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Advocate's Edge

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Dealing with *Daubert*

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Although *Daubert v. Merrell Dow Pharmaceuticals* focused on the admissibility of scientific expert testimony, its progeny have had a great impact on financial expert testimony. Rule 702 of the Federal Rules of Evidence was amended in 2000 in response to *Daubert* and its offspring. (See "Expert testimony refresher," below.)

The rule states that expert testimony should be allowed if: 1) It is based on sufficient facts or data, 2) it is the product of reliable principles and methods, and 3) the witness has applied the principles and methods reliably to the facts of the case.

Challenges to financial expert testimony have skyrocketed in recent years, but attorneys may be able to preclude, or at least survive, challenges to their witnesses by using these rules and case law as a guide. The opinions in the following cases where financial testimony has been challenged provide insights on how courts approach the admissibility question.

Headley v. McCleary

In *Matthew Headley Holdings, LLC v. McCleary, Inc.*, the plaintiff acquired a defunct snack food brand (Guy's), and agreed to let the defendant become the exclusive distributor of the brand in Kansas, Missouri and southern Illinois. McCleary, however, failed to introduce the Guy's brand anywhere but Kansas City. Headley brought suit for breach of contract and breach of an implied covenant of good faith and fair dealing.

A CPA with 27 years of experience, including extensive forecasting and projecting of future business performance, offered testimony on Headley's lost profits. He was familiar with the historical performance of Guy's because he had conducted auditing and accounting service for the brand for three years. By reviewing the brand's past performance and comparing it to the defendant's actual and potential performance under the contract, he forecast the plaintiff's damages.

Expert testimony refresher

Over the years, the Supreme Court has delivered several decisions clarifying its standards for the admission of expert testimony:

In *Frye v. U.S.*, the Court stated that expert testimony will be admitted if based on a methodology "generally accepted" by the scientific community.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, the Court concluded that the trial judge must act as a gatekeeper for expert testimony, considering several nonexclusive factors applicable to the testimony's reliability and relevance, including:

- ☑ Whether the theory or technique has been or can be tested,
- ☑ Whether the theory or technique has been subjected to peer review or publication,
- ☑ The known or potential rate of error, and
- ☑ Whether the theory or technique is generally accepted in the relevant scientific community.

In *General Electric v. Joiner*, the Court found that an appellate court should not overturn a trial judge's ruling on the admissibility of expert testimony absent an abuse of discretion. And neither *Daubert* nor the Federal Rules of Evidence require a trial court to admit expert testimony that is connected to existing data only on the expert's say-so.

In *Kumho Tire Co. v. Carmichael*, the Court concluded that the *Daubert* reliability factors apply to all experts offering testimony under Federal Rule of Evidence 702, regardless of whether the proposed testimony is based on science.

McCleary challenged the admissibility of his testimony, citing eight infirmities — each taking issue with assumptions used in the damages estimate. But the court stated that "time and again, we have noted that the factual basis of an expert's opinion generally relates to the weight a jury ought to accord that opinion," not admissibility.

Further, Headley's expert made assumptions in areas where it was impossible to gather more concrete data because of the defendant's nonperformance. Thus, the circuit found the expert's testimony and report to be sufficiently reliable and relevant.

Champagne Metals v. Ken-Mac Metals

In the aluminum industry, "service centers" routinely act as middlemen between mills and end users. When the plaintiff in *Champagne Metals v. Ken-Mac Metals, Inc.*, attempted to launch a new service center and met with difficulty, it brought an antitrust suit claiming an understanding exists in the industry to exclude new competitors. The district court excluded plaintiff's economic expert on reliability grounds and granted summary judgment to the defendant.

The Tenth Circuit explained that service centers participate in two markets: 1) the upstream market, which involves sales of aluminum coils by mills to service centers, and 2) the downstream market, which involves sales of flat-rolled, processed, and cut aluminum by service centers to end users.

