Time Worth Spending

Keeping Your Financial Damages Expert in the Case

By Nancy J. Fannon
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Make the investment to ensure that your expert's report can withstand *Daubert* or other challenges. It can mean big savings for your client.

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According to a recent study by PriceWaterhouseCoopers, 41 percent of challenges against financial experts in 2007 were successful. Financial Expert Witness 2007 *Daubert* Challenge Study, at 8 (PriceWaterhouseCoopers, Aug. 2008), http://www.pwc.com/us/en/forensic-services/publications/index.jhtml. This high rate of successful challenges occurs at a time when financial damages experts have come under increasing scrutiny, as the courts have stepped up their gatekeeping function under the guidance of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), *General Electric Co. v. Joiner*, 522 U.S. 136 (1997), and *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999). The stark reality of a 41 percent success rate is that attorneys have frequently ignored the lessons of 10 years of jurisprudence under the *Daubert*, *Kumho* and *Joiner* trilogy. To avoid the plaintiff's expert providing the only opinion to the jury, defense attorneys and their retained lost profits damages experts must be well-versed in the collective wisdom of *Daubert*, *Kumho*, *Joiner* and their progeny.

In the decade following *Kumho*, the courts set a clear bar for financial experts. Closely reading these cases reveals that many exclusions might have been avoided had attorneys better understood the data upon which experts relied or failed to rely. Many others could have been avoided had attorneys better understood their own expert's methods and conclusions. As David Cooner and Zane Riester recently observed in DRI's *Daubert Online*, "securing credible scientific testimony and challenging your opponent's experts is critical to success." David Cooner & Zane Riester, *Science Sooner: Moving Daubert to an Earlier Stage of Litigation*, Daubert Online Vol. 1, No. 8, at 5 (Aug. 2009), http://www.dri.org/open/Newsletters.aspx.

The words "relevant and reliable" are the watchwords in motions challenging experts, covering a broad swath of fact patterns in cases in which courts have excluded expert testimony. With challenges to expert opinions now the norm, it is imperative that a defense attorney analyze his or her own expert's report with the same critical perspective as he or she would the opponent's expert. A defense attorney must complete this critical analysis through discussions with the expert *while* the expert gathers evidence and prepares an opinion and *before* disclosing the opinion and subjecting it to the opposition's scrutiny.

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With the explosion of discovery since the relatively new electronic evidence rules went into effect—at the same time that clients have clamored to keep costs down—keeping experts informed of all relevant facts is an increasing challenge. Understanding the methodology used by the expert, sometimes lost in a haze of spreadsheets, projections, discount rates, and econo-talk, also poses challenges. This haze must not, however, obscure the basic tenets of *Daubert*, *Joiner*, and *Kumho*.

Daubert enunciated that a trial judge's responsibility regarding expert opinions is to "ensure that any and all scientific testimony or evidence admitted [at trial] is not only relevant, but reliable." *Daubert*, 509 U.S. at 589. *Kumho Tire* extended a trial judge's gatekeeping obligation to "'technical' and 'other specialized knowledge'." *Kumho Tire Co.*, 526 U.S. at 137. This clearly brought *Daubert* into the realm of financial damages. However, it was *Joiner* that has had the most teeth for excluding financial experts. *Joiner* allowed that a court may conclude that there is simply "too great an analytical gap between the data and the opinion proffered." *General Electric Co. v. Joiner*, 522 U.S. at 136, 146. That "gap" has reared its head in many exclusions, as experts have swung and missed, failing to connect their opinions to the claims that attorneys have made. According to the Sixth Circuit Court of Appeals, "[t]he task for the district court in deciding whether an expert's opinion is reliable is not to determine whether it is correct, but rather to determine whether it rests upon a reliable foundation, as opposed to, say, unsupported speculation." *In re Scrap Metal Antitrust Litigation*, 527 F.3d 517 (6th Cir. 2008).

