CHAPTER 1

Introduction

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This book is designed to provide a methodological framework for how lost profits should be measured in business interruption litigation. Such a framework is provided so that a standard approach can be followed in the measurement of such damages.

In following the discussion, readers will notice the interdisciplinary nature of commercial damages analysis. Depending on the type of case, the expert who seeks to measure a plaintiff's lost profits needs to possess a well-rounded knowledge of the research and practices in various areas of expertise. In some cases, the issues are more limited and defined. Other cases are complex and require broad areas of expertise. These may include certain major subfields of economics (macroeconomics, microeconomics, econometrics, and forensic economics), several subfields of finance (investment analysis, capital market theory, and corporate finance), and accounting. Given the broad range of expertise that ultimately may be needed and that few individuals would be experts in all of these fields, a team of experts, such as economists working with accountants, is often the optimal solution for complex cases.

While we recognize, and we will elaborate on, that a reliable economic loss analysis may require expertise of experts from disciplines (such as economics, finance, and accounting), this edition will endeavour to focus more on the important economic issues that are relevant to so many different types of cases.

This book is not meant to present an exhaustive review of all the issues relevant to commercial damages analysis. Rather, it is meant to discuss those issues that are the most important and fundamental. It is necessary to bear in mind, however, that each case brings with it a unique set of factors that need to be considered on an individual basis. No broad-based book, such as this one, can anticipate all of the unique circumstances that may be

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encountered. For this reason, this book focuses on those circumstances that are most commonly encountered and attempts to present a general damages evaluation framework capable of handling most of them.

Development of the Field of Litigation Economics

The field of litigation economics, which is sometimes referred to as forensic economics, has developed significantly over the past two decades. During this time period, the National Association of Forensic Economics (NAFE) was formed. It is a national body of economists who work in the field of litigation economics and who may provide expert testimony in court proceedings. The organization is composed primarily of PhD economists, many of whom have academic affiliations. In addition to the advent of NAFE, two well-received, refereed (peer-reviewed) academic journals devoted to the field of litigation economics have been created. They are the *Journal of Forensic Economics* and the *Journal of Legal Economics*. These journals have given litigation economics an academic stature similar to other subdisciplines in the field of economics. In addition to this forum for respected scholarly work in the area, most of the major meetings and the leading professional conferences of economists in the United States, including the annual meetings of the American Economics Association and various regional associations, now have several sessions, sponsored by NAFE, devoted exclusively to litigation economics. Such conferences have allowed an exchange of ideas that has further developed the methodologies in the field.

At present, the leading use of damages experts, often economists, is in personal injury and wrongful death litigation. This is not surprising, since this type of litigation is the most common.[1] While there are some similarities between lost profits analysis and the estimation of damages in personal injury and wrongful death litigation, there are major differences that cause them to be two separate fields, often including different groups of practitioners. Most economists who do personal injury damages analysis have a background in labor economics but may not have a background in finance. Many of these experts are sole practitioners who often have a full-time academic position. Experts in business interruption matters, however, tend to be a more diverse group. Some of them work for large firms, including some public companies. They come from a variety of backgrounds, the most common of which are accounting, economics, and finance.

[1] Lance Bachmier, Patrick Gaughan, and Norman Swanson, "The Volume of Litigation and the Macroeconomy," *International Review of Law and Economics*, 24(2) (2004): 191–207.

Development of the Field of Forensic Accounting

Forensic accounting has undergone great development and has become a well-defined specialization in the accounting profession. Part of this development was due to the competitive pressures that were placed on traditional accounting work such as auditing and taxation. However, the most fundamental reason has been the growth in demand for this very specialized expertise. Some of this development has been focused on the detection of fraud. Other work has been directed toward the development of standard methodologies for the valuation of businesses. Various organizations have sought to market training and offer certification programs in these areas.

As noted, economists are often called on to provide testimony on damages in personal injury and wrongful death litigation. These cases utilize a methodology that does not vary significantly among cases. This methodology has been well developed in the forensic economics literature.[2] In addition, a concise statement of many of the generally accepted steps in the damages measurement process for personal injury cases has been set forth in *Economic Expert Testimony: A Guide for Judges and Attorneys*.[3] The methodology usually involves projecting lost earnings and fringe benefits (net of mitigation in personal injury cases) over the work-life expectancy of the plaintiff, as well as valuing lost services over a time period that may approach the life expectancy (or, more accurately, the healthy life expectancy) of the plaintiff/decedent. The worklife is the generally accepted standard for the terminal date of lost earnings estimates, while the life expectancy is often used as a guide to establish the length of the loss period for the valuation of lost services. (The life expectancy may be reduced to reflect the diminished ability to provide services due to the aging process, and this may be reflected in the healthy life expectancy.)[4] Both the life expectancy and the worklife expectancy are based on statistical data that establish averages from demographic and labor market characteristics. This contrasts with lost profits analysis in which the loss period is usually determined by a different set of circumstances, such as a time period set forth in a contract. Naturally, there may be differing interpretations of this contract and what it means about the length of the loss period.

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[2] Stanley P. Stephenson, David Macphearson, and Gerald Martin, *Determining Economic Damages*, Revision 25 (Costa Mesa, CA: James Publishing, 2016).

[3] Thomas Ireland, Stephen M. Horner, and James Rodgers, "Reference Guide for Valuing Economic Loss in Personal Injury, Wrongful Death and Survival Actions," in *Economic Expert Testimony: A Guide for Judges and Attorneys* (Tucson, AZ: Lawyers and Judges Publishing, 1998), pp. 1–108.

[4] Michael Brookshire and Frank Slesnick, "A 1990 Survey Study of Forensic Economists," *Journal of Forensic Economists* 4(2) (Spring–Summer 1991): 125–149.

In personal injury litigation, the monetary amount that is presented is often derived from the historical earnings of the plaintiff or decedent. For those who have not yet had much of an earnings history, lost earnings may be derived from government statistics, which list earnings as a function of age, sex, and education. Where appropriate, historical compensation data may allow the expert to measure the value of fringe benefits. Once the total compensation base has been established, the expert constructs a projection by selecting a proper growth rate. The projected values are then brought to present-day value terms through the application of an appropriate discount rate.

In employment litigation, the expert may project damages using similar methods as those employed in personal injury cases. In this type of lawsuit, the issue may not be losses over a plaintiff's worklife but may involve losses over the expected amount of time the plaintiff would have remained at a given employer. In such cases, the economist may utilize databases and probabilities that allow him or her to estimate that time period. Sometimes these probabilities are referred to as "Baum factors."[5]

The role of the economist can be expanded when there are claims of bias or other discriminatory practices. Here, in addition to possibly measuring the damages of the plaintiff, the economist may be called on to utilize his or her econometrics background to render an opinion on the liability part of the case.[6]

Business interruption loss analysis tends to exhibit more variability than that of those other types of lawsuits. Although some of the evaluation techniques used may be similar, the circumstances often vary more widely from case to case. In addition, the industries involved can be very different and may each present unique issues. Given this wide variability, business interruption cases often exhibit a greater degree of complexity than the two types of litigation mentioned previously. They typically involve significant time demands for the expert who must conduct a thorough analysis. These time demands often are greater than those associated with a typical personal injury or wrongful death loss analysis, thereby making an expert business interruption analysis a more expensive proposition for clients.

Another important difference between business interruption analysis and personal injury or wrongful death loss analysis is the role of cost analysis. The losses of a worker are typically wages and benefits; job-related expenses usually are not a significant factor. In business interruption analysis, however, costs related to lost revenues are generally quite important. It is here that the skills of an accountant may be most useful in measuring the appropriate costs that would have been incurred in order to realize certain lost revenues. This is why we have devoted an entire chapter to cost analysis.

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[5] Charles L. Baum II, "Employee Tenure and Economic Losses in Wrongful Termination Cases," *Journal of Forensic Economics*, 24(1) (2013): 41–66.

[6] Michael Piette, "Economic Methodology and the Analysis of Employment Discrimination," *Journal of Forensic Economics* 4(3) (Fall 1991): 307–316.

