

E.L. Thompson Farms, Ltd. v. Aurora County, South Dakota: Milk Cows, Manure, and Management Problems—Utilizing Experts to Maneuver through the Muck of Inverse Condemnation

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Legal counsel commonly retain valuation and/or forensic accounting professionals to assist in eminent domain and expropriation disputes. Such engagements may include the valuation of a going-concern business interest or the quantification of economic damages related to the condemnee. This discussion provides insights into an inverse condemnation litigation dispute involving a dairy farm operation in South Dakota. More specifically, this discussion provides an example of how forensic accounting experts and real estate appraisal experts worked together in an inverse condemnation dispute. Many eminent domain controversies require both types of forensic experts.

INTRODUCTION

Responding to a study that manure runoff from confined animal facilities within the county was contaminating the source of drinking water for the nearby city of Mitchell, and to increasing concern over the odors caused by large confined animal farms, the County Commissioners of Aurora County, South Dakota, enacted a zoning ordinance.

The ordinance placed a limit of 1,200 animal units (AU) that could be at any one confined animal feeding operation.

E.L. Thompson Farms, Ltd. (“Thompson Farms”), brought an inverse condemnation lawsuit against Aurora County, alleging that the AU limit in the zoning ordinance constituted a regulatory taking.

This lawsuit was filed because the ordinance prevented an expansion of the dairy that Thompson Farms claimed it had planned and invested in prior to the enactment of the ordinance.

The case, which commenced in April 2002, took a long and eventful path over the next 10 years, culminating in a jury trial in July 2012. A judge bifurcated the action in September 2002 to first address liability (whether there was a taking) and only if necessary to address the issue of damages at a second trial.

Whether Aurora County “caused” any damages to Thompson Farms under the regulatory takings doctrines of *Penn Central Transportation Co. v. City of New York*¹ was a primary focus.

Although the dairy operation of Thompson Farms did indeed fail during the period after the AU limit was enacted, Aurora County argued that numerous factors unrelated to the zoning ordinance brought about the dairy’s demise.

First, this discussion highlights the facts of this unique inverse condemnation action. Second, this discussion explains the “measure of damages” methods the court directed the parties to utilize. Finally, this discussion describes the experts in forensic accounting and agricultural (dairy farm) appraisal



whose work was useful in establishing causation and damages in this regulatory taking/inverse condemnation saga.

THE FACTS OF THE CASE

In the mid-1990s, Thompson Farms began planning to expand an existing 350-head dairy. Years earlier, the farm had converted its beef feeding operation to a dairy operation, and the farm also included a crop production operation on its 1,400 acres. Dirt work and work on the dairy lagoon began in September 1996.

Aware that the Aurora County Commission was at the time considering proposed zoning ordinances that would place limits on the number of AUs allowed on any one facility, Thompson Farms wrote a letter to the Commission in September 1996.

The letter confirmed a discussion held two days earlier with the Commission that the Thompson Farms 1,200 head dairy facility would be “grandfathered,” but that it must otherwise comply with zoning standards.

Aurora County did not have zoning ordinances in place at the time of the letter. But, thereafter, in October 1996, Aurora County enacted a temporary zoning ordinance that included a requirement that a conditional use permit be obtained for animal feeding operations of more than 800 AUs.

Meanwhile, Thompson Farms was altering its original plans for the dairy’s milking parlor. Rather than installing a smaller parlor that could be expanded to accommodate more cows at a later date if needed, as originally planned, it instead installed a larger Rotary 40 milking parlor.

Work on the new dairy buildings was completed and cows were brought in during April 1998.

The people of Aurora County brought an initiated measure calling for a limit of 1,500 AU on any one confined animal facility (1,500 AU equals approximately 1,050 mature dairy cows), which was approved in a special election held in February 1998.

Because the temporary zoning expired after two years, Aurora County enacted comprehensive permanent zoning ordinances in October 1998, following numerous public hearings and much public input.

The permanent zoning ordinances enacted included the 1,500 AU limit at any one facility. The effect was to prohibit any farming operation, including Thompson Farms, from having over 1,500 AUs in any one confined feeding operation.

However, Aurora County honored the Thompson Farms earlier request to be grandfathered, and allowed it to have 1,200 head of mature dairy cows.