In the following sections, some of the most successful instances of expert exclusions are summarized, providing guidance for clear areas where defense attorneys should examine their opponent's experts' testimony, as well as that of their own experts prior to disclosing their reports.

Mind-Shift

A plaintiff or plaintiff's attorney will hire a financial expert to calculate the financial damages that were caused by a defendant's alleged actions. Conversely, defendants and defense attorneys hire financial experts to demonstrate that the alleged acts either did not cause the damage or, if damage was caused, that the plaintiff's alleged damages are overstated. In calculating damages, experts "must identify the facts and data forming the basis for their testimony" so that courts can access them, and they must "base their opinions on scientific methods and procedures." *Trugreen Co., L.L.C. v. Scotts Lawn Service*, 508 F. Supp. 2d 937, 938 (D. Utah 2007). Courts have made it increasingly clear that they expect experts to do more than just run numbers. They expect experts to gather financial evidence, and to then use their expertise to assess that evidence. When an expert does not know facts, ignores facts, unduly speculates, or relies, either exclusively or too heavily, on parties that are perceived as biased, a court may exclude the expert's opinion.

This is not only a mind-shift for the courts, which have become increasingly bold in their gatekeeping function, but it requires a mind-shift for many financial experts as well. Many, if not most, financial experts do not consider evidentiary standards—and the record of expert-opinion exclusions are replete with examples documenting this failure. Instead, financial experts have relied on the kind of data that they customarily have used in consulting matters, which has been previously untested by the rigorous vetting of the litigation process.

An August 2008 study of the American College of Trial Lawyers Joint Project with the Institute for the Advancement of the American Legal System on Discovery found that "[t]here is a serious concern that the costs and burdens of discovery are driving litigation away from the court system and forcing settlements based on the costs, as opposed to the merits, of cases." The same report found that "[e]xpert witness fees are a significant cost factor driving litigants to settle, ranking just slightly behind trial costs and attorneys fees."

While there is no doubt that the electronic discovery rules are one reason for the increased cost of producing expert opinions, likely another is the greater focus on challenging experts' reports. Many experts participate in opposing motions to exclude the expert and his or her report. Defense experts may, in some instances, also prepare review reports that are used to rebut the plaintiff's expert's reports and to assist attorneys in drafting motions to exclude plaintiff's experts. The "battle of the experts" is off and running, with fees mounting. While it can be difficult to suggest spending more time and money to your clients, with a little prevention, you can preserve your expert's testimony, or at least cut short the challenge process, which could save more costly fees. In some cases, the expert's assistance with undermining or excluding the plaintiff's expert's opinion may make the case ripe for summary judgment or otherwise change the outcome.

Karen Sloan wrote in the August 18, 2009, edition of Law.com that "potential litigants are carefully evaluating the value of their cases, what they want to accomplish and whether they can accomplish it cheaply." Civil litigation dropped by more than two percent in 2008, according to Debra Cassens Weiss of the ABA Journal's "Law News Now." Intellectual property litigation dropped by as much as eight percent, according to Ms. Sloan, who further

indicated that these drops were at least in part attributable to the burdens and costs associated with electronic discovery. Further, an Altman Weil "Flash Survey on Law Department Cost Control" revealed 75 percent of general counsel faced 2009 budget cuts averaging 11.5 percent.

In each case, there is a balance between ensuring that an expert has sufficient evidence to render a credible opinion, without incurring excessive cost or risking exclusion.

Know Thy Expert

Carefully selecting an expert can be crucial to a case. Courts have demonstrated that they will exclude experts unless the expert possesses the specialized knowledge required under Federal Rule of Evidence 702, meaning that he or she is "qualified as an expert by knowledge, skill, experience, training or education," who can "assist the trier of fact to understand the evidence or to determine a fact in issue." The courts are particularly troubled by experts who reach beyond their area of experience or who render opinions beyond that which the facts demonstrate.