Qualifications of an Economic Expert

It is important that the business interruption expert possess a well-rounded background in order to measure the damages reliably and withstand the criticisms that will come during cross-examination. While courts are generally somewhat lenient in whom they accept as an expert, the "expert must possess requisite skill, training, education, knowledge, or experience from which it can be assumed that the opinion is reliable."[7] Given that these are generic attributes, it is important to evaluate the expert's specific credentials relevant to measuring economic damages.

The desirable qualifications of an economic expert witness are given in various publications in the field of litigation economics. Examples can be found in Stuart Speiser's *Recovery for Wrongful Death and Injury,* Michael Brookshire and Stan Smith's *Economic/Hedonic Damages,* Gerald Martin's *Determining Economic Damages*, and Baker and Seck's *Determining Economic Loss in Injury and Death Cases*.[8] The qualifications listed in these publications focus on applications in personal injury and wrongful death litigation. The requisite qualifications for competently estimating business interruption lost profits and rendering an expert opinion are similar. However, the expert qualifications in business interruption matters are normally broader. These have also been set forth in the forensic economics literature.[9]

A list of the desirable qualifications of an economist who could provide expert witness testimony on business interruption losses includes:

- PhD in economics or finance
- Background in finance or financial economics
- University teaching position, preferably at the graduate level
- Scholarly publications in economics, finance, or accounting
- Professional presentations in economics, finance, or accounting
- Experience in industry analysis and forecasting
- Experience in commercial damages analysis

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[7] *Mattott v. Ward*, 48 N.Y. 2d 455, 423 N.Y.S. 2d 645 (1979).

[8] Stuart Speiser, *Recovery for Wrongful Death and Injury,* 2nd ed. (Lawyer's Cooperative Publishing, 1988); Michael L. Brookshire and Stan V. Smith, *Economic/Hedonic Damages, The Practice Book for Plaintiff and Defense Attorneys* (Cincinnati, OH: Anderson Publishing, 1990); Gerald Martin, *Determining Economic Damages* (Santa Ana, CA: James Publishing, 1995); W. Gary Baker and Michael K. Seck, *Determining Economic Loss in Personal Injury and Death Cases* (Colorado Springs, CO: Shephard's/McGraw-Hill, 1987).

[9] Patrick A. Gaughan, "Economics and Financial Issues in Lost Profits Litigation," in *Litigation Economics,* Patrick A. Gaughan and Robert Thornton, eds. (Greenwich, CT: JAI Press, 1993).

The qualified witness may not possess all of the above but may have strengths in one area that outweigh deficiencies in other areas. Courts and juries should consider such factors when weighing the testimony of individuals who have been presented as experts but who may lack many of these attributes or who only possess minimal levels of the listed qualifications. Other individuals who are strong in most or even all of the areas may "bring a greater level of expertise to the table."

Overview of the U.S. Court System

In the United States there are two different court systems: federal courts and state courts. Civil lawsuits are typically heard in state courts, although many large commercial lawsuits are heard in federal court.

Federal courts are organized on three levels. The first level consists of 94 federal districts. District courts are the main trial courts of the federal system. Above the district courts are 13 circuit courts which, in turn, are below the U.S. Supreme Court, which is the highest court in the land. These circuit courts handle appeals that may arise from a district court. These circuits correspond to various geographical areas, which may include various states.

Sometimes state court claims can be brought in federal court based upon a claim of diversity jurisdiction where the parties reside in different states. For example, a defendant who is located in a different state may pursue the removal of a case to federal court by citing such diversity. One reason a defendant may want to do this is that he or she may believe they might receive more favorable treatment in federal court. Sometimes this is due to the fact that some states tend to give high verdicts for plaintiffs in certain types of cases.

Judges in federal courts are selected by the president and are confirmed by the advice and consent of the U.S. Senate. Such judicial positions could be held for life (barring misconduct), even though many federal judges often resign at some point.

The other part of the U.S. court system is the state courts. The trial courts of the state system are referred to as superior courts. These courts tend to be organized at the county level. Appeals of state court decisions are brought to state appellate courts. In appellate courts, the appeal issues are argued before a panel of judges where decisions are rendered through majority rule. In such decisions the panel can decide to let the original verdict stand, reverse the verdict, or call for a new trial. The state court system also has a state supreme court where appellate court decisions may be brought.

State court judges can be appointed or elected. State courts enforce state laws and handle the bulk of civil disputes such as breach of contract claims.

Example of How Courts Weigh and Compare Credentials of Experts

When hearing the opinions of two opposing damages experts, courts will naturally consider the credentials of the experts when deciding how much weight to give their opinions. This was very clear in *United Phosphorous, Ltd. v. Midland Fumigant, Inc*. In discussing the respective credentials of two economists put forward as damages experts, the courts summarized their backgrounds in this way:

> *Hoyt received a B.S. degree in Milling Technology from Kansas State University in 1962, and a PhD in Agriculture and Applied Economics from the University of Minnesota in 1972. Hoyt previously held a teaching position at the William Mitchell College of Law in St. Paul, Minnesota and served as a guest lecturer at the University of Minnesota and at St. Olaf College. Hoyt has published a total of seven articles in his entire career, two of which appear in agricultural economics journals, and two of which were published in law reviews, and were therefore not subject to peer review by economists.*
>
> *In contrast, Dr. John Siegfried is a professor of economics at Vanderbilt University and has served as a professor there for 24 years. Siegfried earned a bachelor's degree in economics from Rensselaer Polytechnic Institute in 1967, a Master of Arts degree in economics from Penn State University in 1968, and a PhD in economics in 1972. At Vanderbilt, Dr. Siegfried served as chair of the department of economics from 1980 to 1986. He taught numerous courses at Vanderbilt, including undergraduate and graduate courses on industrial organization and antitrust economics.*

The court continued with a discussion of Dr. Siegfried's credentials and then addressed his publication record:

> *Siegfried has authored over 100 articles, which have been published in economics journals or as chapters in various books on economics. Siegfried currently serves on the editorial board of three economics journals, and frequently "referees" articles submitted for publication as a contribution to scientific knowledge in the field of economics.*[10]

It is interesting to note that the court put particular emphasis on the relative publication and scholarship records of the two experts. One had a more limited publication record, a record that was not focused on the areas on which he was testifying. The other had an extensive publication record

[10] *United Phosphorus, Ltd. v. Midland Fumigant, Inc.*, 173 F.R.D. 675, 1997.

and was also a referee for such publications. The court seemed impressed with these credentials, and it is not surprising that it put more weight on that expert's opinions.

Qualifications of an Accounting Expert on Damages

In lost profits litigation, the courts have consistently ruled that both economists and accountants are appropriate expert witnesses to testify on damages. Like economists, the background of accountants can vary considerably. Sometimes we find that attorneys hire accountants to do lost profits analysis assuming that by virtue of the training and experience in accounting, they have the requisite expertise to conduct such an analysis. As with economists, such general assumptions often are wrong. Lost profits analysis is a unique area requiring specialized expertise and experience.

The typical accountant possesses a bachelor's degree in accounting and often is a certified public accountant (CPA). Some accountants may not have passed the CPA exam and lack this certification, but it is unusual to see such individuals presented as litigation experts – especially when there is such an abundance of accountants who are CPAs. Many CPAs also possess a higher degree – often a Master's in Business Administration. This degree may feature a specialization in certain relevant areas such as accounting or finance. The characteristics of an MBA degree and what it implies about an expert's credentials will be discussed later in this chapter.

As the practice of accounting has gotten increasingly competitive, accountants have branched out into more lucrative areas of consulting such as expert witness work. Some accountants have also been able to bring specialized knowledge such as what they may have acquired from training as a certified fraud examiner (CFE). They also may bring to bear their experience working with clients and matters in industries that may be related to the lawsuit in question.

Interdisciplinary Nature of Commercial Damages Analysis

Most commercial damages analysis is performed by an expert from one discipline – economics, finance, or accounting. However, when the analytical demands of the case require diverse skills and knowledge, expertise in just one of these areas may not be enough. When experts go outside of their own fields and dabble in areas for which they have little training or expertise, this may yield a bad result. For example, if an individual, such as an accountant who has little or no training in statistics or econometrics, constructs a projection of lost revenues using multiple regression or time series analysis, the projection may be replete with flaws. Such flaws could

be readily avoided by gaining the assistance of an econometrician or statistician or by using more basic projection methods.