In August 2000, Thompson Farms wrote a letter to the Aurora County Commission proposing that the dairy wished to expand its 1,200 head operation above the 1,500 AU limit to 2,000 head, saying it planned to expand as far back as 1996.

During September and October of 2000, the Aurora County Commission studied Thompson Farms’ proposal to lift the AU limit, and held several public meetings to gather input on the issue. Also during this same time period, Thompson Farms attempted to sell the dairy, advertising for buyers. And, Thompson Farms began reducing the cow numbers.

The Thompson Farms attorney sent Aurora County a draft federal court complaint for a takings cause of action on January 22, 2001, based upon the 1998 zoning ordinance. The federal action was never commenced.

On January 31, 2001, the dairy’s existing holding barn collapsed under the weight of a heavy snowfall, totally destroying the barn. At the time, there were approximately 800 cows in the barn. A significant number were killed or badly injured, and all surviving cows were moved off the farm immediately.

Despite the fact that Thompson Farms was no longer milking any cows, on March 22, 2001, Thompson Farms applied for a building permit to build a “second” barn on the location to accommodate “additional” dairy cattle.

During the trial, Aurora County argued this was nothing more than an attempt to “create” a cause of action.

Aurora County denied the building permit application based upon the zoning ordinance. The Commission decision was appealed to the circuit court, and the court affirmed the Commission.

Thompson Farms did not appeal this decision, and instead commenced separate litigation on the basis of a regulatory taking/inverse condemnation.

THE LAW ON INVERSE CONDEMNATION AND REGULATORY TAKINGS

As a regulatory taking, the legal doctrines under *Penn Central* were applied in this case. In *Penn Central*, the U.S. Supreme Court addressed whether the governmental restrictions imposed on the property owner's use of its property effected a taking of the property within the meaning of the Fifth Amendment of the U.S. Constitution.²

The traditional balancing test under *Penn Central* involves factual inquiry focusing on three factors:

1. The character of the governmental action
2. Economic impact of the regulation on the claimant
3. The extent to which distinct investment backed expectations have been interfered with by the regulation³

In determining whether the regulation has caused a taking, the court is to look at the nature and the extent of interference with the rights in the parcel as a whole.

Under the first factor, character of the governmental action, it should be established that the governmental action was the cause in fact of the claimant's harm; the liberty interests of the property owner are to be balanced against the government's need to protect the interests of the public.

Under the second factor, economic impact, the regulation must interfere drastically with a property's possible uses to be a "taking."

Finally, under the third factor, extent of interference with investment backed expectations, the claimant must show that the regulation has nearly the same effect as complete destruction of the owner's property rights; it is not a taking simply because the owner is being denied the ability to exploit some property interest.

Court proceedings were held in May 2008 to determine whether the Aurora County AU limit had caused a regulatory taking against Thompson Farms.

The court issued its decision in February 2009, ruling that a regulatory taking had occurred.

The court gave particular weight to the degree of "interference with investment based expectations" factor, opining that Thompson Farms had invested substantial sums of money to modernize and expand its dairy prior to the effective date of the zoning ordinance, yet was "prohibited from obtaining the use of its investment to its full extent when the County denied the request to exceed the 1,500 [AU] limit."

Therefore, the matter proceeded on to a jury trial to determine the amount of damages.

THE MEASURE OF DAMAGES

In advance of a trial to determine the amount of damages, the court made a series of rulings as to the measure of damages:

1. Temporary or permanent taking.

Soon after the court ruled on liability, motions were filed and hearings were held to establish how damages would be determined. A threshold issue was whether the regulatory taking had been a "temporary" or a "permanent" taking. The court reasoned that it could not characterize it as "temporary" because the zoning ordinance was still in effect.

The court continued, explaining that it believed Thompson Farms had been permanently prohibited by the zoning ordinance. Therefore, the taking was ruled a "permanent" taking.

2. Date of taking.

At the same time it was setting a "measure of damages," the court was simultaneously hearing motions to determine the date of taking, which would be necessary in determining damages in this inverse condemnation matter.



Thompson Farms argued that the date of taking was March 22, 2001, the date that it applied for and was denied a building permit. Aurora County pointed out that Thompson Farms had, up to this time, been asserting that it was the adoption of the 1998 zoning ordinance that “took” from, or damaged, Thompson Farms.

