Lightning Strikes Twice, MRI Associates Wins Big Again—Halloween Verdict Proves to Be Frightening to Regional Health System

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On October 31, 2011, MRI Associates, Inc. (MRIA) was awarded $52 million in economic damages by an Idaho jury for claims relating to a variety of alleged breaches on the part of Saint Alphonsus Diversified Care, Inc., and Saint Alphonsus Regional Medical Center (collectively, "SARMC"). The breaches related to a magnetic imaging joint venture. The verdict represented the second time in four years that an Idaho jury ruled in favor of MRIA regarding substantially the same complaint. This discussion presents the key facts and circumstances regarding the case, with an emphasis on the damages models and related opinions offered by the financial experts retained by each party.

Introduction

In the matter of *MRIA v. SARMC*, the October 31, 2011, jury verdict awarding $52 million to MRIA represented the second largest jury verdict in Idaho history.

While the amount of this jury award is noteworthy in and of itself, of possibly equal significance is the fact that the largest jury verdict in Idaho history—an award of $63 million—was awarded to MRIA for the same litigation, tried initially in 2007.

A review of the 2007 jury decision by the Idaho Supreme Court resulted in (1) a reduction in estimated economic damages to $36 million, and (2) a remand of the case to the District Court for retrial.

After approximately 10 weeks of trial in 2011 (comparable to the trial period in 2007), the jury once again found in favor of the plaintiff and awarded slightly more than $52 million in economic damages to MRIA.

Because the basis for any jury decision can never be established with certainty, this discussion focuses primarily on the arguments presented by the legal counsel for each party.

In particular, this discussion describes (1) the economic damages models and (2) the related opinions offered by each party's respective financial experts.

The topics addressed in this discussion include the following:

1. The facts of the case
2. The plaintiff claims
3. General economic damages theory
4. Calculating the amount of economic damages
5. The plaintiff's economic damages theory
6. The defendant's economic damages theory
7. The jury verdict

The Facts of the Case

MRIA was created in April 1985 through a partnership among several health care entities. At its formation date, the partners in MRIA included the following:

1. SARMC, a not-for-profit, tax-exempt hospital system
2. Two other (taxable) hospital partners
3. Doctors Magnetic Resonance, Inc. (DMR), an Idaho-based, private radiology practice

Based on the partnership agreement, MRIA was formed to purchase or lease and transfer medical diagnostic devices, equipment, and accessories. The initial diagnostic equipment acquired was a magnetic resonance imaging device.

The partnership agreement provided for the creation of a single limited partnership, MRI Center (MRIC). MRIC was formed in August 1985 for the general purpose of operating a magnetic resonance imaging scanning facility on the SARMC main campus in downtown Boise, Idaho.

MRIC was expected to provide MRI services to SARMC, Mercy Medical Center, and Caldwell Memorial Hospital inpatients and outpatients, as well as other patients referred by physicians.

MRIC was structured to rely on MRIA for management services. And, MRIC contracted to pay MRIA an annual management fee.

The other operating unit of MRIA was MRI Mobile (MRIM), an entity that provided magnetic resonance imaging services through mobile units throughout the Treasure Valley in Idaho.

The partnership agreement provided that any hospital partner could withdraw from the partnership at any time under certain conditions.

In sum, a hospital partner could withdraw if its continued participation in the partnership:

1. jeopardized the tax-exempt status of the hospital partner or its parent or subsidiaries,
2. jeopardized Medicare/Medicaid or insurance reimbursements,
3. was contrary to the ethical principles of the Catholic Church, or
4. would violate local, state or federal laws.

The Partnership Agreement

The partnership agreement permitted a partner to sell or transfer an interest in MRIA to the partnership or to another partner. However, a partner receiving a third-party offer to acquire its interest in MRIA was first required to give the other partners an opportunity to purchase that partnership interest before accepting the offer.

Finally, the partnership agreement contained a noncompetition covenant that prohibited the partners from engaging in competitive activities.

The Noncompetition Agreement

The noncompetition covenant related to both:

1. those business activities in which the partnership was engaged and
2. those prospective business activities whose development received unanimous support from the partners.