In complex business loss cases, it may be preferable to employ a team of experts, with one leading expert providing the methodological structure for the analysis and performing the part that is within his expertise. Other experts will then provide their own input on which the leading expert will rely to put forward the loss measure.

While it is acceptable for one expert to rely on the opinions of other team members when putting forward an opinion, at times it may be useful to have more than one expert on the team testify. In this manner, each expert stays within his or her own knowledge base and is capable of handling the cross-examination on the relevant issues that arise.

Relative Strengths of Economists versus Accountants

Economists have training in various forms of macroeconomic and microeconomic analysis. Often economists have extensive training and expertise in statistical analysis and econometrics, skill areas that may be invaluable in forecasting. However, unless they have separately acquired a background in finance, many economists have limited familiarity with the analysis of financial statements. Such analysis is not part of the normal training of economists who do not do work in finance.

Accountants, especially ones who have training in financial analysis and corporate finance, may be able to bring such skills to a case. In addition, knowledge of cost accounting is also very useful in lost profits analysis.

Each case brings with it its own specialized skill demands. An accountant with a CPA and Master's in Business Administration (MBA) may be able to do a competent job in a straightforward lost profits analysis. However, it is important to bear in mind that in terms of educational training, an MBA is a general business degree. The economics and forecasting courses in MBA programs are often elementary and provide the student with only limited training in these areas, training that would not be considered expertise by economists. These courses are not comparable to the training that a PhD economist normally receives. Experts who possess only an MBA have been rejected by courts when they seek to offer expert opinions requiring specialized and advanced knowledge. For example, in *Thomas J. Kline, Inc. v. Lorrilard,* the court concluded that a witness with only an MBA was merely a professional witness and did not possess the requisite expertise, such as a background and training in antitrust economics, to testify whether a company's credit practices constituted a violation of the Robinson Patman Act.[11] One should also bear in mind that a doctorate in Business Administration

[11] *Thomas Kline v. Lorrilard,* 878 F. 2d 791 (4th Cir. 1989).

is offered, which offers significantly greater training than an MBA. Some accountants have PhD degrees and also possess such training. However, one of the strengths of accountants is their field experience. It is particularly useful if it is in the industry that is being considered in the lawsuit. Accountants with PhD degrees may be pure academics and may not have the experience of a practicing accountant.

An example of the court's reaction to opposing experts who possessed some of the strengths and shortcomings discussed above can be found in *Digital Analog Design Corporation v. North Supply Company*. The plaintiff introduced an expert who had a PhD and who presented himself as an expert in economics and business finance. While the court appeared confused by the forecasting methods the economist employed, it was notably impressed.

> *In this regard DAD's economic expert in the field of economic analysis, with a large number of publications and professional activities to his credit. The evidence would reasonably support his technique of cost-profit analysis, the so-called "time series analysis and projection."*
>
> *NSC, by comparison did not produce a comparable expert. Instead, NSC relied upon the testimony of a certified public accountant, an employee controller of NSC, a Mr. Simon, neither of whom it appears had as extensive training or expertise in the time series analysis method as had Dr. Zinser, and neither of whom utilized a competing method of analysis to calculate a lesser amount of profits.*[12]

Although impressed by the economist's forecasting abilities, the court found his cost analysis lacking. The economist applied the gross margin to projected lost sales without more carefully measuring incremental costs along the lines of what is discussed in Chapter 6. A solution that neither side attempted would have been to have an economist do the lost revenue projection and an accountant conduct the analysis of the costs associated with the forecasted lost revenues. Such an approach is advocated throughout this book.

Difference Between Disciplines of Economics and Finance

Attorneys are more aware of the relative skills of economists versus accountants than they are when comparing specialists in economics versus finance. This is partly due to the fact that the fields are interrelated. Many economists consider finance to be a subfield of economics. Indeed, there

[12] *Digital & Analog Design Corporation v. North Supply Company,* 44 Ohio St. 3d 36; 540 N.E. 2d 1358, 1989.

is a subfield of economics called financial economics, which applies economic analysis to financial markets. However, there are several differences between a PhD in finance and a PhD in economics. For one, finance degrees are often conferred by a college of business within a university; economics degrees, however, may be offered by the university outside of the college of business. This difference is not important. What is more relevant is the different training of the individuals.

A finance PhD and an economics PhD provide different training. A PhD in finance may have some training in accounting and may have taken certain courses taught in business school that economists are not required to take. Many economists lack any knowledge of finance and financial statements. It is possible, for example, to get a PhD in economics without ever having even seen a financial statement (as shocking as this sounds). Indeed, many economists do their work in complicated and esoteric areas and consider topics such as the analysis of financial statements simplistic. Nonetheless, it is important that the economists in commercial damages analysis have a broad knowledge base that goes beyond the training received in graduate school. Those, for example, who write their dissertation on a financially related topic may get this background as part of their thesis research. Each expert has a unique combination of credentials, training, and experience. The court and jury will have to consider this set of credentials and then determine the weight to apply to the testimony.

Finding a Damages Expert

There are many ways for an attorney to find a damages expert. One of the most often used is word-of-mouth referrals, whereby an attorney consults with colleagues he or she respects and gets the names of experts who have successfully performed for them. If this process is not productive, other methods must be employed.

There are certain media that advertise the services of experts. They include regional legal publications as well as legal reference diaries. It is important that references be gathered and checked, particularly in cases where the attorney does not have any information on the expert other than what the advertisement lists. This review process can be enhanced by a verdict search, which may reveal the names of cases in which the expert has testified.[13] The attorneys who retained the expert in the past and the attorneys who cross-examined the expert in prior matters can be consulted for feedback. However, an adversarial attorney may fail to give an objective

[13] A data source that publishes such information on a weekly basis is *Verdict Search* (East Islip, NY: Moran Publishing Company).

review, particularly an attorney who did not do as well as he or she would have liked in the case in question.

Other sources where one can obtain information on experts are the expert referral companies. These are firms that maintain names and curriculum vitae (CVs) of experts with many different specialties whom they refer to attorneys for a fee.[14] A CV is a document that lists an expert's credentials. The fee that these companies charge may include an initial charge as well as a built-in hourly charge incorporated into the expert's fee. This causes the expert's fee to be different from what it otherwise would be if he or she were contacted directly without a referral intermediary. However, referral agencies can greatly speed up the process of finding an expert – particularly if one is looking for unique expertise from a specialist in a narrowly defined industry.

Another source of experts is local universities. A professor at a nearby university may have a certain appeal to a jury from the same community. In addition, professors may possess the ability to explain complicated concepts clearly. However, attorneys have to be very careful if they hire an academic who lacks litigation and testimony expertise. It takes a certain personality to withstand the rigors of the adversarial litigation process in the United States. Furthermore, the way one voices arguments and positions in an academic environment can be very different from how one expresses those same arguments and positions in an adversarial litigation environment. As obvious as this sounds, many would-be litigation experts who are pure academics may find this difficult to comprehend. Therefore, attorneys need to exercise caution in using untested experts – their testimony may be somewhat unpredictable. The role of experience will be discussed later in this chapter.

Several economic consulting firms offer litigation-related services. Some specialize in commercial matters while others offer a variety of damages-related services. These economic consulting firms range from small "boutiques" to large national firms. Some attorneys may mistakenly think that if they hire a large firm they may be hiring a well-qualified expert. This may or may not be the case. It is also important for attorneys to bear in mind that the role of an expert witness is ultimately an individual role. Being part of a large firm with many coworkers may be nice but it may not help the expert when he or she is on the witness stand as an individual.

Critically Reviewing a Potential Expert's Curriculum Vitae

Many attorneys take at face value the content of a potential or opposing expert's curriculum vitae. They merely give the CV a cursory scan and conclude from the length of the CV that the expert possesses impressive credentials.

