Daubert and Economic Damages: An Update

March 28, 2012
Agenda

• Introduction
• Presentation
• Questions and Answers — (anonymous)
• Slides — now available on front page of Securities Docket
  — www.securitiesdocket.com
• Wrap-up
Webcast Series

• April 18, 2012: “The Curious Case of Carlyle...and Efforts to Shut Down Investor Access to the Courts”
Today’s Presenters

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DAUBERT AND ECONOMIC DAMAGES: AN UPDATE

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Issues to be Covered

**Daubert and Economic Damages: A Legal Perspective**

- Expert Testimony is Not Legally Required for Some Damage Analysis
- Evidentiary Standards for Experts
- The *Daubert* Gate
- Expert Qualifications
- Relevance
- Reliability
- Practical Pointers for Experts
- The *Frye* Standard
Issues to be Covered (Cont.)

*Daubert* and Economic Damages: A Financial Expert’s Perspective

- Damages Overview
- Measures of Damages
- Evidentiary Challenges
- A Case Study of Damages
- Summary of Issues Covered
Daubert and Economic Damages: A Legal Perspective
Expert Testimony Is Not Legally Required For Some Damages Claims

- Rule 701 Allows for Lay Opinion Testimony (e.g., business owner)
- Must Be Based on Perception of Witness
- Can’t Be Based on Scientific, Technical or Other Specialized Knowledge Within Scope Of Expert Rule
- Sometimes Business Owners Present Damages Calculation Under Rule 701
  - Can Be Subject to Attack on Reliability, or Evidentiary Grounds Or If It Is Attempt to Evade Expert Witness Requirements
Advantages of Expert Witness for Damages Proof

- Practical – Persuasiveness
- Legal
  - Unlike Lay Opinion Witness, Experts Are Not Limited To Personal Observations and Experiences
  - Experts Can Rely on Facts Not In Evidence (Hearsay)
  - “A projection of lost profits will often, though not always, require some form of expert testimony.” *KW Plastics v. United States Can Co.*, 131 F. Supp. 2d 1265, 1275 (MD Ala, 2001)
Evidentiary Standards For Expert/Damages Testimony Can Be Case Dispositive

- Proof of Harm/Damages Generally A Necessary Element of Typical Business Contract/Tort Case
- Lack of Admissible Damages Proof Can End Plaintiff’s Case
  - Summary Judgment Before Trial
  - JMOL After Plaintiff’s Proof
Getting Through The Daubert Gate: Basic Requirements For Any Expert

- Necessary Expert Qualifications
- Testimony Is:
  - Relevant
  - Reliable
Expert Qualifications (Necessary; Not Sufficient)

- Damages Experts Typically Have Quantitative Expertise in Fields Such As
  - Accounting
  - Valuation
  - Economics

- Qualifications Alone Will Not Carry The Day
  - See, *e.g.* In Re Brand Name Prescription Drugs Antitrust Litigation, 186 F. 3d 781 (7th Cir. 1999)
Relevance: Is the Expert Answering a Question That Matters to the Case

- **Expert Testimony Will Be Barred If It Addresses Irrelevant Issues**
  - Lesson: Expert’s Analysis Must Be Informed/Guided By Lawyer’s Careful Analysis of Governing Damages Law
Reliability

- Most Frequent Source of Daubert Challenges to Damages Experts
  - Expert Must Rely on Appropriate and Credible Facts and Figures
    - Experts Cannot Merely Rely on Spoon Fed Documents or Summaries from Lawyers
    - *E.g.*, *Aircraft Filing Systems, Inc. v. Southwest Airlines Co.* 2011 WL 6122627 (N.D. Okla.) (damages testimony of expert barred because it was based on summary of damages provided by party and expert did not consult supporting documentation)
Most Frequent Source of Daubert Challenges to Damages Experts, Continued

- Expert Must Apply A Valid Methodology
  - Expert Testimony Is Excluded When “it is connected to existing data only by the *ipse dixit* of the expert.” *General Electric v. Joiner.* 522 U.S. 136, 146 (1997)
  - Subjective Determinations Cannot Form the Basis for a Valid Damages Claim. *See e.g., Silicon Knights, Inc. v. Epic Games, Inc.*, 2011 WL 6748518 (E.D.N.C.)
Most Frequent Source of Daubert Challenges to Damages Experts, Continued

Expert Must Properly Apply that Valid Methodology

- See e.g., ATA Airlines v. Federal Express Corp. 665 F.3d 882 (7th Cir. 2012) (eight page appellate discussion on inadequacies of plaintiff’s damages expert’s regression analysis.)