Each partner was forbidden from engaging in any competitive activity while a partner, a shareholder of a partner, or an affiliate of a partner.

Further, both the private physician partner group and SARMC, and any of their respective affiliates, were forbidden from engaging in any competitive activity for a period of two years after lawfully terminating membership in the partnership.

On April 1, 2004, SARMC dissociated from the partnership. SARMC ultimately affiliated with a group of area radiologists operating as Gem State Radiology (GSR).

Prior to dissociating from the partnership (i.e., October 1998), SARMC announced plans and engaged in activities resulting in the formation of Intermountain Medical Imaging (IMI).

IMI operated as a freestanding medical imaging center that provided, in addition to other services, magnetic resonance imaging services. The IMI operations ultimately competed directly with the MRIA operations.

The Plaintiff Claims

In sum, MRIA claimed that certain conduct of SARMC, prior to SARMC's dissociation from MRIA, resulted in the diversion of business from MRIC and from MRIM to IMI.

Specifically, MRIA pressed the following claims against SARMC:

1. Breach of noncompete clause
2. Breach of covenant of good faith and fair dealing
3. Intentional interference with prospective contractual, economic relations, or business expectations
4. Breach of fiduciary duty
5. Engagement in civil conspiracy

General Economic Damages Theory

Economic damages generally are recognized as a loss in "value," often characterized as lost profits, experienced by one party as a result of another party's alleged actions.

From a legal perspective, the plaintiff has the burden of establishing (1) causation (i.e., that damage actually was experienced) and (2) damages (i.e., that economic loss actually was incurred).

The first hurdle for the plaintiff, establishing causation, requires adequately addressing three legal principles:

1. Proximate cause
2. Reasonable certainty
3. Foreseeability

Proximate Cause

Simply stated, the principle of proximate cause addresses the concept that the defendant's alleged wrongful actions represented the proximate (i.e., approximate) cause of the economic damage experienced by the plaintiff.

As implied in its definition, the proximate, or approximate, cause should not be interpreted as representing the sole cause of the plaintiff's economic damage.

Generally, the plaintiff must prove that the defendant's alleged actions represent at least the major cause of the economic damage experienced by the plaintiff.

Reasonable Certainty

The principle of reasonable certainty relates to the premise that the plaintiff actually experienced economic damage. In essence, the plaintiff carries the burden of proving that economic losses were actually incurred.

It is noteworthy that courts do not require absolute certainty. Rather, courts require only that economic damages are capable of measurement based on known reliable factors and are free of undue speculation.

Foreseeability

The concept of foreseeability is an element of contract law. Generally, foreseeability relates to the premise that the economic damages experienced by the plaintiff were a natural and probable result of the alleged wrongful actions (i.e., contract breach) of the defendant.

Calculating the Amount of Economic Damages

First, the plaintiff must establish the fact that it has experienced damage, through satisfying the following principles:

1. Proximate cause
2. Reasonable certainty
3. Foreseeability (in a breach of contract claim)

Second, the plaintiff must establish the actual amount of economic damages that it suffered.

Generally, and with regard to a lost profits case, proving the fact of damages requires the plaintiff to establish that there would have been some profits absent the alleged wrongful actions of the defendant.

Current literature indicates that economic damages typically are estimated based on the application of some variation of one or more of the following damages methods:

1. The before-and-after method
2. The yardstick (comparable) method
3. The sales projection (but-for) method

The Before-and-After Damages Method

The before-and-after method is based on the premise that economic damages reasonably can be estimated by comparing:

1. actual profits realized by the plaintiff company during the damage period with
2. projected profits for the plaintiff company assuming no wrongful acts had been committed.

In essence, the difference between the projected profits (before the alleged wrongful acts and assuming the continuation of pre-damage operating results) and the actual profits (after operations have been negatively impacted by the wrongful acts) represents the economic damages.

Economic damages based on this method are represented by the present value of the difference between the plaintiff company's projected performance (before the alleged wrongful acts) and its actual performance (after the alleged wrongful acts) during the damage period.