[14] Technical Advisory Service for Attorneys, (www.tasanet.com) and ExamWorks (www.examworks.com).

A closer review of the listings included on the CV, however, may possibly expose the misleading nature of the items. For example, in lieu of quality publications, an expert may list presentations made before attorneys, which are nothing more than marketing appeals and sales pitches. A CV may list very general articles published in legal newspapers and magazines. These articles, though, do not enjoy the scrutiny that a peer-reviewed or refereed journal article or book would. Sometimes what is listed as a publication is a paper or article that has not even been published. Opposing counsel may be able to take advantage of such misleading entries on a CV.

Degrees

Some basic comments on degrees are mandatory. The most fundamental characteristic of a degree as it relates to litigation is the relevance of the degree. It is very common for experts to want to testify in an area that is outside their expertise. Courts, though, have been supportive of objections to experts who testify outside their expertise.[15] In the area of commercial damages, one sees a variety of individuals present themselves as experts. Courts are often liberal in accepting such individuals and rely on the *voir dire* process and cross-examination to expose any deficiencies. However, attorneys should be aware that PhDs in some fields provide little or no training in the areas that are relevant to most types of commercial damages analysis. For example, fields like engineering or operations research may provide little training relevant to measuring damages in litigation.

Attorneys should be very wary of the "mail-away PhD." These are PhD degrees that one can earn at home. Several institutions offering such PhDs have sprung up, and some even advertise their degrees in major publications. This issue has become more convoluted as online higher education has grown considerably; now even major academic institutions are offering online courses. In fact, online education has become one of the faster-growing areas of academia. If the degree-granting institution is unknown, the attorney should read its catalog course descriptions and degree standards to review the criteria employed for issuing degrees. When encountering experts with questionable degrees, this can be a very fertile area of inquiry.

Published Books

Published books can be impressive credentials for an expert to have. These books are even more noteworthy if they are published by major publishers, who can afford to be more selective. Books that have received acclaim or won awards for their quality are even better. In addition, books that have

[15] *Wright v. Williams*, 47 Cal. App. 3d 802, 121 Cal. Rptr. 194 (1975).

been used as textbooks may also provide the author with credentials that other experts who have not published any books may lack. Books in the area in which the expert is testifying can be invaluable. It is ideal to use as an expert the person "who wrote the book" in the area.

Beware of books published by vanity publishers. These publishers "publish" a book for an author – for a fee. They are not unlike photocopy houses as opposed to the more traditional publisher. Having a book published in such a way implies that none of the reputable publishing houses considered the work worthy of publication. It also implies that the book in question has a very limited readership and may not be regarded as authoritative by anyone in the field.

Refereed or Peer-Reviewed Journal Articles

In addition to published books, another important standard used for evaluating scholarship in academia is *refereed,* or peer-reviewed, journal articles. A refereed journal is one that utilizes a group of experts to blindly review articles submitted to the journal in their specialty. A journal's editors will allocate the articles to the referees and ensure that the process is completed without revealing the names of the authors or the referees. These referees judge the quality of the article and decide if it is worthy of publication. Peer-reviewed articles are very different from articles that undergo editorial review; in the latter case, an editor simply decides whether a piece is of interest to the readers.

As noted earlier, there are two refereed journals in the field of litigation economics. They are the *Journal of Forensic Economics* and the *Journal of Legal Economics*. At one time there were three journals in the field. However, another journal, *Litigation Economics Review,* has been merged into the *Journal of Forensic Economics*. While many of their articles focus on areas other than commercial damages, a certain quantity of articles on business interruption losses have been published in each of these refereed journals. Other refereed journals which feature articles in the area of commercial damages can be found in the closely related field of law and economics. This is a subfield of economics in which someone getting a PhD in economics can specialize. The five leading journals in the field are the *Journal of Law and Economics; Journal of Legal Studies*; *International Review of Law and Economics; Journal of Law, Economics and Organization;* and *Journal of Empirical Legal Studies*. In finance, there are many refereed journals. These include the *Journal of Finance, Journal of Financial Economics, Journal of Applied Corporate Finance, Financial Management, Financial Analysts Journal*, and *Journal of Accounting and Economics*. In econometrics, there are several quality journals, such as *Econometrica,* the *Journal of Econometrics,* and the *Journal of the American Statistical Association*.

In the field of accounting, *Accounting Review* and *Accounting Horizons* are two leading refereed journals. *Accounting Horizons* is published by the

American Accounting Association. While not a refereed journal, the *Journal of Accountancy* is published by the American Institute of CPAs and is widely distributed to all members of the Institute. In addition, the *Journal of Corporate Accounting and Finance* is known as a source of quality articles in accounting and finance.

Presentations

An expert's CV often contains lists of presentations. In the academic world, the publication process often begins with a refereed presentation to one's peers in the specific area of the article. Refereed presentations are those that are accepted after a "call for papers" has been announced and submitted articles are reviewed by the organizers of paper sessions at academic conferences. The standards for acceptance vary widely but are usually higher than those for nonrefereed presentations. Attorneys should be wary of listings that are merely sales presentations made before potential clients. For example, a talk before a group of attorneys or at a law firm may be nothing more than a marketing session. This should not be considered a "credential."

Concluding Comments on CV Content

The expert witness arena has become quite crowded – professionals from many fields have discovered that they can charge substantial fees by serving as experts in litigated matters. They have learned that they may be better able to get the assignment if they have a long CV filled with impressive-sounding contents. Therefore, it is incumbent on the attorneys to carefully review the listed items and ascertain their quality. When reviewing the contents of an opposing expert's CV, one's own expert can be invaluable. For example, it has been observed on many occasions that experts who lack publications may try to compile a list of alternative credentials that may take up several pages. As noted above, one tactic employed by such witnesses is to list testimonies. It is important to note that prior testimony experience is not a real credential. Some attorneys may be reluctant to challenge an expert's background if the expert has been accepted as an expert a number of times by other courts. This may be a mistake. It simply could be the case that attorneys in those other cases made the same mistake. This was the court's position in *Kline v. Lorrilard:* "Although it would be incorrect to conclude that Gordon's occupation as a professional expert alone requires exclusion of her testimony, it would be absurd to conclude that one can become an expert simply by accumulating experience in testifying."[16] It is not unusual to have an expert with marginal credentials present a CV that is six or even ten pages in length. This may include several pages of testimony lists and

[16] *Thomas Kline v. Lorrilard,* 878 F. 2d 791 (4th Cir. 1989).

marketing presentations but little scholarly, peer-reviewed work. The retaining attorney must then decide if a list of court appearances as an expert witness is truly a credential, particularly if there is little else on the CV. Another example of misrepresentation is what may be listed under the heading of publications. Experts who lack legitimate publication credits often list items that range from papers that were not even published to speaking appearances. A cross-examining attorney may expose such misrepresentations. Therefore, it is the retaining attorney's responsibility to review the contents of an expert's CV carefully.

One additional comment on expert credentials is necessary. As noted earlier, it is common that attorneys merely give a CV a cursory scan prior to retaining or cross-examining an expert. They often conclude that if the CV is several pages in length, then the individual must possess sufficient expertise. Often attorneys who know that the expert has testified several times assume that there is no point in challenging the individual's expertise. This is sometimes an error. It could be that many of these other testimonies were made possible by other attorneys neglecting to make similar challenges. Moreover, prior courts could have concluded that the expert was allowed to testify but that the jury could hear the challenges and accord the testimony whatever weight it wanted to. The fact that an expert has testified does not indicate anything about what weight the jury ultimately gave the testimony. If there is a legitimate concern about the strength of an individual's expertise, the opposing attorney should not hesitate to pursue this.