- Forecasts Used Must Be Valid and/or Tested

Practical Pointers Regarding Experts From Lawyer’s Perspective

- Lawyers need to carefully choose experts
- Lawyers and Experts Need to Thoroughly Work Through Issues and Analysis (Cooperation Is Easier Under Revisions to Rule 26)
- Be Wary of “Undisclosed Sub-Expert” Issue *e.g. Dura Automotive Systems of Indiana, Inc. v. CTS*, 285 F. 3d 609, 613 (7th Cir. 2002)
- When in doubt, err on side of providing information and documents to experts
Illinois and Other States Apply the *Frye* Standard

- 14 States Plus Washington D.C. Apply the *Frye* Standard:
  - Alabama*
  - Florida
  - Maryland
  - New Jersey
  - Pennsylvania
  - Arizona
  - Illinois
  - Minnesota
  - New York
  - Washington
  - California
  - Kansas
  - Montana**
  - North Dakota
  - Washington DC

- Under *Frye*, expert opinion testimony is admissible if the expert's techniques or working principles are generally accepted as reliable in the relevant scientific community

- The *Frye* standard makes it more difficult to sustain a challenge of the expert
Know What Standard Applies In Your Jurisdiction

- 24 States Apply the *Daubert* Standard
- The Remaining 12 States Apply Other Tests
Economic Damages: A Financial Expert’s Perspective
Damages Overview

- “But For” Concept
- Definition of Damages: The **MONETARY COMPENSATION** which the law awards to one who has been injured by the action of another
- Types of Monetary Damages / Remedies:
  - Compensable
  - Consequential
  - Punitive
Legal Criteria in Proving Damages:
- Causation
- Mitigation
- Reasonable Certainty
- Speculation
- Foreseeability
Measures of Damages

■ Determinants of Measurement
  ■ Temporary vs. permanent impairment

■ Three Measurements of Damages:
  1. Out-of-pocket Costs
  2. Lost Profits
  3. Destruction of Business Damages

■ Measure of Recovery:
  ■ Lost Profits
  
  Or

  ■ Fair Market Value Before and After
Traditional Lost Profits Model

Pre-Impairment Period   Post-Impairment Period

Date of Impairment   Date Retained   Date of Trial

Lost Profits

Theory 1: Discount to Injury Date
Theory 2: Escalate Back / Discount Front

Impaired Unimpaired

$5.0 $10.0 $15.0 $20.0 $25.0


Millions
Date to Which Future Losses Should be Discontinued

The Supreme Court Stated:

"It is both easier and more precise to discount the entire lost stream of earnings back to the date of injury – the moment from which earning capacity was impaired."

(Jones & Laughlin Steel Company v. Pfeller)
Destruction of a Business Measure of Damages

Fair Market Value (Going Concern)
One Day Prior to the Impairment $XXX

Less/Plus: FMV/Liquidation Value
One Day After the Impairment (XXX)

Economic Damages/Diminution in Value $XXX
Evidentiary Challenges

- **Daubert Case**
  - Can the Theory be Tested?
  - Subjective Interpretation of the Expert
  - Subject to Peer Review / Publication
  - Has the Technique been Accepted by the Scientific Community?
  - Any Non-Judicial uses of the Technique / Theory?
Advanced Battery Systems, Inc.
v.
Berringer’s Worldwide/ Western Battery Systems

A Case Study
Case Background

■ PLAINTIFF:

Advanced Battery Systems, Inc. ("ABS") is a medium sized industrial battery manufacturer and distributor.

■ DEFENDANTS:

Western Battery Systems ("Western") is an established industrial battery manufacturer and distributor.

Berringer’s Worldwide ("Berringer") is an international detective agency.

■ OTHER PARTIES:

Dry Dock Lifts manufactures Liquid Propane ("LP") Systems (a new technology) – Competitor of ABS/Western.

AquaLift is a manufacturer of forklift type vehicles – Major customer of ABS that went bankrupt as a result of new technology.
The industrial battery industry is divided into two segments:

- **STATIONARY** – backup power to hospitals and similar institutions in the event of a power failure
- **MOTIVE** – portable power for forklift trucks and other similar smaller vehicles
1940 • Western is formed
1989 • ABS is formed by Johnson and Davis
1991 • ABS becomes established in stationary batteries
1992 • ABS enters the motive battery business; Williams is hired away by ABS
1994 • AquaLift places a $150,000 order for batteries with ABS and ABS delivers
1995 • AquaLift files for bankruptcy; ABS writes down $150,000
1996 • February, Sharp is hired away by ABS; Western hires Berringer to investigate ABS
• July, Berringer broke into ABS offices twice to steal data
• A Western executive and three Berringer investigators are arrested and charged
• Williams and Sharp fear for their personal safety (due to the burglary and theft) and leave ABS
1997 • ABS loses its distribution agreement and is out of the motive battery business
Case Background: Industry Snapshot

- ABS made an immediate impact in the industry and took substantial market share away from Western.