Champagne's expert opined that the defendant had sufficient market power in the upstream market that "a threat by these service centers to shift their purchasing of aluminum away from a mill 'represents a credible threat.'" Although the expert's opinion focused on the upstream market, it was based on data from the downstream market. The expert offered no explanation for using downstream market share as an indicator of upstream market share. The court concluded that the expert's opinion was "solely the argument of counsel."

In a footnote, the court acknowledged another defect: Many of the expert's opinions were exclusively based on facts provided by the plaintiff, and the expert failed to specify that he was only assuming such facts. It stated that "expert testimony that fails to make clear that certain facts the expert describes as true are merely assumed for the purpose of an economic analysis may not assist the trier of fact at all, and, instead, may result in confusion."

U.S. v. Hamaker

In a criminal trial for bank fraud, *U.S. v. Hamaker*, the United States offered testimony regarding financial and business records by an FBI financial analyst. The defendant objected on the basis that the analyst was not designated as an expert during discovery. But the district court overruled the objection, allowing the analyst to testify as a lay witness.

The Eleventh Circuit found that the analyst didn't testify based on his financial expertise or express expert opinion. He reviewed and summarized more than 7,000 financial documents. In his testimony, he described records factually and matched a subset of payroll, accounting and invoice records.

The court opined that, "while his expertise and the use of computer software may have made him more efficient at reviewing [the] records, his review itself was within the capacity of any reasonable lay person." The testimony was therefore admissible under Rule 701. The court concluded that "the fact that [the expert] is a financial expert does not in and of itself require that his testimony about financial records be treated as expert testimony."

The right stuff

As the case law suggests, no financial expert is safe from close scrutiny by the court. But you can protect your case by hiring experts accordingly. Exclusion of financial testimony can seriously damage a case, so enlist the assistance of experts with strong reputations and proven experience in the relevant field. ✧

Cut to the chase

Joint business valuations can reduce costs and time

Jointly retained valuations in disputes involving a business have grown dramatically in recent years. They can cut costs and time, and at least one court actually requires joint valuations in family law proceedings. Also, many buy-sell agreements contain provisions which obligate parties to use a single appraisal, or allow their own appraisers to choose a third appraiser. But joint valuations can pay off only if both parties follow certain guidelines — particularly in divorce cases, where a company's value can be among the most contentious issues.

An acceptable value

Traditionally, both parties in a dispute hire their own appraisers. Each appraiser submits values that can vary greatly, likely favoring the respective client's position. The attorneys then construct their cases to support their expert's valuations and undermine their opponent's. Eventually, the parties reach a middle ground, either by settlement or via costly and time-consuming litigation.

A joint valuation uses only a single appraiser who works for both parties and favors neither. Ideally, the final value represents a reasonable amount that both parties find acceptable, if not entirely to their liking. The appraiser's goal isn't to produce a value that satisfies both parties, but to present a fair market one.

Retaining a joint appraiser

Retention of a qualified appraiser is critical for joint business valuations. The ideal appraiser offers past experience with joint valuations and understands the complexities of working for both parties. Avoid retaining financial professionals who have worked with your client before, either as an accountant or tax return preparer.

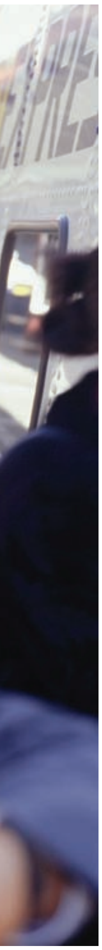
In a joint valuation, the parties split the appraiser's fees, cutting costs significantly. Attorneys' time and fees also generally drop, as less work is required to prepare for and participate in settlement conferences or trial. Further, joint business valuations typically expedite the entire process and reduce tensions.

General guidelines

The appraiser in a joint valuation is charged with investigating the facts, conducting the appraisal and producing a neutral final report. To this end, the appraiser follows several matters:

Ground rules. The appraiser establishes basic rules for the engagement, agreed to by both parties, before conducting any work. Everyone should understand the timeline and procedures from the start.

