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Litigation & Valuation

REPORT

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Measuring the intangible

Valuation issues in health care transactions

In the highly complex and heavily regulated world of health care, business valuations can be particularly challenging. Last year's U.S. Tax Court decision in *Derby v. Commissioner* illustrates this point.

Looking at the history

Derby involved the sale of a medical group to a not-for-profit health care organization that was part of an integrated delivery system of hospitals and medical practices. The group contended that the value of the assets it transferred — including goodwill and other intangibles — exceeded the value of what it received in exchange. The group's members, therefore, claimed charitable tax deductions for their shares of this excess value.



The Tax Court denied the deductions, concluding that the physicians were unable to show that the value of what they received was less than the value of what they transferred. The lack of noncompete agreements with the physicians and the lucrative bundle of benefits they received played key roles in the court's decision.

Spreading the risk

In *Derby*, physicians who were part of an independent practice association called United Health Medical Group Inc. (UHMG) became affiliated with a larger health care organization so that they might better manage risk and take advantage of specific efficiencies and economies of scale.

Ultimately, UHMG settled on Sutter Health, a regional health care system that operated group medical practices through its not-for-profit subsidiary, Sutter Medical Foundation (SMF). These group practices, along with Sutter's affiliated hospitals, formed an integrated delivery system.

Sutter's primary objective in integrating medical groups was to gain immediate access to a roster of patients for its clinics and hospitals, but for legal and financial reasons it was unwilling to pay the UHMG physicians anything for goodwill or other intangibles.

On the advice of a health law attorney, the UHMG physicians decided to donate their practice intangibles to SMF and deduct the value of those charitable donations on their tax returns. This approach had been used successfully by other medical groups and was recognized in IRS training manuals for field agents.

Doing the deal

The physicians formed a professional medical corporation that did business as Sutter West Medical Group (SWMG) and then entered into a professional services agreement with SMF.

The professional services agreement, which required SWMG to provide professional services exclusively to

SMF's patients, was conditioned on at least 25 UHMG physicians becoming shareholder-employees of SWMG and selling their practices to SMF under prescribed asset purchase agreements. Although the professional services agreement contained a noncompete provision, it exempted physicians who left SWMG's employment.

The professional services agreement based SWMG's compensation on a percentage of net revenues from patients. The percentage varied depending on the type of revenues. It also provided for each full-time physician to receive a \$35,000 signing bonus. SWMG was also given a role in the management of SMF.

The court noted that the appraiser made no distinction between personal goodwill, which is associated with the individual practitioner, and enterprise goodwill, which is associated with the practice.

Ultimately, 29 UHMG physicians signed on, selling their practices to SMF and entering into physician employment agreements with SWMG. The agreements required the physicians to practice full time and exclusively for SWMG (except for a reasonable amount of volunteer work). The agreements also permitted departing physicians to solicit patients that were on their patient lists as of the agreement's effective date and obtain the medical records of patients who chose to go with them.

Each physician entered into an asset purchase agreement transferring all tangible and intangible assets related to his or her practice to SMF.

The parties engaged a valuation firm to determine the "business enterprise value" of the to-be-formed medical group and obtained a separate appraisal of the physicians' tangible assets. To determine the value of goodwill and other intangibles, the business valuation firm took the business enterprise value (which was based on a discounted cash flow analysis) and subtracted the value

of the fixed assets as well as the aggregate accounts receivable, which were retained by the SWMG physicians.

The residual, which was presumed to be the value of the intangible donation to SMF, was allocated among the SWMG physicians according to a formula devised by one of the physicians, not by the valuation firm.

Going to trial

In preparation for litigation in Tax Court, the SWMG physicians retained a new appraiser to value their intangible assets. The appraiser postulated that this value was equal to SWMG's business enterprise value less its "implied working capital" and its fixed assets.

The appraiser determined the enterprise value through a combination of income, asset and market methods. Significantly, in applying the income method, he based future distributable earnings on the median compensation of physicians in the region rather than on the actual, above-market compensation the SWMG physicians had negotiated. The appraiser concluded that this compensation "had no market value beyond the value of their professional services."

Implied working capital also was based on industry standards, and fixed assets were valued at their previous appraised value. He allocated intangible value among the physicians according to the formula described above.

The Tax Court noted that the appraiser made no distinction between personal (or professional) goodwill, which is associated with the individual practitioner (and isn't transferable), and enterprise goodwill, which is associated with the practice itself.

More important, however, the court found the physicians failed to show that they had donated their intangible assets to SMF. The physicians argued that they had received no consideration for intangibles because payment for goodwill would have been illegal. But this argument ignored the substantial consideration they received in the form of future employment with SMF. The asset purchase and physician employment agreements were contingent on each other, such that the entire arrangement was part of an integrated transaction in which the physicians sold their practices in exchange for future employment "on carefully delineated terms."

The court observed that SMF clearly wanted the physicians' patient lists and other intangibles and that the physicians "negotiated aggressively for the best terms they could get," which included employment with above-market compensation, signing bonuses, a management role, the absence of noncompete agreements and greater professional autonomy than other potential acquirers had offered. They had even turned down a previous deal with a for-profit organization that would have purchased their intangible assets because they feared a loss of autonomy.