For example, courts are sometimes skeptical of testimony by an expert testifying outside of his or her normal field of expertise and by experts who have a "'hired gun' background," determining that, due to this background, experts "'would not possess the professional safeguards ensuring objectivity.'" *DePaepe v. General Motors Corp.*, 141 F.3d 715, 719 (Ill. 1998) (internal citations omitted) (excluding expert evidence because he testified beyond his field of expertise); *Tokio Marine & Fire Ins. Co. v. Grove Mfg. Co.*, 958 F.2d 1169 (1st Cir. 1992) (affirming trial court testimony exclusion of an expert who was a hired gun). In addition, experts cannot base their opinions solely on their reputation. Indeed, in one case a defendant claimed that the court should allow an expert's testimony because the expert was well respected; the court held that being held in high regard "is not a substitute for analysis" of the *Daubert* factors. *G.T. Laboratories, Inc. v. The Cooper Companies, Inc.*, 1998 U.S. Dist. LEXIS 15745, at *23 (N.D. Ill. 1998). Similarly, in another instance in which an expert relied solely on information provided by the attorney, the court said an otherwise "supremely qualified expert cannot waltz into the courtroom and render opinions unless those opinions are based on some recognized scientific method and are reliable and relevant under the test set forth by the Supreme Court in *Daubert*." *MDG International v. Australian Gold, Inc.*, 2009 WL 1916728 (S.D. Ind. 2009).

The courts appear to have created a line between what is inadmissible and what should be weighted and subjected to vigorous cross-examination. On the one hand, when experts misapply or misuse factual data, courts tend to favor weighing the testimony. On the other hand, courts tend to exclude speculation, conjecture, or unsupported conclusions. For example, "where testimony…of lost profits is not based on historical data, and is only based on the expert's 'experience and knowledge'" of a particular market, it will be excluded as overly speculative." *Kemp v. Tyson Seafood Group, Inc.*, 2000 WL 1062105 (D. Minn. 2000). This is because Federal Rule of Evidence 703 "implicitly requires that the information be viewed as reliable by some independent, objective standard beyond the opinion of the individual witness." *Security Sys. Canada, Inc. v. Checkpoint Sys., Inc.*, 249 F. Supp. 2d 622, 695–96 (D. Pa. 2003).

The courts also seek consistency. In one case in which the "expert's deposition testimony and expert report were "at war with each other," the court "had no idea which of [the] assumptions truly formed the basis of his calculations." *KW Plastics v. U.S. Can Co.*, 131 F. Supp. 2d 1289, 1293 (M.D. Ala. 2001). Another expert was excluded in a case in which "the expert's own sworn testimony in other matters had previously stated that the method applied in the current case was "unreliable, inadvisable, or unsupportable." *Port Authority of New York and New Jersey v. Affiliated FM Ins. Co.*, 245 F. Supp. 2d 563, 568 (D.N.J. 2001). Certainly, different methods may be appropriate in the context of alleged lost profits damages because of the available data or type of business. However, if an expert has testified in a different case that the method that he or she is currently using is unreliable, inadvisable, or unsupportable, he or she must be ready to explain why it is appropriate in your particular case.

In short, a court requires factual data and information from reliable sources, using calculations based on proven methods that can be tested. Likely the best way to determine whether an opinion will pass muster is to analyze whether a court, if it had the expert's background and education, could take the data used by the expert (assuming it was relevant and reliable), use the method applied by the expert, and get the expert's result. If a court cannot do so, an expert's opinion is missing an important link, which that expert must add to avoid exclusion.

The expert's assistance with undermining or excluding the plaintiff's expert's opinion may make the case ripe for summary judgment or otherwise change the outcome.

Can the Expert Trace the Damages to the Alleged Breach?

One of the most common areas in which defense motions to exclude financial experts' are successful involves experts' testimony of damages calculations that do not explain or account for the claims that plaintiffs make. If an expert does not trace the damages to the alleged breach, then a court will generally exclude the expert's testimony.