Citing *Palazzolo v. Rhode Island*,⁴ Aurora County argued that from the 1998 enactment of the zoning ordinance forward, Thompson Farms had been precluded from expansion under the ordinance. Therefore, it was the date of the enactment itself that was the date of taking.

The court ruled that the date of taking in this matter was March 22, 2001, the date the building permit was denied.

3. Original order on measure of damages: two methods—“fair market value of operation” and “investment equity.”

The court noted that the South Dakota Supreme Court had not yet addressed the measure of damages in a case involving a permanent, regulatory taking.

Thompson Farms argued for a “before and after” calculation of damages, based either upon their equity in the property, or upon the fair market value of the property.

Aurora County argued for a “lost use” calculation taking into account the probability that Thompson Farms’ expansion would not have been successful, or alternatively for reimbursement of Thompson Farms’ actual expenses.

The court concluded damages should be based on a “before and after” test, as was done by the South Dakota Supreme Court in *Hurley v. State*,⁵ a permanent physical taking case.

The court noted that here it would not make sense to base damages on the value of the real property because the physical property itself was not taken; instead, it was the opportunity to use that property to support the dairy operation.

The court settled on two separate methods for measuring damages based on the “before and after” principle; both measures would be available to the jury as alternative measures of damages, and the parties were directed to present evidence as to both methods.

First, the court directed that damages would be measured by considering the fair market value of the dairy operation as a going concern immediately before and after the date of taking, March 22, 2001.

The court explained that “fair market value” is the price that Thompson Farms could have reasonably expected to be paid for the operation had it been sold on the open market.

Among the relevant factors is the probability that Thompson Farms’ expansion plans would have been a success, as the probability of success would have weighed heavily in the mind of any prospective buyer in 2001 and affected the price that buyer would have been willing to pay.

Second, the method of damages to be presented to the jury was the value of the Thompson Farms equity before and after the taking.

The court stated its expectation that the parties would present evidence as to the value of the Thompson Farms investment equity prior to the taking, as well as the value, if any, of its equity after the taking.

4. Revised order: “investment equity” removed; new category of “permanent partial regulatory taking” announced.

June 22, 2012, less than a month before the jury trial was set to begin, the court revised its prior order on measure of damages.

Thompson Farms made a pretrial motion to eliminate the investment equity measure of damages and to eliminate all evidence of profits and losses except as necessary to determine the fair market value of the real property as a going concern.

The court granted the motion, thereby reversing in part its 2009 ruling on measure of damages, opining that loss of investment equity method would provide an unreliable and inaccurate result bearing no relationship to the actual loss of Thompson Farms.

In the court’s discussion on this issue it deliberated that only part of Thompson Farm’s overall property rights had been taken; accordingly, the court announced a category new to South Dakota law: that of a “permanent partial regulatory taking.”

Aurora County sought clarification from the court to ensure that it would be allowed to present its “measure of damages”

evidence on the “fair market value” method since its experts had utilized aspects of loss of equity in their determinations under the now remaining measure of damages.

Aurora County also sought clarification of another pretrial ruling by the court granting the Thompson Farms motion introducing, for the first time in this matter, the concept of “as affected by the taking” into the methodology for measuring damages.

THE ROLE OF THE EXPERTS

Developing evidence to present to the jury on the two measures of damages required the significant use of expert testimony by both parties.

Aurora County engaged the services of a forensic accountant to analyze (1) the financial situation of Thompson Farms, (2) the likelihood of success of its claimed expansion plans, and (3) whether the Thompson Farms loss was a result of the Aurora County zoning ordinance (i.e., causation).

Extrapolating from tax and other financial/business records, this accounting expert determined that Thompson Farms had incurred a significant amount of interest-bearing debt in its initial expansion and in operation of the dairy, resulting in the loss of its equity value prior to March 22, 2001, primarily due to its large operating losses.

According to its tax records, the dairy had significant cattle losses totaling \$627,200 from 1998 to 2000. By the end of 2000, the dairy had liabilities of over \$7 million, nearly \$6 million of which was funded through long-term debt. For fiscal year 2000, Thompson Farms incurred interest expense of approximately \$500,000.

