As the finder of fact, I will address at trial whether the reasons asserted by [the expert] for disregarding the [appraisal] are sufficiently logical and persuasive to conclude that an expert in [his] field would reasonably *not* rely upon the [appraisal]. (Emphasis added.)

Although experts are "virtually always" required to make certain threshold determinations regarding which data to consider or reject, "nevertheless, an expert's selective exclusion of only that data which is unfavorable to his client's litigation position warrants close scrutiny by the Court," and any expert should be prepared at trial "to address what objective criteria he relied upon in making such determinations."

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