The Yardstick (Comparable) Damages Method

The yardstick (comparable) method is based on the premise that economic damages reasonably can be estimated by estimating the performance of the plaintiff company on a trend line that parallels the performance of comparable companies or the plaintiff company's relevant industry.

The difference, or delta, between the actual operating results of the plaintiff company and the trended operating results for the plaintiff company represents the economic damages based on lost profits.

Economic damages based on this method are represented by the present value of the difference between the plaintiff company's projected performance (based on the comparable company or industry-based trend line) and its actual performance (negatively impacted by the alleged wrongful acts) during the damage period.

The Sales Projections (But-For) Damages Method

The sales projections (but-for) method essentially requires the development of a company-specific performance model for the plaintiff company, considering relevant industry and economic factors, as well as required rate of return projections.

Using the model, operating results for the plaintiff company are projected over the damage period, absent the impact of the alleged wrongful acts.

The plaintiff is assumed to have incurred economic damages to the extent that projected results exceed actual results over the damage period.

Economic damages based on this method are measured by the present value of the difference between the plaintiff company's projected performance (based on the company-specific performance model) and its actual performance (negatively impacted by the alleged wrongful acts) during the damage period.

The Plaintiff's Economic Damages Theory

MRIA was represented by the Boise-based law firm of Banducci, Woodard, Schwartzman, PLLC (BWS).

The damages theory presented by BWS was based on the argument that certain actions of SARMC relating to its affiliation with IMI were wrongful.

These actions resulted in IMI realizing scan business that otherwise would have gone to MRIA (either MRIC or MRIM).

Extending the damages theory, BWS argued that the lost scans could be converted to lost revenues, which ultimately resulted in lost profits to MRIA.

Through its experts, FTI Consulting, Inc. (FTI), and Willamette Management Associates (WMA), BWS presented a bifurcated economic damages claim.

The BWS law firm argued that:

1. MRIA experienced historical lost profits, represented by the economic value of estimated lost scans that were diverted from MRIA to IMI (roughly covering 1999 through 2010), and
2. MRIA experienced future lost profits, represented by the economic value of projected lost scans from 2011 through the initial termination period of the partnership (i.e., 2015).

BWS also presented evidence of a "disgorgement theory." Based on the disgorgement theory, BWS argued that the profits realized by SARMC as a result of its affiliation with IMI represented ill-gotten gains that could be viewed as a measure of the economic damages experienced by MRIA.

It is worth noting that the measure of economic damages resulting from the disgorgement theory

presented by BWS represented approximately 50 percent of the economic damages ultimately awarded to MRIA by the jury.

Historical Lost Profits

The historical lost profits analysis completed by FTI was based on an extensive review of referral patterns between physicians in the Treasure Valley and MRIA, and considered the migration of scans from MRIA to IMI that historically were:

1. administered on the SARMC campus, and
2. attributable to physician referrers who either were exclusively affiliated with SARMC or had referred to MRIA before IMI opened.

FTI converted the estimated lost scans to estimated lost revenues and related profits. The estimated lost revenues and related profits were based on a financial analysis of historical operating results for MRIA and were net of estimated capital investments required to maintain the service capacity needed to provide the estimated lost scans.

Future Lost Profits/Lost Business Value

WMA estimated the amount of economic damages relating to lost future profits. This analysis was based on a consideration of:

1. a projection of operating revenues and related profits for MRIA through 2015, continuing from the historical point at which historical losses estimated by FTI ended, and
2. the estimation of the decrease in business value experienced by MRIA as of the end of 2010 based on the indicated number of diverted scans and related revenues and profits lost in 2010.

The damages calculations completed by WMA were intended to represent alternative means of examining the forward-looking economic damages incurred by MRIA.

In essence, the estimated decrease in business value experienced by MRIA as of the end of 2010 was analyzed from the perspective of representing a comparable level of future loss experienced by MRIA.

This estimated decrease in the MRIA business value was calculated based on:

1. the estimated decrease in scans and related revenues and profits for the year and
2. the projected lost profits for the five-year period through 2015.