The forensic accountant determined that Thompson Farms could not take on more debt. If Thompson Farms were to borrow money to finance the estimated \$3.3 million expansion cost to reach its target size, its long-term borrowings would be approximately \$10.5 million as of March 22, 2001.

The forensic accountant concluded that the likelihood of successful expansion was minimal.

Aurora County also engaged the services of a real estate appraiser experienced in appraising dairy operations. Considerable attention was given to the concept of “going concern” in the context of valuing the dairy under the cost approach, the sales approach, and the income approach.

The dairy farm appraiser ultimately determined that the “cost to cure”—the expense of expanding the dairy to 2,000 head—would exceed the additional value created by such an expansion by nearly \$200,000. Therefore, the appraiser’s conclusion was that there was no damage caused to Thompson Farms under the “before and after” fair market value measure.

The dairy farm appraiser testified that, for example, the expansion would require extensive construction to increase the manure storage system, additional feed storage would need to be constructed, and additional barns and milk holding tanks would be necessary to handle cows isolated due to health reasons to keep their milk separate from that of the main dairy.

In this appraiser’s opinion, the entire dairy operation, other than the oversized Rotary 40 milking parlor, was sized for a 1,100 head dairy, not for a 2,000 head dairy.

The appraiser also explained that, in his view, most buyers, would not like the overall set up of the dairy with its various scattered and older buildings. The high voltage power lines running across the property would also be a negative factor to sale.



In addition, all buyers or investors would have looked at the dairy farm's past earnings, breeding and production records, significant death losses, milk quality, manure management system, and feed handling systems, all of which were problematic at Thompson Farms.

Both of the county experts, the forensic accountant and the dairy farm appraiser, were aware of the poor management performance. This poor performance was corroborated through the testimony provided by several veterinarians who had witnessed first-hand day-to-day problems on the dairy that resulted in, among other things, high rates of dairy cattle losses.

The dairy farm appraiser also analyzed the intangible assets that create "goodwill," such as superior management, excellent credit rating, efficiency of the operation, sufficiency of capital, and a long-standing enviable reputation, and concluded that the "goodwill" value of the dairy, based on earnings capacity and resting upon the excess of net earnings over and above a fair return on the tangible assets, was zero.

Thompson Farms only used a real estate appraiser as its expert. Its appraiser also analyzed the dairy and concluded that the Thompson Farms damages loss under the before and after method analysis was \$2.8 million.

Both parties' appraisers determined that the cost of expansion would be slightly more than \$3 million, and both experts' numbers as to the "after" value—the value without the AU limitation—were similar.

However, the two experts disagreed as to the "before" values—the value without the AU limitation, with the Thompson Farms appraiser's values under each property valuation approach (cost approach, income approach, and sales approach) being approximately \$3 million higher than the values arrived at by the Aurora County appraiser.

The trial on damages spanned seven days. The jury reached a verdict that Thompson Farms had been damaged by the ordinance.

While the Thompson Farms expert opined that damages amounted to \$2.8 million, the jury's verdict for \$600,000 in favor of Thompson Farms was a number far less than the Thompson Farms claim (and, ironically, approximately the cost of the Rotary 40 milking system that had been installed).

The jury's verdict was also far less than the amount that Thompson Farms stated it was seeking in its 2001 unfiled federal action complaint, of \$5.6 million in damages.

CONCLUSION

Without the experts' analysis of factors affecting causation, as well as damages, the impact of important variables, such as financial distress resultant from dairy cattle loss and too much interest-bearing debt owed to creditors, may not have been uncovered.

In this matter, the Aurora County experts used their financial skills to uncover critical facts in what was a fact-rich lawsuit.

The county experts in this matter simplified and conveyed complex inverse condemnation damages issues that included a court-directed change involving how to measure damages.

This matter provides an example of how forensic accounting experts and real estate experts worked together in an inverse condemnation matter. Typically, condemnation matters often require both types of financial experts.

Notes:

1. Penn Central Transportation Co. v. City of New York, 438 U.S. 104 (1978).
2. "nor shall private property be taken for public use, without just compensation." U.S. Constitution, Amendment V.
3. Penn Central, 438 U.S. at 124.
4. Palazzolo v. Rhode Island, 533 U.S. 606 (2001).
5. Hurley v. State, 134 N.W.2d 782 (S.D. 1965).

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