Credentials Versus Experience in Litigation Analysis

Attorneys need to be aware that litigation-related analysis is a specialized field and not all highly credentialed experts can perform well in it. One classic example of an expert who possessed extremely impressive credentials but who lacked a familiarity with litigation analysis occurred in a recent antitrust case where the class action plaintiffs hired the Nobel Prize – winning economist Dr. Robert Lucas.[17] With respect to his credentials, the court had these comments:

> *We next come to Dr. Robert Lucas and the opinions he expressed, particularly as regards to the alleged collusion engaged in by all of the Defendants. First, it is proper to recognize Dr. Lucas' eminent and distinguished credentials. He is affiliated with the University of Chicago, indisputably one of the finest educational institutions in the world.*

[17] *In Re Brand Name Prescription Drugs Antitrust Litigation,* 1999 U.S. Dist. Lexis 550, January 19, 1999 (*decided and docketed*).

He is also a past recipient of the Nobel Prize in Economics, an award without equal in recognition of scholarship and contributions in his chosen discipline. It was with high expectation that the Court anticipated his testimony and denied requests from the defendants to preclude his testimony or to conduct a separate Daubert hearing out of the presence of the jury.

However, with respect to his analysis, the court was not as complimentary.

Sad to say, Dr. Lucas' testimony did not measure up to his unique qualifications. Among other things, his testimony showed the following:

He abdicated entirely the concept of the independence of the expert witnesses and simply became the sponsor for the Class Plaintiff's theory of the case
He was ignorant of material testimony and other evidence
His essential opinions were not only not based on the evidence, they were inconsistent with it
His opinions were offered without any scientific basis or having been the subject of economic methodological testing

Dr. Lucas reached his conclusions within 40 hours of his engagement and before he undertook any substantial or detailed study of the prescription drug industry. Most of the facts upon which he based his opinions and conclusions were supplied by Class Plaintiff's counsel, although he admitted he did not expect Class Plaintiff's counsel to have a balanced presentation. His expert's report was redrafted by Class Plaintiff's counsel in its entirety and only included what counsel wanted. In Dr. Lucas' own words: "I don't think there is a single sentence in this affidavit that's intact from the first draft that I proposed."

It seems that in the above case, the attorneys who retained Dr. Lucas probably thought that presented with such a notable expert, the court would simply adopt his opinions. However, Dr. Lucas is a known expert in macroeconomic theory – a field that is somewhat removed from the issues of that particular lawsuit.

The expert's credentials can certainly add weight to the presentation, but the expert's work has to be able to hold up under scrutiny. Notable academic articles that one has written along with awards for prior work can be very helpful, but the work done in formulating and supporting the opinions expressed in the current case has to maintain a high standard. In addition, academic credentials without experience in litigation work should give cause for concern.

Getting the Damages Expert on Board Early Enough

One of the errors that attorneys sometimes make in commercial as well as other types of litigation, such as personal injury and employment litigation, is not retaining the damages expert early in the process. Attorneys often devote much of their time to the liability side of their case while paying less attention to the damages aspect. Sometimes when they focus on damages, such as when gathering necessary damages-related documents, attorneys attempt to do so without the aid of a damages expert. This may result in a failure to collect important documents or to ask essential questions in depositions.

This error occurs for a variety of reasons. One is that the attorney may think he knows enough to gather the necessary damages-related materials and to conduct a complete deposition on his own. Another reason is that there may be cost constraints driving the litigation; the client is trying to control litigation expenses and the attorney does not want to add to the client's costs by hiring an expert – until the last minute when it can't be put off any longer. This often happens when deadlines for naming experts are near and the client either has to incur this cost or proceed without an expert. While the attorney may believe that he has gone to great lengths to keep his client's costs down, failing to retain the damages expert may cause the damages side of the case to suffer. If this happens, the apparent cost consciousness may in the long run be a disservice to the client.

In commenting on the failure to retain an economic damages expert early in the process, one expert noted:

> *A typical disaster scenario. The damage expert gets hired two days before the deadline for expert disclosure. A pile of documents and depositions arrive at the expert's office a week later. When the expert calls the attorney to ask for key data that was not in the pile, the litigator says, "It looks like we never asked for that in the document request or at depositions. Oh by the way, they want to take your deposition next week." The expert must do a damages analysis that makes assumptions about key facts and then alter those assumptions depending on trial testimony. This often results in a poorer analysis and increases experts costs by a factor of 2 or 3.*[18]

[18] James Plummer and Gerald McGowan, "Ten Most Frequent Errors in Litigating Business Damages," Association of Business Trial Lawyers (ABTL), *Northern California Report* (November 1995).

Courts' Position on Experts on Economic Damages

Courts have underscored the importance of expert testimony on economic damages. In fact, in *Larsen v. Walton Plywood Company,* the court stated:

> *Respondents point out that a reasonable method of estimation of damages is often made with the aid of opinion evidence. Experts in the area are competent to pass judgment. So long as their opinions afford a reasonable basis for inference, there is a departure from the realm of uncertainty and speculation. Expert testimony alone is a sufficient basis for an award for loss of profits.*[19]

The Federal Rules of Evidence are quite broad regarding what is considered acceptable expertise in an expert witness. Rule 702 states, "A witness may be qualified as an expert by *knowledge, skill, experience, training or education*." With such broad criteria, a wide variety of individuals may serve as experts. However, an individual who possesses some of the necessary criteria set forth in Rule 702 may still be unqualified to testify if opposing counsel can demonstrate to the court that the expertise is not specific enough to the areas in which the expert is testifying.

Not all states, however, have adopted standards similar to the Federal Rules. Some states, such as California, employ broad standards and will allow a wide array of individuals to testify if their testimony will be of assistance to the jury in reaching its decision. Even in the face of such broad rules, opposing counsel may be able to exploit the weakness in an expert's credentials on *voir dire,* which may reduce the weight that a jury gives the expert's testimony.

Using Management as Experts

In some cases, attorneys have tried to utilize management and the company's officers as experts at trial. Courts have accepted such testimony. In *Aluminum Products Enterprises v. Fuhrmann Tooling,* the court allowed the plaintiff's president to testify based on his knowledge of the business and the industry.[20] The disadvantage of such testimony is that the witness is an interested party in the litigation. The witness does, however, bring firsthand

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[19] *Harold Larsen et al., Respondents, v. Walton Plywood Company et al.,* Appellants, Washington Plywood Company, Inc. No. 36863, Supreme Court of Washington, Department One, 65 Wash. 2d 1; 390 P. 2d 677; Wash.

[20] *Aluminum Products Enterprises v. Fuhrmann Tooling,* 758 S.W. 2d 119, 112 (Mo. Ct. App. 1988).

knowledge from working in the industry every day. Depending on the facts of the case, a combination of internal fact/expert witnesses and outside experts may be very effective. This is the case when internal financial witnesses, such as company controllers, are used to authenticate and describe the collection of data (such as cost data) on which the outside damages expert is relying. It also is helpful when the expert lacks a significant background in the industry. The internal expert can be used to testify on trends and practices in the industry. Such an expert can also confirm numerical trends that the external expert may testify that he or she has found when analyzing industry data. The internal expert may be able to verify that these quantitative trends, such as reduced sales of distributors caused by manufacturers' selling directly to retailers, were experienced by those who worked in the industry.

Using an Expert as a Consultant

A damages expert can be invaluable to an attorney even if the individual never testifies; an expert can assist the attorney in understanding an opposing expert's report and opinions. Often an attorney may not have specialized training in the field in which the opposing expert is testifying. The fields of economics, finance, and accounting are very specialized, and it is difficult for an attorney to be knowledgeable in the law and also have expertise in these other related areas. In addition, like many other scientific fields, disciplines, such as economics, finance, and accounting have their own jargon, notation, and the like, that may require interpretation. Having a knowledgeable expert to rely on can be of great benefit. Such an expert can be used to interpret the opposing expert's report or to prepare detailed lines of cross-examination for deposition and trial. The expert-consultant can also check for the presence of errors in the opposing expert's report. Without the necessary background, the opposing attorney may not be able to do a careful quantitative review of the opposing expert's analysis. Attorneys should be aware that such work can be surprisingly time-consuming. This is because an opposing expert's report may be intentionally cryptic and may not fully reveal the derivations of the various numerical values. The consulting expert may have to invest substantial amounts of time discerning exactly how the numbers were computed. In addition, once the method used by the opposing expert is known, counsel may want to stage different scenarios using more favorable factual and economic assumptions to see their impact on the loss estimates. This is a very thorough way of pursuing the damages part of the case. However, attorneys should know that such work may be time-intensive and may require the consulting experts to invest more time than even the opposing expert.