In other words, the court said, the SMF deal allowed them to "maintain or improve their accustomed level of earnings from the practice of medicine," which was inconsistent with the "donative intent" required for

a charitable deduction. The physicians also failed to establish that their transfer of intangibles was a partially deductible "dual character" donation, because they were unable to demonstrate that the value of the intangibles exceeded the value of the benefits they received.

Using a holistic approach

Derby demonstrates that valuation in the context of a health care transaction requires a valuator to look at the entire relationship between the parties. This includes expected post-transaction compensation (including signing bonuses), the impact of noncompete agreements (or the lack thereof), intangible benefits (such as professional autonomy or participation in management) and other relevant terms of the deal. ♦

Are valuations recyclable?

The paper a valuation report is printed on may be recyclable, but in most cases the content is not. In fact, recycling a valuation may be downright hazardous to your legal health.

2 problems

Recycling valuations poses two major problems: First, the value of a business or other asset can change dramatically over time — in some cases, overnight. Second, a valuator's methods and conclusions depend to a large extent on the valuation's purpose.

So, unless you need to value an asset "as of" the same time and for the same purpose, reusing a previous valuation can lead to inaccurate results, not to mention admissibility problems.

Conflicting standards

Business owners may be tempted to stretch their valuation dollars by using a single valuation for several different purposes. But a valuation conducted for one purpose is likely to be inappropriate when used for another.

The most widely recognized valuation standard is fair market value, but several business and legal situations call for a different standard.



A business owner contemplating a sale, for example, would likely start with fair market value to get a feel for a reasonable asking price. But suppose a specific buyer is positioned to take advantage of tax benefits or operational synergies that wouldn't be available to other buyers. In that case, *investment value* might be more appropriate.

In a legal context, state or federal statutes, regulations or case law may impose a specific standard of value. In dissenting shareholder litigation, for instance, most states use *fair value* to determine a fair price for a shareholder's stock. But not all states define fair value exactly the same way. In some states, for example, it's similar to fair market value but doesn't recognize some adjustments, such as discounts for lack of marketability. Fair value also may exclude stock value appreciation or depreciation in anticipation of the event, such as a merger, that gave rise to the dispute.

Costly mistake

Let's look at a hypothetical example where recycling a valuation goes awry.

Frank is the owner of Frank's Auto Repair, which specializes in servicing European luxury imports. In 2007, he gives a 20% interest in the business to his son, Frank Jr. In connection with this gift, Frank has the business valued by a professional appraiser at \$1 million. The appraiser also values the gift to Frank Jr., after applying a 30% combined discount for lack of control and lack of marketability, at \$140,000.

In a legal context, state or federal statutes, regulations or case law may impose a specific standard of value.

In early 2009, Frank and his wife get divorced. To save money, he reuses the 2007 valuation and stipulates that the value of his 80% interest is \$800,000. This is a big mistake. Not only is the valuation out of date, but high gas prices and a struggling economy have discouraged consumers from buying luxury cars, so Frank's business

"GOODWILL" IN DIVORCE

Different valuation standards may apply in divorce cases, particularly when a significant marital asset, such as a business or professional practice, needs to be divided. Although most states apply fair market value, the treatment of goodwill varies dramatically from state to state.

Most states treat some or all goodwill as a marital asset, while a handful of states exclude goodwill entirely from the marital estate. Many states, however, make a distinction between personal goodwill (that is, goodwill associated with an individual spouse) and enterprise goodwill (that is, goodwill associated with the business, or practice, itself). These states include enterprise goodwill as part of the marital estate but treat personal goodwill as the owner-spouse's separate property.

has suffered. Had Frank consulted a valuator in 2009, he would have discovered that the business's value had declined to \$900,000, so that his 80% interest is now worth only \$720,000.

The valuator also would have advised Frank that, in his state, personal goodwill is excluded from the marital estate. The business depends heavily on the many repeat customers who patronize the repair shop because of Frank's reputation for reliability and integrity. The valuator would have concluded, therefore, that 40% of his interest in the business, or \$288,000, consists of goodwill and that 60% of that amount, or \$172,800, is attributable to Frank's personal goodwill.

By recycling a two-year-old valuation prepared for a different purpose, Frank overvalues his interest in the business, for divorce purposes, by \$252,800.

More trouble than it's worth

In our example, Frank's reliance on a recycled valuation costs him a lot of money. But it could have been worse. Suppose his wife had hired a valuator who valued the business at \$1.2 million and concluded that Frank's 80% interest was worth \$960,000.

In light of the limited relevance of Frank's valuation to the case at hand, a court would likely disregard it and rely on the opposing expert's conclusions. You can avoid Frank's mistake by obtaining a new valuation for any type of litigation in which valuation is an issue. ♦

Constructing a claim for lost productivity damages

When a construction project is disrupted through no fault of the contractor, lost productivity may be an important element of the contractor's damages. Quantifying the cost of lost productivity, however, is one of the most difficult challenges in construction litigation.

What is lost productivity?