It is well settled that "the damages… must be reasonably certain and directly traceable to the breach, not remote or the result of other intervening causes." *Coastal Aviation v. Commander Aircraft*, 937 F. Supp. 1051 (S.D.N.Y. 1996). Frequently, courts will exclude expert testimony that insufficiently ties damages to defendants' alleged conduct on the grounds that it has not provided evidence of causation. For example, in a case in which the expert assumed that the defendant was liable for all counts that the plaintiff alleged and did not take into account other factors that may have contributed to profit losses, the court ex-

cluded the expert's testimony. *PharmaNetics, Inc. v. Aventis Pharmaceuticals, Inc.*, 182 Fed. Appx. 267, 272–73 (4th Cir. 2006).

It is also important to examine whether an expert has ruled out other possible causes for losses. Often, failing to consider other industry or economic factors that could have affected a plaintiff's performance during the damage period will lead a court to exclusion of an expert's testimony. In a 2005 Delaware case, the court decided that the plaintiff's expert's testimony was insufficient because the expert failed to consider whether the plaintiff's loss of sales could have been caused by (1) increased competition; (2) the bankruptcy of a primary supplier; and (3) a major construction project near the entrance to its store." *Penn Mart Supermarkets, Inc. v. New Castle Shopping, LLC*, No. 20405-NC, 2005 WL 5757707 (Del. Chan. 2005).

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Cases abound similar to one Seventh Circuit case in which the court determined that "expert testimony may be excluded where the expert failed to consider other causes for the lost profits such as market saturation and reduced prices of alternate products." *Isaksen v. Vt. Castings, Inc.*, 825 F.2d 1158, 1165 (7th Cir. 1987). While *Isaksen* is a pre-*Daubert* case, it is relevant to this discussion because *Daubert* requirements are higher than what was required to support the opinion pre-*Daubert*. Moreover, in a more recent case, a court found that an expert's testimony was insufficient because he failed to consider that "over seventy factors" could have affected radio revenues, instead attributing all the profit losses to one tortious act, without considering the other factors. *Whitby v. Infinity Radio, Inc.*, 951 So. 2d 890, 899 (Fla. Dist. Ct. App. 2007).

Issues as simple as calculating damages using the wrong date can cause a court to exclude an expert's testimony as irrelevant to the matter at hand. In one case, an expert calculated reasonable royalties from the date that the lawsuit was filed. However, applicable law required that the calculation use the date of the first infringement. As a result, the court excluded the expert's report. *Avocent Huntsville Corp. v. ClearCube Technology, Inc.*, 2006 WL 2109503 (N.D. Ala. 2006) (amend. Aug. 21, 2006).

Economic Reality

The courts are also on guard for opinions about the extent of losses that exceed the bounds of reason. Entitlement to lost profits does not permit viewing lost profits damages as "the purchase of a winning lottery ticket… any lost profits award must be limited to the actual damages sustained." *Sostchin v. Doll Enterprises, Inc.*, 847 So. 2d 1123, 1129 (Fla. App. 2003). The court in this case found objectionable the use of so-called "accounting alchemy" to transform a "humble enterprise" into "an engine of commerce." *Id.* at 1125.

In another case, the expert took a very short period of success for a new business and calculated damages based on a forecast that exceeded even the business plan of that new entity. The court found that "while estimates and speculation are sometimes necessary in lost profits cases, extrapolations that are so removed from economic reality are not an appropriate opinion upon which to determine damages." *Olympia Equipment Leasing Co. v. Western Union Telegraph Co.*, 797 F.2d 370, 382 (7th Cir. 1986).

Is Your Expert Necessary?