Federal Rules of Evidence and Experts

The Federal Rules of Evidence govern the introduction of evidence in both civil and criminal lawsuits. The Federal Rules of Evidence, having been formally adopted by the U.S. Congress, were effectively adopted for federal courts in 1975. Although not binding on state courts, approximately 40 states have adopted the substance of these rules.[21] This is analogous to the Uniform Commercial Code, which has been adopted by all states. Before the rules were formally adopted, the law governing what is allowed to be adopted as evidence was mainly a product of decisional law. In 1965, Chief Justice Earl Warren formed a committee to develop formal rules. This led to a common set of rules that were adopted by federal courts ten years later.

The Federal Rules of Evidence govern the admissibility of expert testimony. They basically determine what evidence a trier of the facts can utilize to reach a decision. Numerous case decisions have interpreted the rules and provide further elucidation on the nuances that arise in applying these rules to the background of experts and their testimony.

Standards for Admissibility of Expert Testimony

For approximately 70 years, between 1923 and 1993, the standard applied in federal court for admissibility of expert testimony was the *Frye* test. This was based on the 1923 criminal case *Frye v. United States,* in which expert testimony on the results of a lie detector test was ruled inadmissible.[22] The *Frye* test focused on whether the analysis and testimony were based on methods and standards that were generally accepted within the given field. That the Federal Rules of Evidence superseded the *Frye* test was decided by the United States Supreme Court in 1993 in the *Daubert v. Merrill Dow* case.[23] This case dealt with damages claims resulting from a mother ingesting Bendectin; the Supreme Court ruled that Rule 702 of the Federal Rules of Evidence is inconsistent with and supersedes the *Frye* test. The Court stated that it did not find anything in the Federal Rules that requires general acceptance. The Supreme Court indicated that one should look to what is contained in the Federal Rules to determine whether testimony is admissible.

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[21] Robert L. Dunn, *Expert Witnesses in Commercial Litigation* (Westport, CT: Lawpress, 2003), p. 2.

[22] *Frye v. United States,* 293 F1013 (D.C. Cir. 1923).

[23] *Daubert v. Merrill Dow,* 509 U.S. 579 (1993).

The Court stopped short of putting forward a checklist of characteristics to which expert testimony must adhere.[24] Nonetheless, the Court did set forth a list of four factors that expert testimony should possess:

1. **Testing.** This factor is most applicable to the physical sciences.[25] However, insofar as statistical analysis involves various forms of statistical testimony, such as hypothesis testimony, this factor could become relevant in business interruption cases.
2. **Peer Review and Publication.** Another factor that the United States Supreme Court highlighted was peer review and publications. This is particularly relevant for unique methodologies. If they have been subject to peer review, such as through the publication process in refereed journals, there may be a greater degree of reliability.
3. **Known Rate of Error.** If the analysis has a known rate of error, then this may be an indicator of its reliability. This can be applied to the case of statistical analysis, which, for example, provides confidence levels for the value of a coefficient generated by a regression analysis that is used to project lost revenues.
4. **General Acceptance.** While the Supreme Court did not explicitly rule that general acceptance is required, it did point to such acceptance within the relevant community as one factor that a trial judge could use when evaluating such proposed testimony. The components of the loss measurement process that are described in this book are standard components of related disciplines and general acceptance is normally not an issue. However, to reinforce this point, commonly used texts are cited throughout this book to emphasize this issue.

The application of the *Daubert* standard to accounting, economics, finance, and damages testimony, in particular, continues to evolve. There have been various instances of *Daubert* being used to deny economic expert testimony in the areas of hedonic damages (the use of certain research studies in labor economics to value a human life or show the loss of the enjoyment of life).[26] However, in the commercial damages arena, many of the techniques that are used, such as forecasting methods and cost accounting methods, are quite standard and not controversial. Therefore, the fact that *Daubert* has replaced the *Frye* test may be less relevant to economic damages testimony than it is for other areas of expert testimony.

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[24] Robert Dunn, *Expert Testimony: Law and Practice* (Westport, CT: Lawpress, 1997), vol. 1, 195–201.

[25] Lawrence Spizman and John Kane, "Defending against a Daubert Challenge: An Application in Projecting the Lost Earnings of a Minor Child," *Litigation Economics Digest* 3(1) (Spring 1998): 43–49.

[26] *Hein v. Merck & Co.,* 868 F. Supp. 203 (M.D. Tenn. 1994), and *Ayers v. Robinson,* 887 F. Supp. 1049 (N.D. Ill. 1995).

Daubert focused on scientific testimony. However, later decisions expanded the application of *Daubert* to other types of expert testimony. In *General Electric v. Joiner,* four years after *Daubert,* the Court clarified the role of trial courts on the admissibility of expert testimony.[27] In this case the 11th Circuit reversed a decision by the trial court that did not allow the testimony of a medical expert. In this decision the Court indicated that the standards for excluding expert testimony are higher than allowing it. In reaching this decision the Court indicated that trial courts have much discretion in reaching such decisions.

In *Kumho Tire,* two years after *Joiner,* the Court determined that, while the four specific *Daubert* tests may not necessarily apply to a given case, a general test of expert testimony reliability applies to all such testimony.[28]

Applicability of *Daubert* to Economic Damages Testimony

Courts have held that while *Daubert* originally focused on scientific rather than economic and financial issues, it is also relevant to such matters.[29] One court specifically focused on economists when it concluded that *Daubert* should be applied when assessing the admissibility of their testimony.[30] In *Frymire-Brinati v. KPMG Peat Marwick,* the appellate court ordered a new trial partially because the plaintiff's economic damages expert did not satisfy its interpretation of the relevance and reliability standards raised in *Daubert*.[31] In applying *Daubert* standards, the court in *Newport Ltd. v. Sears Roebuck & Co.* allowed the expert to utilize econometric techniques such as multiple regression analysis, a method that has long been accepted by many courts, particularly in the area of employment litigation. However, the court recognized that such analysis is dependent on specific assumptions that must be considered consistent with the relevant facts of the case in order for them to be probative.[32] This court required that in order for the plaintiff's economic expert to testify using this type of analysis, the relevance and accuracy of the assumptions must first be established.

Daubert has also been found to be relevant to the closely related field of business valuations.[33] In *Ullman-Briggs, Inc. v. Salton-Maxim Housewares, Inc.,* the U.S. District Court for the Ninth District of Illinois agreed with the defendant's argument that the proposed expert witness put forward by

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[27] *General Electric Co. v. Joiner,* 522 U.S. 136; 118 S. Ct 512 (1997).
[28] *Kumho Tire v. Carmichael,* 526 U.S. 137; 119 S. Ct. 1167 (1999).
[29] *Liu v. Korean Airlines Co.,* 1993 Westlaw 478343 (S.D.N.Y.).
[30] *Garcia v. Columbia Medical Center,* 996 F. Supp. 617, 621 (E.D. Tex. 1998).
[31] *Frymire-Brinati v. KPMG Peat Marwick,* 2 F3d 183 (7th Cir. 1993).
[32] *Newport Ltd. v. Sears Roebuck & Co.,* 1995 Westlaw 328158 (E.D. La.).
[33] *Ullman-Briggs, Inc. v. Salton/Maxim Housewares, Inc.,* 1996 Westlaw 535083 (N.D. Ill.).

the plaintiff was not really an expert and did not utilize a reliable methodology. In its ruling the court stated:

> Ullman-Briggs *contends that the* Daubert *test does not even apply to Goldfarb's testimony, because* Daubert, *and nearly all the cases that follow it, deal with the admissibility of scientific expert testimony, and not the many areas in which expert opinion testimony may be proffered, but for which the methods and procedures of science are simply not available. It argues that the valuation of a business is not a matter of scientific knowledge, is not the subject of scientific testing or experimentation, and is not an area in which peer-reviewed journals evaluate the research methodology of prospective experts.*

Later in its opinion the court clarified its reasoning:

> Ullman-Briggs *reads* Daubert *much too narrowly. While business valuation may not be one of the "traditional sciences," it is nevertheless a subject area that employs specific methodologies and publishes peer-reviewed journals.*

The court then went on to point out that the plaintiff's expert was not truly an expert but was really a deal maker. It found that he did not employ a reliable methodology but really only supplied a bottom-line value that was arrived at by others. It stated that "an expert who supplies nothing but a bottom line supplies nothing of value to the judicial process."