Although not required by law, an engagement letter is advisable. It should identify the clients, the scope of the engagement and any related limitations, and the fee arrangement. It also should acknowledge the parties' joint retention of the appraiser.



Communications. The success of a joint valuation rests largely on the appraiser's lack of bias. To avoid even the slightest perception of bias, the appraiser ensures that all correspondence is copied to both parties. The appraiser also will prohibit the parties and their attorneys from contacting him or her, except in writing, unless specifically requested.

Information gathering. The appraiser begins the gathering process by compiling a list of required information related to the subject business. Document requests are made in writing and include deadlines, and each party is asked to designate a contact person for such requests. Then the appraiser interviews both parties, as well as company management. Interviews conducted individually and without attorneys tend to draw out more useful information.

Document sharing. The appraiser and the attorneys establish at the outset whether documents are subject to sharing with both parties. Obtaining an acknowledgment that both parties are entitled to all documents can help define the scope of the engagement.

Draft valuation report. The appraiser submits a draft valuation report to both parties for their written comments. The draft report includes a comprehensive discussion of the factors considered and outlines the methods used to arrive at the proposed value. The parties can confirm the accuracy of cited data and verify that the appraiser had access to all relevant information. The comment period will be restricted, and the parties must copy their comments to the other party. A second comment period gives the parties an opportunity to respond.

A joint valuation uses only a single appraiser who works for both parties and favors neither.

Final valuation report. The appraiser issues the final valuation report soon after the second comment period. In most cases, an appraiser needs no more than a month to consider the parties' comments and determine the final value. In addition to the standard valuation report information, the final report addresses any significant issues raised in the comments and any subsequent revisions to the report's content.

Benefits of joining up

A joint business valuation is beneficial only if it is unbiased, verifiable and supported by all involved from the beginning. Half-hearted participation or a lack of full disclosure can defeat the purpose and land the parties in court, resulting in higher costs, increased stress and timelines, and a less predictable outcome. ✧

New businesses: Building the case for lost profits

Claims for lost profits damages can arise in everything from shareholder disputes and insurance litigation to breach of contract, tortious interference, and intellectual property actions. Courts recognize that a plaintiff should not be precluded from recovering lost profits where the defendant's actions have prevented the plaintiff from establishing a track record.

But the methods typically employed to calculate lost profits damages may prove tricky when the case involves a new or unestablished business. Financial experts can help you recover damages in the absence of the usual evidence.

structures. A new business may not have sufficient data for analysis, and, if it's offering a new product or service, an expert might not be able to locate comparable businesses. Projected revenue and cost structures also may be difficult to pin down.

Piecing together a picture

Attorneys for nascent businesses need not despair. Financial experts may be able to conduct some forecasting to build nonspeculative lost profits claims. An expert can rely on company projections for future revenues if the data allows him or her to calculate lost profits with "reasonable certainty."

An expert also might apply industry growth rate projections to existing company data to develop multiple sales projections with varied combinations of actual and projected data. If the projections reach similar conclusions, the expert could cite those findings as evidence of lost revenues. From there, the expert can use company-specific data to develop cost structures by determining fixed and variable costs and the cost of goods sold.

Gaps for new businesses

Although damages calculations basically are the same with new as with established businesses, less data is likely to be available and more assumptions are necessary. Lost profits calculations usually are based on two steps: 1) Applying a variety of available methods, a financial expert first determines the subject business's lost revenues, and 2) the expert then adjusts the projected lost revenues by appropriate profit margins to estimate lost profits.

Regardless of the method applied, the expert must weigh both future revenues and profit margins. To project future revenues, experts generally rely on data related to historical company performance, industry and general economic trends and forecasts, and company projections. With a new business, though, an expert may find insufficient performance data, insufficient company data to correlate with trend data or a product so early in its development that the company hasn't yet made projections.