- The AquaLift bankruptcy highlighted concerns many in the industry had that LP-based systems would penetrate the market.
  - If AquaLift were to come out of its Chapter 11 reorganization, it intended to manufacture LP-based systems.
  - The LP-based system rendered some motive battery systems obsolete for certain outdoor functions.

- Manufacturers of forklifts and other products represented 25% of the overall Motive Battery market before the introduction of LP-based systems.
Case Background: Allegations

- ABS alleges that Western threatened its senior management (former Western employees), Williams and Sharp, with bodily harm if they continued to compete with Western in the battery business.

- ABS alleges its Motive Battery Division was destroyed as a result of Western’s and Berringer’s actions.
Past Financial Performance: ABS
## ABS Consolidated Income Statements

<table>
<thead>
<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>$875</td>
<td>$963</td>
</tr>
<tr>
<td><strong>Gross Margin</strong></td>
<td>385</td>
<td>452</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>269</td>
<td>273</td>
</tr>
<tr>
<td>Depreciation</td>
<td>34</td>
<td>34</td>
</tr>
<tr>
<td>Bad debt</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>306</td>
<td>312</td>
</tr>
<tr>
<td><strong>Interest Expense</strong></td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td><strong>Pre-Tax Net Income</strong></td>
<td>($9)</td>
<td>$52</td>
</tr>
<tr>
<td><strong>Pre-Tax Profit Margin</strong></td>
<td>(1%)</td>
<td>5%</td>
</tr>
</tbody>
</table>

Extraordinary Bad Debt?  Write-off/Destruction of Motive Battery Division
## ABS Stationary Battery Division

<table>
<thead>
<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>$875</td>
<td>$963</td>
</tr>
<tr>
<td><strong>Y-o-Y Change (%)</strong></td>
<td>10.1%</td>
<td>40.0%</td>
</tr>
<tr>
<td><strong>Pre-Tax Net Income</strong></td>
<td>($9)</td>
<td>$52</td>
</tr>
<tr>
<td><strong>Pre-Tax Profit Margin</strong></td>
<td>-1%</td>
<td>5%</td>
</tr>
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</table>

**Damages?**
## ABS Motive Battery Division

### Damages?

<table>
<thead>
<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>$ 758</td>
<td>$ 1,160</td>
</tr>
<tr>
<td>Y-o-Y Change (%)</td>
<td>53.0%</td>
<td>29.3%</td>
</tr>
<tr>
<td><strong>Gross Margin</strong></td>
<td>326</td>
<td>522</td>
</tr>
<tr>
<td><strong>Operating Expenses:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>241</td>
<td>315</td>
</tr>
<tr>
<td>Depreciation</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Bad Debt</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total Operating Expenses</strong></td>
<td>270</td>
<td>345</td>
</tr>
<tr>
<td>Less: Interest Expense</td>
<td>70</td>
<td>70</td>
</tr>
<tr>
<td><strong>Pre-Tax Net Income</strong></td>
<td>$ (14)</td>
<td>$ 107</td>
</tr>
<tr>
<td>Pre-Tax Profit Margin</td>
<td>2%</td>
<td>9%</td>
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</tbody>
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**Extraordinary Bad Debt**  
Write-off/Destruction of Motive Battery Division
# ABS Motive Battery Division

## Normalized Pre-Tax Net Income

<table>
<thead>
<tr>
<th></th>
<th>Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>(000's)</td>
<td></td>
</tr>
<tr>
<td>Pre-Tax Net Income As Reported</td>
<td>($14)</td>
</tr>
<tr>
<td>Extraordinary Bad Debt</td>
<td></td>
</tr>
<tr>
<td>Normalized Pre-Tax Net Income</td>
<td>($14)</td>
</tr>
<tr>
<td>Pre-Tax Profit Margin %</td>
<td>-2%</td>
</tr>
</tbody>
</table>
**Motive Battery Industry Statistics:**

**Industry Stable/Maturing**

<table>
<thead>
<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Industry Sales</strong></td>
<td>$300</td>
<td>$314</td>
</tr>
<tr>
<td><strong>Y-o-Y Change (%)</strong></td>
<td>4.7%</td>
<td>4.8%</td>
</tr>
<tr>
<td><strong>Industry Profit Margin</strong></td>
<td>19%</td>
<td>22%</td>
</tr>
<tr>
<td><strong># of Manufactures</strong></td>
<td>19</td>
<td>22</td>
</tr>
</tbody>
</table>
## ABS Motive Battery Division
Reasonable Assumptions for Analysis

