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Fiduciary Duty Prevails, Defendents' Fail to Offer Alternative Computations

Taheri v. Khadavi, 2012 Cal. App. Unpub. LEXIS 312 (Jan. 17, 2012)

After establishing a successful dermatology clinic, two doctors decided to open a separate surgery center with a third doctor, an anesthesiologist. Without putting anything in writing, the three doctors agreed to invest equal amounts in the new clinic and share profits equally. They did not discuss the number of patients each would be expected to treat or the business each would be expected to generate.

Instead, they assumed that one of the doctors, who was independently involved in several other dermatology practices, would send his patients for treatment at the new center, for which it would charge a facility fee. Otherwise this doctor would not have any active role in the center's daily operations or management.

A doctor defrauded. After a two-year wait, the surgery center finally underwent an inspection by the Accreditation Association for Ambulatory Health Care (AAAHC), which promised accreditation within two weeks. Despite the positive report, the two managing doctors told the third, nonactive partner that the surgery center had failed its AAAHC accreditation and that he needed to sell his interest "right away" to the anesthesiologist, who would use the clinic for minor procedures and extra office space. The sale price was $140,000.

Accordingly, in March 2006, the two dermatologists sold their 33.3% shares to the anesthesiologist for a total of about $283,000. Three weeks later, AAAHC awarded accreditation and the surgery center opened for business. The nonactive doctor had no idea of these events—or that six months later, the other doctor bought back into the practice for $282,700 (thus repaying the anesthesiologist what he'd just spent). In 2006, alone, the two partners withdrew a total of $600,000 in profits from the center. When their former, nonactive partner finally learned what they'd done in 2008, he sued for fraud and breach of fiduciary duty.

At trial, the plaintiff's damages expert said he was entitled to recover over $5.3 million in lost profits, which represented one-third of the over $16 million in profits that the center had made from the three years since its inception to the time of trial. The expert based these calculations on the center's financial records and included salary deductions (totaling over $1.9 million) for the still-practicing defendants.

The plaintiff's expert also calculated the surgery center's value under three methods. From this total, she deducted the amount the plaintiff received for the sale of his interest ($140,000) to calculate his proportionate (33.3%) share of business at $3.7 million. From a possible total of approximately $9 million in total lost profits and business value, the jury awarded the plaintiff just over $8 million, but then added nearly $1 million in punitive damages, and the defendants appealed.

Defendants could have put on their own expert. The defendants first argued that since the plaintiff had ratified the sales agreement, he could not recover lost profits, but was limited to recovering the actual value of his shares at the time of the sale. Under California law, however, when a plaintiff is defrauded by its fiduciaries, it is entitled to the "broader" measure of damages, including the actual value of the property that was taken as well as any prospective profits, the court

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held. In this case, given the defendants' breach of fiduciary duties, the plaintiff could recover lost profits and the value of his shares at the time of trial.

Even if the plaintiff was entitled to lost profits, the defendants claimed, his evidence did not reliably support the jury's award. But the court said despite having the opportunity, the defendants did not present a damages expert at trial to criticize the analysis, methods, and conclusions by the plaintiff's expert. For these reasons, the appellate court found sufficient evidence to support the $8 million lost profits and lost business value award, plus $1 million in punitive damages.

Can Your Enthusiasm Hurt Your Case in the Delaware Chancery Court?

Being passionate about your work is a good thing, of course, but can that enthusiasm hurt valuation experts if they bring it into court? When is the line crossed between independence and advocacy?

Experts don't have to be shrinking violets, but they detract from their usefulness when they are looking for ways to help the attorney win the case, says Vice Chancellor Donald F. Parsons Jr. of the Delaware Court of Chancery. Parsons isn't troubled if experts stick to their bailiwick, even if they do so with vehemence. The trouble is when the experts become members of the legal team and start coming across as yet another agent for the plaintiff or defendant.

Kevin Shannon, a partner at Potter, Anderson & Corroon LLP, agrees. He thinks there's no problem with an enthusiastic expert, assuming he or she is reasonable and well-supported in his or her position. The line gets crossed when experts take unreasonable positions, such as saying to the client, "Look how high I can get your damages."

To avoid being too partisan, Parsons suggests that experts should have a healthy skepticism about the case-related information the party supplies them. That doesn't mean doubting the documents provided. But if something sounds a little unusual or surprising, the expert should question it. Experts cannot appear spoon-fed and unwilling to probe a little bit deeper into the material if necessary.

The real risk for experts is to lose credibility, as Shannon points out. The court disregards unreliable testimony, so it is important that experts take positions that are grounded in existing finance theory and facts. Better for a client to have a sound number than go in with an exaggerated number that the court just disregards. When this occurs, the court focuses on the other side's experts and either makes some small changes or simply accepts his or her testimony.

Are We Still Confused About Goodwill?

