# Court Decision on Loss of Goodwill Results in Sour Grapes for Business Owners

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California is one of only a few states in which a business may recover for loss of goodwill when property is taken by eminent domain, but even here there are limitations on a business' right to recover for such damages. Before a business can submit its goodwill claim to a jury, there are a number of procedural obstacles that must first be satisfied. These include demonstrating that the loss (i) is caused by the taking, (ii) cannot be prevented by relocation or other reasonable mitigation efforts, and (iii) will not be covered through another form of compensation, such as relocation benefits. A recent California Court of Appeal decision has added one additional procedural hurdle for businesses, and has provided guidance on the judge's role as gatekeeper to determine what evidence, if any, a business can present to a jury to support a claim of lost business goodwill.

In People ex rel. Department of Transportation v. Dry Canyon Enterprises (Nov. 28, 2012, Case No. B234198), the Court held that before a jury can determine the amount of a business' goodwill loss, in addition to satisfying the three express statutory conditions described above, the business must also prove to the judge that it had goodwill before the taking. While the existence of pre-taking goodwill has always been an implied essential condition to recovery (as there can be no loss if there is no goodwill in the first place), adding such a finding to the list of court-determined preconditions is a new requirement.

**Background**
In Dry Canyon Enterprises, Caltrans sought to condemn a strip of Dry Canyon's vineyard to widen Highway 46. The strip of land was home to 1,466 vines slotted to be used for the vineyard's flagship cabernet wine. The parties agreed on the price to be paid for the land and vines ($203,500), but went to trial to determine the amount by which the taking diminished Dry Canyon's goodwill.

Given that Dry Canyon's flagship wine was not profitable, as every year its liabilities exceeded its assets, Caltrans' goodwill appraiser concluded the business possessed no goodwill prior to the taking, and

consequently there could be no loss. In contrast, Dry Canyon's appraiser utilized two appraisal methodologies and concluded that the business suffered a $240,000 loss of goodwill.

Under the business appraiser's first methodology, the "cost to create" approach, the appraiser calculated the loss by adding up all the costs the business incurred (not just the costs associated with the 1,466 vines) in the first four years of its operations, and then divided the figure by four since the 1,466 vines represented approximately 1/4 of the vines destined for the cabernet. These expenditures, according to the appraiser, established what it cost to create the business' goodwill.

Under the business appraiser's second methodology, a newly invented "premium pricing" approach, the appraiser determined the premium that the flagship wine would generate per bottle versus a hypothetical wine grown at an inferior location. The expert then multiplied this premium (about $10 per bottle) by the number of estimated bottles of wine that would be lost over the next 15 years due to the take. The appraiser concluded that this loss of premiums represented the "lost goodwill."

After the parties rested, Caltrans moved for a non-suit, arguing that the business had not proven it had any goodwill to lose. Despite the business' appraiser's presenting an opinion of $240,000 in goodwill loss, the court granted the motion and entered judgment in favor of Caltrans, taking the case out of the hands of the jury. The court concluded that the cost to create method was a reliable measure only when the business clearly had goodwill to start with, and the taking caused a total loss of goodwill. Neither circumstance was present here. The court also found the premium pricing methodology to be nothing more than an improper "disguised attempt to seek lost profits from a single product which is assessed in a vacuum."

**The Appeal**

On appeal, Dry Canyon argued that it was inappropriate for the court to take the case away from the jury because (i) the existence of pre-taking goodwill is never a question for the court, and (ii) the business' expert testimony amply established the existence of goodwill. The Court rejected both arguments.

-- *The Existence of Pre-Taking Goodwill is a Question for the Court, Not the Jury*

With respect to the business' first argument, that the existence of pre-taking goodwill is not a question for the judge, the Court of Appeal explained that while a business has the right to have a jury determine the amount of goodwill loss, this right only attaches if the business meets the qualifying conditions for such compensation. As set forth expressly by statute, the qualifying conditions include (i) that the loss was caused by the taking, (ii) that the loss could not be prevented by relocation or other reasonable mitigation efforts, and (iii) that compensation for the loss will not be duplicated through recovery under another source such as relocation benefits. (See Code Civ. Proc., § 1263.510.) While each statutory condition refers to "loss" of goodwill, nowhere does the statute explicitly provide that proof of preexisting goodwill is an essential condition to recovery. Nevertheless, the Court found that such a finding was clearly implied, and bluntly stated: "We now make it a precondition."

-- *The Judge Has Wide Discretion in Acting as a Gatekeeper to Exclude Speculative Opinions*

With respect to the business' second argument that it presented ample evidence of the existence of goodwill, the Court of Appeal explained that the trial court judge appropriately exercised its role as gatekeeper in concluding the business' appraiser failed to present any competent evidence of lost goodwill. Specifically, the Court explained that goodwill is universally determined by looking at profits – something Dry Canyon did not yet possess. While one previous case has allowed for recovery under the cost to create

approach (Inglewood Redevelopment Agency v. Aklilu (2007) 153 Cal.App. 4th 1095), the Court explained that particular case was an exception to the rule, and its application was limited to situations in which there was preexisting goodwill and a total loss of that goodwill due to the taking. Neither circumstance applied here. Since Dry Canyon had never turned a profit, the Court also rejected the use of the "premium pricing" approach, stating that it was simply an invention of the appraiser and was completely subjective and subject to manipulation.

**Conclusion**

Based on Dry Canyon, it is now clear that before a business is entitled to a jury determination on loss of business goodwill, the business must prove to the judge that it had goodwill to lose in the first place. This makes sense, as a jury determination on the issue would be nothing more than an act in futility if the judge determined as a matter of law that there was no goodwill to lose. Notably, however, the Court left open exactly how the judge performs its role in making the precondition findings, and what burden the business owner bears in demonstrating preexisting goodwill.

While there appeared to be a recent trend of judges passively backing away from their role as gatekeeper and allowing everything to go to the jury, Dry Canyon emphasizes the importance and significance of the judge's gatekeeper function. This gatekeeper responsibility is often a complex task, especially with goodwill claims, as financial figures are easily subject to wide fluctuations and manipulation. If the judge permits the introduction of too much speculative or conjectural evidence, a jury is tainted with improper theories that could yield artificially inflated values. Alternatively, if the judge prohibits the introduction of the business appraiser's opinions, the jury may never hear about "creative" approaches to valuation and, as in this case, leave nothing for the jury to decide.

Dry Canyon also serves as a warning to businesses, as the more a business' appraiser strides into uncharted waters using creative valuation methodologies, the greater the risk of exclusion. The ability to utilize the cost to create approach, in particular, may be significantly limited by this decision.