<table>
<thead>
<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales Growth:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ABS Motive Battery Division</td>
<td>53.0% 29.3% 6.7%</td>
<td>6.0% 0.0% 4.0% 4.0% 4.0%</td>
</tr>
<tr>
<td>Motive Battery Industry</td>
<td>4.6% 4.8% 2.4%</td>
<td>3.8% -4.3% -2.0% 1.5% 2.1%</td>
</tr>
<tr>
<td><strong>Profit Margins:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ABS Motive Battery Division*</td>
<td>9 % 20% 19%</td>
<td>19% 20% 20% 21% 21%</td>
</tr>
<tr>
<td>Motive Battery Industry</td>
<td>22% 20% 18%</td>
<td>17% 16% 15% 16% 18%</td>
</tr>
</tbody>
</table>

* Normalized
Plaintiff’s Damage Presentation
Issues for the Plaintiff to Consider

■ Measure of Damages?
  ■ Lost Profits or
  ■ Fair Market Value Before and After

■ Causation/Mitigation Issues

■ Normalization Issue

■ Determine Reasonable Market Penetration Levels on an Unimpaired Basis

■ Impaired Losses
  ■ Mitigation/replace management and distribution agreement
  ■ Economic effect of the introduction of LP-Based Systems
  ■ Could ABS have manufactured LP-Based Systems
  ■ Liquidation/commercially reasonable
### ABS Expert Damage Calculation
*(20% Sales Growth Assumption)*

<table>
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<tr>
<th></th>
<th>Pre Impairment</th>
<th>Post Impairment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sales</strong></td>
<td>$758  $1,160  $1,500  $1,600</td>
<td>$1,920  $2,304  $2,765  $3,318  $3,981</td>
</tr>
<tr>
<td>Y-o-Y Change (%)</td>
<td>53.0%  29.3%  6.7%</td>
<td>20.0%  20.0%  20.0%  20.0%  20.0%</td>
</tr>
<tr>
<td><strong>Pre-Tax Net Income</strong></td>
<td>$(14)  $107  $297  $153</td>
<td>$372  $460  $566  $693  $846</td>
</tr>
<tr>
<td><strong>Pre-Tax Margin</strong></td>
<td>-2%  9%  20%  10%</td>
<td>19%  20%  20%  21%  21%</td>
</tr>
<tr>
<td><strong>Sum of Pre-Tax Net Income</strong></td>
<td></td>
<td>$2,937</td>
</tr>
</tbody>
</table>

**DAMAGES:** $2.9 million
Critique of Plaintiff’s Presentation

- Lost Profits - $2.9 million in Damages
- Plaintiff Significantly Overreaches and Ignores the Following:
  - 20% Growth assumption/does not reflect economic reality
    - Growth from 1994 to 1995 was only 6.7%
    - Competing product (e.g., LP-Systems) would have impacted sales
    - Mature industry/project growth projected to be negative to 4%
  - No risk-adjusted discount rate
  - Jury will question why ABS withdrew from the market
    - Could ABS have replaced management within six months to two years?
    - Could ABS have manufactured or distributed LP-Based Systems?
Defendant’s Motion to Exclude

- Expert not qualified in specific subject (Rule 702)
  - Broders v. Heise
  - Gammill v. Jack Williams Chevrolet
- Expert failed to follow proper methodology (Rule 702)
  - Ignored historical record and “alternative causes”
- Expert used invalid data (Rule 703)
  - Improper growth assumptions
  - Wrong discount rate (i.e., no discount rate)
- Unfair prejudice (Rule 403)
Plaintiff’s Response

- General expertise sufficient to admit expert
  - Dickerson v. Cushman
  - Exum v. General Electric
  - Witness’ expertise uncontested
- “Proper methodology” is well-established projected income/present value of future cash flow methodology
  - Carefully and consistently followed
  - Valid among other accountants/valuation experts
Validity of data to which expert’s analysis applies
- Expert relied on kind of data generally used in evaluating businesses
- Based on testimony of other witnesses
- Separate fact issue for jury to weigh

Qualified expert’s application of valid methodology “assists the trier of fact to understand” (Rule 702)
- Methodology neither novel nor complex
- Methodology not “scientific” as in Daubert
- Reliability of this expert testimony hinges on testimony of fact witnesses
Summary of Issues Covered

- Experts Should Not…
  - Overreach
  - Speculate
  - Be an advocate for a client

- Experts Should…
  - Be realistic/reasonable
  - Question liability/causation/mitigation
  - Respect the *Daubert* standard
QUESTIONS?
Thank You for Your Time