Accountants as Damages Experts Under *Daubert*

Accountants sometimes are challenged as damages experts under *Daubert*. In *Tuf Racing Products v. American Suzuki Motor Corp.,* the defendant challenged the credentials of the plaintiff's damages expert.[34] Suzuki argued that the expert was a CPA but lacked advanced degrees in fields such as economics and statistics. In its opinion the court stated:

> *Tuf presented its theory of damages by way of its accountant (a C.P.A.), and in the district court Suzuki argued that the accountant should not have been permitted to testify as an expert witness because he does not have a degree in economics or statistics or mathematics or some other "academic" field that might bear on the calculation of damages. The notion that* Daubert *(cite omitted) requires particular credentials for an expert witness is radically unsound. The Federal Rules of Evidence, which* Daubert *interprets rather than overrides, do not require that expert witnesses be academics or PhDs, or that their testimony be "scientific" (natural*

[34] *Tuf Racing Products v. American Suzuki Motor Corp.,* 223 F.3d 585 (7th Cir. 2000).

> *scientific or social scientific) in character. Anyone with relevant expertise enabling him to offer responsible opinion testimony helpful to judge or jury may qualify as an expert witness. The principle of* Daubert *is merely that if an expert witness is to offer an opinion based upon science, it must be real science, not junk science. Tuf's accountant did not purport to be doing science. He was doing accounting. From financial information furnished by Tuf and assumptions given him by counsel of the effect of the termination on Tuf's sales, the accountant calculated the discounted present value of the lost future earnings that Tuf would have had had it not been terminated. This was a calculation well within the competence of a CPA.*

The *Tuf* decision makes clear that accountants cannot be challenged under *Daubert* merely because they lack higher degrees. This does not mean that they as well as experts with such degrees cannot be subjected to effective cross-examination on relevant aspects of their testimony and their knowledge of the relevant literature. All other things constant, higher levels of advanced education are preferable, but other credentials, such as experience, can also be important. Credentials notwithstanding, the knowledge of the expert can be subject to cross-examination. For example, we presume that Tuf's accountant could have been cross-examined on the risk premium included in his discount rate and his knowledge of the relevant peer-reviewed literature on such premiums. While the expert may be permitted to testify and cannot be excluded through a *Daubert* challenge, this does not mean that a very effective cross-examination cannot still be conducted.

Exclusion of Experts

Courts are predisposed to accept experts rather than exclude them. "Rejection of expert testimony is the exception, rather than the rule, and [the court] will generally permit testimony based on allegedly erroneous facts when there is some support for those facts in the record.[35]

Trends in *Daubert* Challenges to Financial Experts

Daubert has long been engrained into the expert witness process in federal courts. State versions of *Daubert* have also been adopted. The accounting firm PwC conducts an annual analysis of the trends in Daubert challenges to financial experts.[36]

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[35] *Numatics v. Baloff, Inc. and H.H. Barnum Company,* quoting *In re Scrap Metal Antitrust Litigation,* 527 F. 3d 517, 530 (6th Cir. 2008).

[36] "Daubert Challenges to Financial Experts: A Yearly Study of Trends and Outcomes 2000-2018," www.pwc.com.

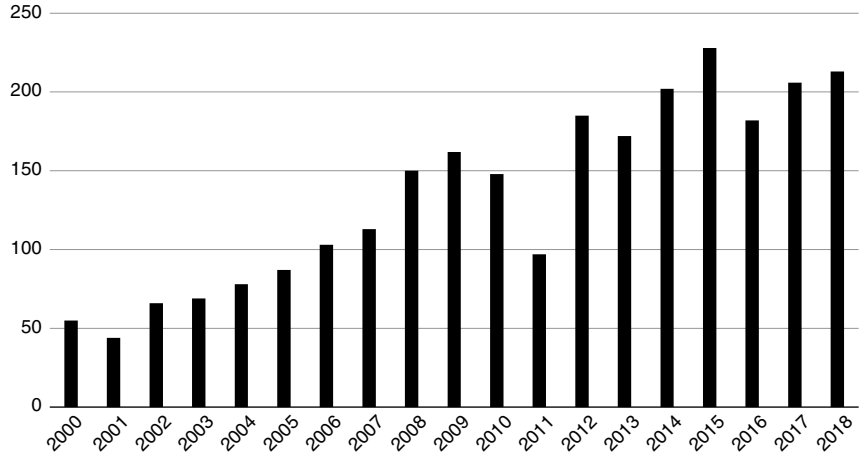

EXHIBIT 1.1 Trend in financial expert challenges.

Source: Branch, D. E., Reddin, C., Damjil, S., Daubert challenges to financial experts: A yearly study of trends and outcomes 2000–2018, PricewaterhouseCoopers LLP.

PwC has been conducting an annual and historical analysis of trends on *Daubert* challenges to financial experts over the past two decades. Interestingly, the number of challenges has been generally increasing over this time period (see Exhibit 1.1). While it was not the highest annual amount, in 2017 there were 206 reported challenges. Of those 206 challenges, 48%, or 99, resulted in either a partial or total exclusion of the expert testimony. There was an increase in partial exclusions in 2017 but over the full time period exclusions and partial exclusions were roughly similar (see Exhibit 1.2). What was especially interesting were the reasons for many of the exclusions.

Reliability

Testimony can be excluded for various reasons, including a lack of reliability, relevance, or insufficient qualifications by the witness. The leading reason for the exclusions was a lack of reliability. PwC researchers have found that this has been a consistently prominent reason for exclusion over the years.

Financial experts, especially those who put forward damages computations, do so based upon data and related information they analyze. It is not surprising that many of the challenges have to do with failings in either the data itself or the analysis of that data. PwC analysts found that this was the leading reason for exclusions with relevancy coming in second.

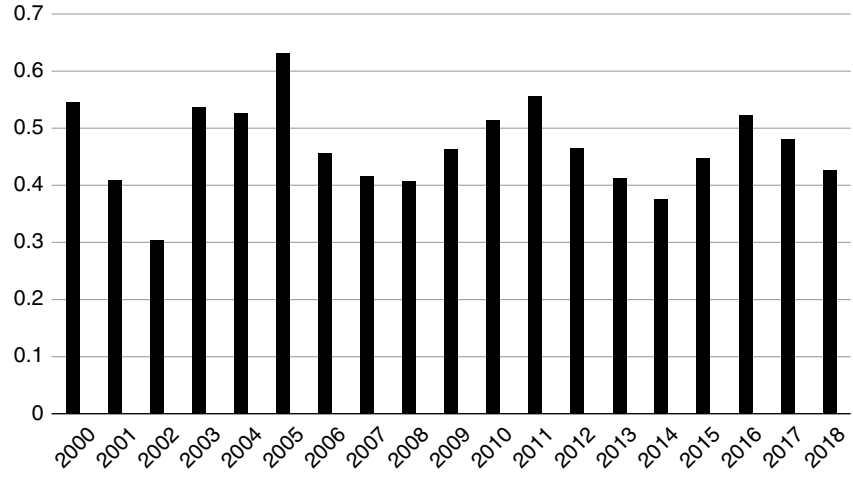

EXHIBIT 1.2 Exclusion rates for financial experts.

Source: Branch, D. E., Reddin, C., Damjil, S., Daubert challenges to financial experts: A yearly study of trends and outcomes 2000–2018, PricewaterhouseCoopers LLP.

Some the other reasons for a cited lack of relevancy were experts offering opinions outside of their expertise, such as really offering legal opinions, or simply seeking to offer testimony that the court concluded would not be an aid to the jury.