Courts across the U.S. still struggle to determine and divide goodwill in divorce cases—particularly in those jurisdictions that follow the majority rule and require making a distinction between personal goodwill (nondivisible) and enterprise goodwill (divisible). "Or is it the valuator who is confused?" asked presenters Sharyn Maggio (Maggio & Co.) and Miriam Mason (Mason Black & Caballero) at the recent AICPA/AAML National Conference on Divorce in Las Vegas.

Some appraisers might consider Maggio lucky; she practices in New Jersey, which does not recognize the distinction. "It's all divisible," Maggio said, "but I work with one practitioner who insists that with respect to a highly skilled professional, there is no goodwill: It's all personal." Other states' courts have agreed, relying on an inverse argument. For example, in a Missouri decision, the husband claimed he was a key employee in his seven-man roofing business, but the court declined to reduce its value by any personal goodwill, finding the husband didn't provide the highly skilled professional services that would qualify.

> Some courts have determined that all professional goodwill must be salable to be divisible...

Some courts have determined that all professional goodwill must be salable to be divisible, as evidenced by a noncompete; still others preclude the appraiser from assuming the presence of a noncompete. Notably, in Gaskill v. Robbins (2009), the Kentucky Supreme Court held:

> *While fair market value of [the wife's practice] anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a "fire sale," meaning that it must be valued in its existing state. This precludes factoring in a nonexistent non-compete clause, as there is no requirement that [the wife] enter into one other than as a possible negotiated term of a real sale.*

The Gaskill court also required that any goodwill value "must" have a rational basis in accounting principles and "should avoid speculation and assumptions as much as possible." This language is a "little disconcerting," Maggio said. BV appraisers have to make assumptions, particularly regarding goodwill. "But courts don't like it," she added, noting that Gaskill is a "must read" case, no matter where you practice. In fact, this year the case came up again after another trip through the courts, and the appeals court affirmed the previous decisions.

Well-Planned FLP Survives IRS Challenge

***Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012)**

It's hard to imagine a better set of facts supporting the formation, funding, and operation of a family limited partnership (FLP), yet still the IRS took issue. In 1990, a widow inherited her husband's quarry business plus additional real property and stock. Shortly thereafter, she executed a will leaving many of the specific assets to her three grown children, dividing the residual equally among them.

Some years later, when their mother was suffering from Alzheimer's, the three children (who all managed the family businesses in various capacities) agreed to divide their mother's estate equally and petitioned the probate court to become her co-guardians.

Three FLPs plus a corporate GP. An estate attorney advised the creation of three FLPs, one for the benefit of each grown child, plus a corporation to serve as general partner (GP) for all three. Each FLP would receive equal assets, while the mother would retain over $1.1 million in a separate guardianship account for her living expenses.

The corporate GP would also receive a "reasonable management" fee for its services, thus ensuring that the mother (who would own all the stock in the corporation) would receive "adequate income to cover [her] probable expenses for support, care, and maintenance for the remainder of [her] lifetime." Finally, they noted the plan should reduce estate taxes by nearly $3 million.

The probate court approved the plan in June 2003. In December 2003, the mother transferred equal values of stock and other property to the FLPs. Over the next three years, she gave partnership interests to the three children, with appropriate entries to her capital accounts. During the same time, the children maintained the properties and the accounts. They also met regularly as officers and directors of the corporate GP.

> ...her estate argued that the decedent's transfer of assets met the "bona fide sale" exception to Sec. 2036(a) because she had "legitimate and significant nontax reasons" for creating the FLPs ...

In 2005, the mother died. Her federal estate tax return reported her remaining ownership interests in the FLPs as well as her full (100%) ownership of the corporate GP. Three years later, the IRS assessed a deficiency of just over $2.2 million based on its determination that the full fair market value of the FLP assets should be included in the decedent's estate pursuant to IRC Sec.

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2036(a). In response, her estate argued that the decedent's transfer of assets met the "bona fide sale" exception to Sec. 2036(a) because she had "legitimate and significant nontax reasons" for creating the FLPs and because she received partnership interests proportionate to the value of the transferred property.

Estate (but not tax) planning is paramount. The facts substantially supported the mother's position: including the mother's clear and primary concern to distribute her estate equally among her children; her legitimate concern about the management of the assets, which was undertaken by her children; and that she received appropriate partnership interests in the FLPs. Although the probate court petition mentions estate tax planning, the court held that "there is no evidence that tax savings motivated the defendant." Thus the value of the FLP transfers fell within the bona fide sale exception to Sec. 2036(a).

As a second argument, the IRS claimed the parties had an implied agreement that the decedent would continue to enjoy the income from the FLPs during her lifetime. The court rejected this argument, too.

The decedent had a bona fide purpose for creating the FLPs, and she had a bona fide purpose for creating the corporation to manage them. She also appropriately reported the full value of the corporation on her estate tax return. Based on all these facts, the court excluded the value of the FLPs from the decedent's gross estate.

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