Courts have demonstrated that they expect experts to apply their expertise to the matter at hand. If their expertise is not required, then they may not be needed in the case. While a party can offer expert opinion evidence to contest the amount of profits lost, an expert opinion is not required to dispute an award of profits damages when they do not involve highly technical issues. *Southwestern Bell Media, Inc. v Lyles*, 825 S.W. 2d 488 (Tex. App. 1992). For example, in one case a plaintiffs' expert accepted revenue figures provided by the defendant—which the parties did not dispute—and, as the plaintiffs claimed that they were owed half of the revenue, simply divided the figure in two to arrive at the amount due to the plaintiffs. *Trademark Properties, Inc. v. A&E Television Networks*, No. 2:06-cv-CWH, 2008 WL 4811461(D. S.C. 2008). The court excluded the expert's testimony, finding it of "no assistance to a common jury." *Id.* at *1.

Just the Facts

Courts expect experts to be knowledgeable about the facts that support, or should support, damages calculations: "When an expert's testimony is not tied to the facts of the case, and assumptions are not based on facts in the record, the testimony will be excluded." *K & V Scientific Co., Inc. v. The Ensign-Bickford Co.*, 2002 WL 31662326, at * 8–9 (Conn. Super. Ct. 2002). For instance, in one case the First Circuit remanded on damages, finding inadequate "factual data to support the expert's conclusions" on economic loss. *Irvine v. Murad Skin Research Laboratories, Inc.*, 194 F.3d 313, 320–21 (1st Cir. 1999). Courts have also excluded expert testimony when experts have been ignorant of data that should have been discovered in the course of discovery. *Supply & Bldg. Co. v. Estee Lauder Int'l, Inc.*, 2001 WL 1602976 (S. D.N.Y. 2001). With the volume of discovery and the associated costs exponentially rising, this is particularly problematic for experts and the counsel who engage them.

Courts are also wary of experts who rely too heavily on data and information provided by the parties that engaged them or if they rely upon data favorable to their clients while ignoring unfavorable information. *Ellipsis, Inc. v. The Color Works, Inc.*, 428 F. Supp. 2d 752, 760 (W.D. Tenn. 2006) (excluding expert testimony because the expert relied exclusively on data provided by the plaintiff"); *Children's Broadcast Corp. v. Walt Disney Co.*, 245 F.3d 1008, 1018, 1022 (8th Cir. 2001) (excluding expert testimony because the expert ignored relevant evidence that was less favorable to the client). In addition, defense attorneys should be on the lookout for experts who engage in "too much hypothesizing." For example, courts have excluded expert testimony when an expert "relied too heavily on hypothesized contracts in hypothesized markets that lacked any sound economic grounding." *DSU Medical Corp. v. JMS Co. Ltd.*, 471 F.3d 1293, 1309 (Fed. Cir. 2006).

Although exclusions have increased, "rejection of expert testimony is the excep-

tion rather than the rule." *In re Scrap Metal Antitrust Litigation*, 527 F.3d 517, 530 (6th Cir. 2008). Differences in opinion regarding the facts in the record, or their relative importance, are typically left for cross-examination: "despite notable deficiencies," opinions are best tested through cross-examination "that would inform the weight to be afforded [the] conclusions." *Chicago Title Ins. Corp. v. Magnuson*, 2004 LEXIS 30743, at *19 (S.D. Ohio 2004). As noted by the Sixth Circuit, courts "will generally permit testimony based on allegedly erroneous facts when there is some support for those facts in the record. *In re Scrap Metal Antitrust Litigation*, 527 F.3d at *529.

Application of Methods

Courts have excluded many expert reports for not properly applying peer-accepted methodology to damages calculations. Federal Rule of Evidence 702 requires an expert to "assist the trier of fact to understanding the evidence or to determine a fact at issue." If experts better understand the fact-and-evidence gathering effort that courts expect assistance with, experts might view their contributions to cases as more than math exercises, and attorneys could potentially avoid many exclusions. To avoid exclusions, however, you must help experts to identify actual damages issues early in the process. Once an expert issues a report, it may be too late.

