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Courts Now Want Experts to Provide Critical Link in Criminal Securities Fraud

Ever since the U.S. Supreme Court's decision in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), federal courts have required shareholders in civil securities litigation to use financial experts to prove loss causation with a sufficient degree of precision. That is, the plaintiffs will likely need an expert event study or a similar statistical model to show that alleged corporate fraud—and not a combination of industry and economic factors—caused a drop in share prices. (See, e.g., *In re Vivendi Universal S.A. Securities Litigation*, 2009 WL 920259 (S.D.N.Y.))

After the ruling in *United States v. Schiff*, 2010 WL 1338141 (C. A. 3 2010), financial experts could be necessary to conduct comprehensive event studies in *criminal* securities fraud cases. In this case, the government accused two former Bristol-Meyers executives of orchestrating a massive securities fraud scheme related to the company's wholesale drug supplies in the early 2000s. Three separate press releases allegedly uncovered the fraud, each leading to drops in the company's market price. Before trial, and based on precedent from civil securities fraud cases (most notably *Dura*), the U.S. District Court (New Jersey) ruled that the government would need an expert to present the stock drop evidence.

Accordingly, the government retained a "stock drop expert" whose report addressed the effect of only one public announcement, which preceded a 15% stock drop. It also dealt only with exogenous events such as market, industry, and economywide effects. The defendants challenged the evidence under *Daubert*, claiming the evidence failed to "fit" the case because the expert did not statistically account for potentially unrelated negative events in the announcement. Further, if any portion of the press release repeated information from a prior announcement, then a stock price drop might be related to the redundant factor.

Government takes a gamble. The government still maintained that all of the negative events in the one announcement related to the fraud, and that several fact witnesses (previously undisclosed) would support this evidence at trial. The court called this a "theory shift" in the case. The expert's report did not rely on this evidence and the defendants might not have enough time to evaluate the new witnesses. The court also wondered whether the new testimony might be more appropriate for an expert.

Nonetheless, the court permitted the government to introduce its factual evidence of the stock price drop at trial and then move to admit its expert evidence. If the government failed to lay a sufficient foundation, however, then its expert's testimony would be "admissible only to refute an argument…that the market for [Bristol's] stock is not efficient or that extrinsic market factors account for the observed stock price drop," the court held.

The government appealed the *Daubert* ruling to the U.S. Court of Appeals for the Third Circuit. After reviewing the record, it found that the district court's "thoroughly explained" ruling allowed the government not only to present its fact witnesses at trial, but to petition the court for presentation of the expert stock drop evidence. Given the broad discretion afforded federal courts to manage cases and evidence, the Third Circuit affirmed the *Daubert* decision.

Five Keys to Protecting Your Financial Expert's Credibility in Court

Attorneys are becoming increasingly sophisticated about business valuation, making it easier for the best of them to pick apart an expert witness's testimony. It's not enough that your expert is qualified by credentials and credibility. To "bullet proof" your expert witness in court against even the most aggressive cross-examination, take note of these five quick tips:

1. **Avoid "puffery."** One of the easiest ways to discredit financial experts is by identifying areas subject to "puffing"—i.e., where they have exaggerated or overstated their qualifications. For example, if an expert boasts he has 25 years of business valuation experience, a good lawyer will ask methodical, detailed questions about that experience. If, at the end of the questioning, it turns out that the expert has been working for 25 years but has only performed four appraisals of the type at issue in the litigation—that's puffing, and it can damage the expert's credibility.
2. **Avoid overconfidence.** Financial experts want a court to take their qualifications seriously, but in an effort to impress the trier of fact, they may take an overly confident or "blustery" approach. ("I've been doing business valuation forever and I know everything" is an exaggerated example.) Make sure your experts aren't caught trying to look as though they have more experience than they in fact do.
3. **Affirm the data.** There are two aspects to reliable expert evidence. First, an expert's valuation must be based on reliable underpinnings. The witness must be able to answer the questions, "Where did you get the data?" "Do you know how the data are collected and compiled?" It is up to the expert to substantiate the source of the inputs supporting his or her opinion, and to disclose (per the Federal Rules) all the documents and data that went into that opinion. *Practice tip*: Ask your testifying experts to come up with a working list or chart of what they need to form their ultimate opinions and discuss any materials that may not be available or forthcoming. Revisit the list later in the litigation to make sure the expert received the materials *and* reviewed them.
4. **Affirm the methods.** Second, an expert's methods must be reliable. For example, courts may be skeptical if an expert fails to perform a discounted cash flow analysis when conducting an enterprise valuation, or fails to explain why it wasn't appropriate in the particular case. If your expert does conduct a DCF, make sure the analysis conforms to valuation authorities' and generally accepted techniques.
5. **Reaffirm educator role.** Remember that the role of your financial expert is to assist the judge or the jury in understanding a complicated, specialized area of knowledge. The bar against unreliable, irrelevant testimony is high, so make sure your experts rely on generally accepted valuation methodologies and omit anything novel or unproven. In addition, make sure your experts can describe their credentials and experience fairly and accurately, without overstatement. Finally—help them disclose and obtain all the materials they need to support their expert opinions, or risk surprise and loss of credibility at trial.