Determining profit margins presents similar difficulties. The process requires analysis of fixed and variable costs — usually studying historical company performances, industry profit margins, and internal forecasts based on projected revenues and cost

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If no useful company-specific data is available, experts can gather a wealth of information from outside sources. They can determine market share and penetration estimates by examining models and studies of new-product lifecycles and use that data to project revenues. Internal data and reports, industry forecasts and other sources can then be incorporated to formulate profit margins. Many governmental agencies, trade associations and research organizations issue regular reports with critical data — including expected demand, prices and cost structures — that can validate projections.

Discount rates figure prominently as well. The rate applied to the lost profits must represent the risk related to the new business and specifically reflect the likelihood that the projected lost profits would be achieved "but for" the actions of the defendant.

All is not lost

Calculating lost profits for new businesses to a "reasonable certainty" may prove difficult and time-consuming, but it can be done in many cases. A qualified professional will provide you with a strong analysis that is capable of withstanding attack. ✧

How contingencies affect business value

Valuation calls for determining the amount an investor would willingly pay for an asset in the absence of compulsion and given the risk associated with the investment. When valuing a business, the assessment of risk includes the role of contingencies, which can require adjustments to the business's value.

Understanding contingencies

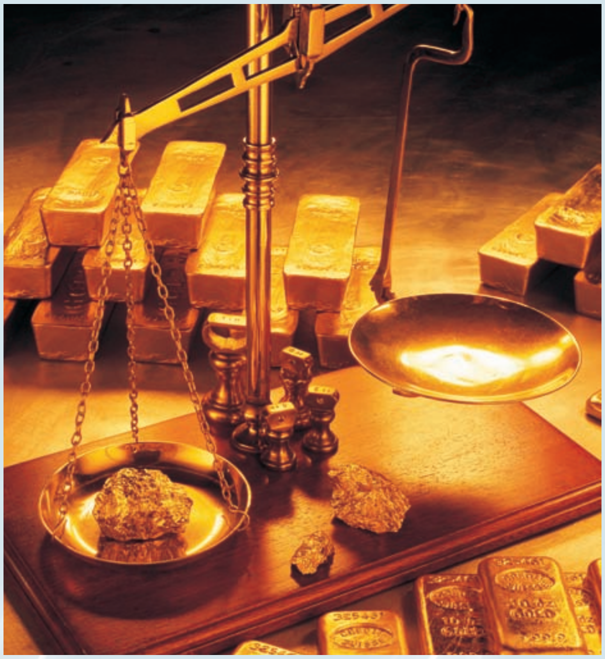
For business valuation purposes, contingencies comprise possible uncertain gains or, more often, possible losses yet to occur or be resolved. In particular, buyers will be concerned with any contingent losses because they may increase risk substantially.

Pending or threatened litigation probably represents the most significant type of contingent losses. They also can stem from actual or possible claims or liability, potential regulatory actions, warranty obligations, and debt guarantees.

Contingent gains can include a litigation-related award or settlement, the grant of intellectual property rights such as a patent, or the execution of a lucrative contract.

Accounting for contingencies

To determine the appropriate treatment for contingencies, a valuator reviews the business's financial statements and related financial documents. While contingent gains generally don't show up on financial statements (except, perhaps, in footnotes), contingent losses may. Such losses typically are categorized as probable, reasonably possible or remote. Probable and reasonably possible losses should be reflected on financial statements.



The valuator also confers with company management to discern the likelihood of the contingency actually occurring. If the contingency is associated with litigation, the valuator discusses potential outcomes with the company's attorney. Note that, in the case of pending or potential litigation, the valuation report could become subject to discovery, so caution should be exercised with it.

If the valuator has quantified the contingency at a significant amount, an adjustment is necessary. When using an asset-based valuation method, the valuator adjusts the value of the business's net assets. Under an income-based approach, the valuator increases or decreases the business's projected future earnings or adjusts the discount or capitalization rate to reflect risk. Valuators essentially use their professional judgment when determining the potential effect of a contingency on a business's value.