All financial damages are calculated in a "but for" world. That is, what would a plaintiff's financial results have been "but for" the alleged actions of a defendant? Financial experts often refer to "before and after," "yardstick," and "sales projection" as "methods" used to determine lost profits damages. Each of these is not so much an economic or financial method as a method by which your opponent and his or her expert may obtain evidence to support a lost profits damages calculation. That is, with the "before and after method," an expert gathers financial evidence of a plaintiff's situation both *before* and *after* the damages period. This evidence is then used to help "fill in" what the plaintiff would have done or had "but for" a defendant's alleged actions. With the "yardstick method," an expert gathers evidence from financial yardsticks, or benchmarks, to help determine what a plaintiff would have done or had "but for" the alleged actions of a defendant. This expert then uses this evidence, to calculate the plaintiff's "but for" forecast. The expert then compares the "but for" forecast to what the plaintiff actually did or had, and the difference is the resultant loss.

The "yardstick method" provides a good example of the need to understand the difference between fact and evidence gathering and a math exercise. An expert utilizes selected comparables to demonstrate a plaintiff's "but for" performance during the loss period. This requires analyses of the "yardstick," or in other words, comparable companies or business units, to determine similar size, location, product, and capabilities, to name a few. Alternatively, an expert uses industry sources of benchmark financial data to predict what a plaintiff's revenues and profits would have been, "but for" the alleged loss.

Fortunately, courts subject suspect benchmark data that many financial analysts routinely use in non-litigation settings to rigorous vetting in the litigation realm. In the litigation realm, this data can easily fall apart. For example, in *Celebrity Cruises v. Essef Corp.*, the judge excluded the financial expert's yardstick analysis, finding the analysis flawed because it included companies that were too dissimilar from Celebrity. *Celebrity Cruises v. Essef Corp.*, 530 F. Supp. 2d 532 (S.D.N.Y. 2008). Even attempting to compare two similar businesses owned by the same person may fail. In a case involving a claim for damages from breach of a pizzeria lease, the plaintiff tried to show that loss of profits from the restaurant involved were comparable to a larger pizzeria that he also owned and operated. The two restaurants had some different characteristics, including locations, equipments, rents, and parking availability, among others. The court rejected the evidence as incomparable. *Nieman v. Bunnell Hill Development Corp.*, 2008 WL 4694998 (Ohio App.).

Experts also commonly use the "before and after method" to point to profits or revenues that were, "before" and "after" alleged actions of defendants at one level, and at a reduced level for presumed damages periods. However, absent evidence linking damaging actions to a loss—or ruling out other causes, as discussed earlier—the relationship between an event and loss is connected by only the *ipse dixit* of an expert. Attempting to fill in the gap with *post hoc, ergo propter hoc*—"after this, therefore because of this"—logic is well recognized as a logical fallacy and departure from the scientific requirements that *Daubert* was meant to address. As previously noted, in a case involving radio revenues, the expert attributed all of the profit losses to the single tortious act of the defendant. The court excluded the expert's testimony because the opinion ignored "over seventy factors which affect radio station revenues," attributing all the profit losses to one tortious act "without considering" the other factors. *Whitby v. Infinity Radio, Inc.*, 951 So. 2d 890, 899 (Fla. Dist. Ct. App. 2007).

> **"Extrapolations that are** so removed from economic reality are not an appropriate opinion upon which to determine damages."

While these exclusions had to do with methodological application, the underlying evidence resulted in the experts' exclusions. You will want to vet the evidence provided by your expert to make sure it can withstand similar scrutiny.

Conclusion

You can avoid many expert-related exclusions by taking preventive measures and by engaging your expert in clear and open conversation before he or she commits an opinion to paper. You can easily identify some of the most common exclusions by checking to make sure that damages relate to claims and that damages have sufficient evidentiary foundation. Other issues, particularly those relating to the application of peer-accepted methodology and data use, can be more difficult to detect, but you can avoid them nevertheless, with proper planning and review. Taking the time and making the investment to ensure that your expert's report can withstand the scrutiny of a *Daubert* or other challenge can result in significant savings for your client—and it may be some of the best spent time on your case. FD