Experts Need to Show 'Analytical Fit' Between Data and Damages

***In re Texans CUSO Insurance Group,* 2010 WL 743291 (Bankr. N.D. Tex.)(March 2, 2010)**

In 2007 the owner of several insurance businesses sold to a Texas insurance company for $19 million plus an earnout payment of up to $21 million over three years. The owner also agreed to stay on as president, to manage his former operations and accrue the additional earnout. But fewer than four months into the transition he was fired. After a bitter and extended arbitration, the company was ordered to reinstate him with all back pay and benefits.

The company failed to comply, however, and the former owner sued for breach of the arbitration award and the parties' repurchase and employment agreements. Just two months before trial, the company filed for Chapter 11 bankruptcy, and the owner filed a proof of claim amounting to $22.3 million.

Company never intended to permit earnout. The facts clearly demonstrated the company fired the owner without cause, never intending to reinstate him, the federal bankruptcy court held. The parties' employment agreement stipulated the amount of back pay and benefits, which an expert for the owner (now plaintiff) determined to be $348,000.

The plaintiff's expert also presented a detailed description of consequential damages based on how the company would have performed had it kept the plaintiff in charge. Interestingly, the expert did not prepare a formal report on damages but relied on trial testimony and demonstrative exhibits. The company objected to the expert's proposed testimony under Rule 702 of the Federal Rules of Evidence and the *Daubert* standard. But since the court did not have a written report, it postponed its *Daubert* findings to permit the expert to present his calculations.

The parties' original sale agreement provided a complicated formula to determine the earnout amount based on annual revenues and earnings over the three-year contractual period (2007-2009). Accordingly, the expert applied the formula to the company's forecasted earnings, fixed and variable costs, and projected EBITDA to conclude that the total earnout payments would have amounted to just over $20 million. During his deposition (which took place three days before the *Daubert* hearing), the expert conceded he was not entirely familiar with the content and methodology of an industry study that he used to develop his damages model. By the day of trial, however, the expert was able to testify in detail about the survey's method. More importantly, he was able to explain the analytical link between the data and his conclusions.

Based on this testimony, the court concluded the expert appropriately relied on industry data and had "cured any deficiency" in his analytical understanding. Further, the expert had accounted for broad economic and industry factors in reaching his damages determinations. Finally, even though he had no prior experience in the insurance industry, the expert's qualifications as a CPA and CFE (certified fraud examiner), with experience in calculating and reviewing financial damages models in litigation, were sufficient to establish his expertise in this case, and the court denied the *Daubert* motion.

Loss of Multi-Million Dollar Damages Shows Appraisers Need to Know Applicable Law

***Dana Corp. v. Microtherm, Inc.*, 2010 WL 196939 (Tex. App.)(Jan. 21, 2010)(unpub.)**

The plaintiff manufactured and sold tankless water heaters. When various components began to fail, it sued the supplier as well as two makers of individual parts. Its claims alleged fraud, breach of contract, and a "laundry list" of violations under the Texas Deceptive Trade Practices Act. The plaintiff sought lost profits as well as lost business value and repairs, arguing the defective component parts resulted in failed water heaters, which in turn drove customers away and diminished the company's worth.

Prior to trial the plaintiff argued that the defendants were jointly and severally liable under applicable law. The court ruled otherwise, however, stating clearly that damages were divisible, and it required the plaintiff to "prove causation and damages separately" against each defendant.

Despite this ruling, the plaintiff took the position throughout trial that its damages were indivisible, supporting its claims with expert evidence of its total (undivided) lost profits and lost value. Only on the day of closing arguments did the plaintiff offer its expert to testify that he could break down damages among the defendants—47% against the supplier and 33% and 21% against the respective parts manufacturers. He also provided a summary exhibit detailing lost customers by each defendant's failure.

The defendants objected to the eleventh-hour submission of evidence and its summary nature. The trail court agreed, excluding the evidence and accepting only the plaintiff's offer of proof (i.e., counsel's statements regarding what evidence would have showed). The jury ultimately found all the defendants liable and, per its instructions, awarded *divisible damages* of $12.4 million against the supplier and $7.3 million and $5.8 million against the parts-makers. The plaintiff accepted the verdict but appealed the court's ruling that damages were divisible.

Can't have it both ways. The defendants argued that because the plaintiff moved to enter the trial verdict and recover on the basis of a divisible award, it could not argue on appeal that its recovery should have been based on indivisibility. The appellate court agreed. "It is undisputed that [the plaintiff] presented no evidence of defendant-by-defendant damages," it held. The plaintiff "knew when the trial began that the case was being tried on separate damages, and [it] had the opportunity to present evidence of separate damages" before and during trial.

For whatever reason, however, the plaintiff provided only the summary exhibit and last-minute testimony by its expert and failed to get these admitted (it chose not to appeal the trial court's exclusion of the evidence). As a result, the plaintiff failed to provide any evidence as to total damages caused by each defendant, the court concluded. At the same time, the plaintiff's evidence of indivisible damages was legally insufficient to support the jury's defendant-by defendant award, and the court vacated the same.

The published opinion leaves many unanswered questions. Why did plaintiff's counsel decide not to present proof of divisible damages? What communication took place (or failed to take place) between the attorney and the lost profits expert? Was the expert apprised of the pretrial ruling that applicable law required proof of divisible damages? If nothing else, the case shows how critical it is for experts to talk with attorneys about the controlling law, especially in lost profits and economic damages litigation, which so often depend on jurisdiction-specific standards of evidence and causation.