Future lost profits were estimated based on the utilization of standard discounting methodology, comparable to that which is employed to complete a discounted cash flow analysis.

The lost business value experienced by MRIA was estimated based on the utilization of standard guideline publicly traded company analysis, applying adjusted valuation multiples to the estimated 2010 lost revenues of MRIA.

The Defendant's Economic Damages Theory

SARMC was represented by the Boise-based law firm of Gjording & Fouser, PLLC (G&F), and the Washington, D.C.–based firm of Jones Day (JD).

The defense presented by legal counsel to SARMC was based on the theory that industry, economic, and competitive factors—including IMI's right to compete against MRIA in the relevant market area with SARMC as a partner—primarily were responsible for any observable decline in the MRIA operating results.

Through its expert, NERA Economic Consulting (NERA), G&F and JD presented a damages defense arguing the following points:

1. Because SARMC dissociated from MRIA on April 1, 2004, SARMC legitimately could compete with MRIA after the expiration of a one-year restriction period.
2. Any observable decline in historical scan volumes of MRIA could be attributed to numerous factors, including physician referral choice, patient location choice, the existence and growth of IMI as a formidable competitor in the marketplace, and the presence of other competitors in the marketplace.
3. Regression analysis provided strong evidence that the alleged actions of SARMC did not cause any observable decline in historical scan volumes of MRIA.
4. Actions of MRIA (such as the firing of GSR, the radiology group that historically "read" scans completed by MRIA) were actually responsible for the historical decline in scan volumes experienced by MRIA.

Based primarily on regression analysis, NERA concluded that MRIA experienced either:

1. no economic damages that were attributable to the alleged wrongful acts of SARMC, or
2. economic damages that were no greater than $2.1 million.

The Jury Verdict

After approximately 10 weeks of trial, and hearing the arguments and theories presented by counsel and their respective experts, the jury awarded approximately $52 million in economic damages to MRIA, attributable to the alleged wrongful acts of SARMC.

The economic damages awarded by the jury compared to economic damages presented at trial by BWS of approximately $60 million, representing the cumulative total of historical damages and future damages calculated by FTI and WMA.

Summary and Conclusion

In the matter of *MRIA v. SARMC*, the jury decision rendered in favor of MRIA suggests that the regression analysis serving as the foundation for the SARMC damages expert was not persuasive.

Further, the legal strategy presented by BWS—bifurcating economic damages into historical lost profits and future lost profits—after apparently having established a solid causation foundation, appears to have resulted in an unbeatable position, for the second time in a row.

The outcome of this judicial decision is instructive for parties involved in medical joint ventures.

In addition, from an analytical perspective, financial experts should take note that a combination of "but-for" analysis and projection analysis, combined with generally accepted business valuation methodology, resulted in a successful presentation of economic damages.

Notes:

1. MRI Associates, Inc., et al. v. Saint Alphonsus Diversified Care, Inc., et al., CV-OC-2004-08219 Id. Dist. Ct. (4th Jud. Dist. Oct. 31, 2011).

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Insolvency and Bankruptcy Tax Planning

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Such decisions can have tax consequences, including whether—and when—an "excess loss account" would be triggered under the consolidated return regulations.

ERISA Liabilities

Proper insolvency planning should take into account whether a business has:

1. unfunded pension plan liabilities, including multiemployer plan exposure or
2. potential liabilities for violations of the statutes governing the administration and operation of employee benefit plans.

While outside the scope of this discussion, such liabilities may often determine the fate of a business reorganization. And, such considerations can be very difficult to shed or otherwise modify, even within the context of a chapter 11 plan.

Section 382 Net Operating Loss Considerations

Even a cursory examination of this subject would consume far more space than permitted in this overview.

Suffice it to say that limitations on net operating losses will be affected differently, depending upon whether a restructuring is conducted in a bankruptcy proceeding.

Moreover, other NOL limitations based on changes in ownership may be triggered by the actions of a controlling shareholder, claims trading, and post-petition sales of stock.

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