Productivity generally refers to the amount of work a contractor can perform during a given time. Lost productivity simply means that an unanticipated disruption of the project causes the contractor to work less efficiently, which may lead to additional labor, equipment and material costs.

Lost productivity is often associated with a delay, but lost productivity damages and delay damages aren't the same thing. A contractor may suffer lost productivity even if the project isn't delayed. Of course, when a delay occurs, lost productivity may become a component of the contractor's damages.

How do you measure damages?

Appraisers can use several methods when quantifying lost productivity damages. Determining the appropriate method depends on the particular job's facts and circumstances. One difficulty in establishing damages is distinguishing whether additional costs were caused by lost productivity or by the contractor's failure to estimate correctly.

For this reason, one of the most common methods (and the one generally favored by the courts) is the measured-mile. It compares a contractor's productivity levels during periods in which work was disrupted with productivity levels during undisrupted periods. The advantage of using this method is that it reflects only recoverable productivity losses, eliminating the need to determine whether a loss is attributable, in whole or in part, to bidding mistakes.

The measured-mile method won't work, however, if a project is disrupted from start to finish. This is because periods of optimal productivity for use as a baseline



don't exist. Also, for a baseline period to be appropriate, it must involve work that's reasonably similar to the work being done during the disrupted period. Finally, the measured-mile method relies heavily on thorough documentation of the type of work being done, the disruptions to the work and the additional costs attributable to those disruptions.

Other methods for calculating lost productivity damages include:

Total cost method. Under this method, the appraiser calculates lost productivity damages by taking actual contract costs and subtracting the bid amount (taking into account agreed-upon change orders). Although this method's simplicity may be appealing, it fails to reflect productivity losses caused by bidding mistakes or otherwise attributable to the contractor. It also ignores the reasonableness of costs the contractor incurred. A "modified total cost method" attempts to address these problems by requiring adjustments to account for unreasonable bids or other cost overruns that are the contractor's responsibility.

Actual cost method. This method, which relies on actual cost and productivity numbers, is the most accurate, but it may not be practical. Why? First, the labor-intensive nature of the method may render it cost prohibitive. And second, it demands detailed, accurate records that include productivity measurements — something few contractors possess.

Jury verdict method. Essentially, this method involves an educated guess on the part of the trier of fact. Some

courts have allowed this method when it's clear that a contractor suffered lost productivity damages but there's no other reliable method of quantifying those damages.

How do you build a case?

Proving lost productivity damages requires lawyers and damages experts to work together closely to establish lost productivity. They also need to identify its causes, document the additional costs involved and select the most appropriate method for measuring it. ♦

VALUATIONS SHOULD ASSUME REASONABLY PRUDENT MANAGEMENT

In *Cox Enterprises, Inc. v. News-Journal Corporation*, the U.S. Court of Appeals for the Eleventh Circuit held that a going-concern valuation should assume that a business “will be managed in a reasonably prudent manner going forward, regardless of how poorly it may have been run in the past.”

News-Journal Corporation (NJC) is a closely held Florida corporation that publishes the *Daytona Beach News-Journal* and several shopping guides. Cox Enterprises (Cox) is a privately held, Atlanta-based corporation that owns 17 daily newspapers throughout the Southeast and had owned a 47.5% interest in NJC. NJC's CEO and members of his family owned the remainder of its stock.

Under the guidance of its CEO, NJC provided millions of dollars in financial support to several not-for-profit cultural organizations. Upon learning of these activities, Cox sued NJC, alleging various acts of fraud, waste and mismanagement. Pursuant to Florida law, NJC elected to buy back Cox's shares at “fair value.”

The parties were unable to agree on the fair value of the stock, so the federal district court held a bench trial to determine that value.

Trial court uses normalized earnings

Cox's expert valued its shares based on NJC's fair market value as a “going concern.” He used a comparable sales analysis and also performed a discounted cash flow analysis as a check on his comparable sales approach.

In determining NJC's value, Cox's expert “normalized” NJC's 9.3% operating margin to 28.3%, which was the average operating margin of 11 publicly traded newspaper companies at the time. He estimated the company's value at \$306 million, or \$145.35 million for Cox's shares.

NJC's valuation expert relied exclusively on a discounted cash flow approach, but he assumed that NJC would maintain its historical operating margins going forward. Using this approach, he arrived at a value of \$61.9 million, or \$29.4 million for Cox's shares.

The district court adopted Cox's valuation approach. The court, however, found it more appropriate to normalize NJC's operating margin to the average of similar closely held newspapers (24.8%), rather than the 11 public companies the expert had used. Based on this approach, the court determined that the fair value of Cox's shares was \$129.2 million.

11th Circuit agrees

On appeal, NJC challenged, among other things, the district court's interpretation of “going concern” and its normalization of NJC's earnings. But the appellate court upheld the district court's approach, explaining that “to apply a definition of ‘going concern’ which requires a valuation on the basis of any previous mismanagement or waste would provide an incentive for majority shareholder/directors to violate fiduciary duties and commit waste to drive down the value of minority shares.” Thus, the appellate court found that normalizing NJC's earnings was appropriate.