Types of Cases Giving Rise to Most Challenges

PwC analysts found that over the 18 years of analysis they did, the most common types of cases featuring expert witness challenges were breach of contract/or fiduciary duty (these were grouped together) followed by intellectual property. Within specific case types, however, securities lawsuits had the highest exclusion rates (55%), followed by intellectual property and fraud cases (49% each).

Types of Experts Having Higher Exclusion Rates

In their comprehensive study, PwC analysts found that accountants and economists had comparable rates of *Daubert* challenges followed by appraisers. However, over the 18 years of analysis, PwC found that economists had the lowest rate of exclusion. They also found that experts retained by the plaintiff were much more likely to be subject to challenges than experts retained by defendants.

Expert Reports

In the Federal Rules of Civil Procedure, Rule 26 (a)(2) requires that the expert provide a signed expert report. According to Rule 26, this report should include these items:

- A complete statement of expert's opinions
- The basis for these opinions
- Data and other relevant information considered
- Exhibits to be used in the support of these opinions
- Qualifications of the witness
- List of all publications authored by the expert in the last ten years
- Compensation paid for report
- List of cases in which the expert has testified as an expert, at trial or in deposition, over the prior four years

The above disclosure is required in all federal cases. States, however, vary in their report disclosure requirements. Some follow the Federal Rules and some do not. Although the Federal Rules require more disclosure in reports, leeway can still be applied in determining how detailed reports are. One school of thought advanced by attorneys is to provide a very detailed report showing the other side that the analysis is very thorough and that the damage estimates are firm. Armed with such a report, attorneys may believe that the case is more likely to settle. Further justification of abundant disclosure is that providing extra report details prevents the opposing counsel from objecting on the grounds that the proper pretrial disclosure was not made. Conversely, the other school of thought is to provide only the minimum required under the Rules so as to avoid providing fodder for cross-examination. Both approaches have pros and cons.

Level of Detail in Expert Reports

Court rules are typically not very specific regarding the level of detail required in such reports. Clearly, the requirements in federal courts are greater than in state courts. In general, this is a somewhat gray area in litigation; the expert has a wide degree of latitude in deciding what to include in the report and what to omit.

Some expert reports are quite terse – particularly ones filed in state courts. Some are even intentionally cryptic so as to make it difficult for opposing counsel to challenge the analysis. It is difficult to challenge something that one does not understand. When faced with an incomprehensible analysis, it is important for the attorney to have his own damages expert carefully dissect it. Attorneys should be aware that this work can be very time-consuming. Experts may have to devote many

hours to "reverse engineer" the opposing expert's calculations. Once this is done, however, and the relationship between the computations and their underlying assumptions is established, cross-examining attorneys can quantitatively assess the ramifications of adjusting the existing assumptions and substituting more favorable ones.

The National Association of Forensic Economics has put forward certain ethical standards. One of these standards relates to expert reports. With respect to disclosure the standards require practitioners to "provide sufficient detail to allow replication of all numerical calculations, with reasonable effort, by other competent forensic economics experts, and be prepared to provide sufficient disclosure of sources of information and assumptions underpinning their opinions to make them understandable to others."[37]

Excluding Experts Due to Insufficient Disclosure in Expert Reports

There have been a number of cases where experts have been excluding because important disclosure, such as details on the loss methodology, were not disclosed in the expert report. One prominent example was *Oleg Cassini, Inc. v. Electrolux Home Prods, Inc*. [38] In that case the court excluded an expert it found to be well qualified due to the fact that she did not provide sufficient disclosure in her expert report on how she applied a comparative market approach to valuing damaged art work. The expert also failed to bring such support to her deposition, as opposing counsel's subpoena demanded, thus compounding the error. Frankly, this "problem" should have been addressed by counsel that retained her. He or she could have gone over her report, and later, what she was bringing to her deposition. Sometimes this requires an investment of time and the client's money and it is often necessary – especially in cases where opposing counsel is willing to very fully challenge the damages expert. It is up to counsel retaining the expert to make sure this is effectively addressed. However, sometimes clients handicap their attorneys, and also their experts, by not providing the requisite funds to finance the litigation.

Attorneys Writing the Expert's Report

The expert should write his or her own report. However, courts recognize that attorneys can provide some valuable input and may assist in the process. However, sometimes attorneys get too aggressive and may try to write much or even all of the report. This is a mistake. Using the words of the

[37] www.nafe.net/Ethics.

[38] *Oleg Cassini, Inc. v. Electrolux Home Prods, Inc.,* No. 11 Civ. 1237 (S.D.N.Y. April 15, 2014).

court in *Manning v. Crockett,* "preparing an expert's opinion from whole cloth and then asking the expert to sign if he or she wishes to adopt it conflicts with requirements of Rule 26 (a)2(B) requirement that the expert 'prepare' the report."[39] It would seem that if an attorney finds the expert unable to adequately write the first draft of the expert report, the attorney may want to consider finding another expert.

Draft Reports and Related Communications

In years past, draft reports were discoverable in federal lawsuits.[40] That led to many inefficiencies as experts and attorneys tried to find ways to deal with the process. Federal Rules have now changed, and drafts are generally protected. In addition, some communications between a party's attorney and the expert may also be protected. Excluded from such protections, however, are those that relate to fees for the expert's work, assumptions, facts, or data that the attorney provided to the expert and that the expert relied upon in the formulation of the expert opinions.

Testifying Outside the Bounds of the Expert Report

While there may be variances in the degree of disclosure, courts have excluded testimony that is clearly outside the bounds of the expert's report. In *Liccardi,* the court stated that expert testimony should have been excluded where such testimony went "far beyond the scope of [the expert's] report."[41] Other courts have reached similar conclusions.[42]

Supplementary Reports

Rule 26 (e)(1) stipulates that a supplement to pretrial disclosures be provided when there are meaningful changes in the opinions and their bases given in the original report. The Rules are not clear as to exactly when such information is to be provided. They merely indicate that such information should be supplied at "appropriate intervals." If the expert's report is not appropriately supplemented on a timely basis, then the expert may be

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[39] *Manning v. Crockett,* 1999 WL 342715 (N.D. Ill. 1999).
[40] *W.R. Grace & Co. v. Zotos International, Inc.,* 2000 WL 1843258.
[41] *Liccardi,* 140 F3d at 364.
[42] *Eastern Auto Distributors, Inc. v. Peugeot Motors of America, Inc.,* 795 F2d 329, 338 (4th Cir. 1986); *American Key Corp. v. Cole National Corp.,* 762 F2d 1569, 1581 (11th Cir. 1985); and *Merit Motors, Inc. v. Chrysler Corp.,* 187 U.S. App. D.C. 11, 569 F2d 666, 673 (D.C. Cir. 1977).

limited to his original report. This was the case in *NutraSweet Company v. X-L Engineering Company*.[43]

Demonstrative Exhibits

Experts may want to buttress their testimony with demonstrative exhibits. As we will discuss in Chapter 2, exhibits such as graphs and other charts can be helpful to a jury's understanding of relevant issues, such as trends in a business's revenues before and after an interruption. While a court may allow use of such exhibits in conjunction with an expert's testimony, it may or may not allow the exhibits to be admitted into evidence. Courts have found that such exhibits may be cumulative to the expert's actual testimony. They have found that exhibits can be a helpful aid, but this does not mean they will necessarily be admitted as evidence.

Net Opinions

Opinions that are vague and provide a conclusion without any supporting basis for the opinion may be considered "net opinions" and may not be admissible. Rule 26 requires that the expert provide the basis for his or her opinions. Although this still leaves room for interpretation, simply stating the opinion without any support for it may be insufficient.[44] Given the complexity of many business interruption cases, it is unlikely the expert would try to submit a very terse statement of opinion. However, opposing counsel should review the opposing report carefully to make sure that it fulfills the requirements of Rule 26 and is not a net opinion in disguise.

State courts have commonly excluded net opinions. They have excluded these opinions when they were "based merely on unfounded speculation and unquantified possibilities".[45]

Expert Testifying Outside of Expertise: Opining on Issues in Economics Without True Expertise

The *Daubert* challenge process also gives counsel the opportunity to closely examine the expert's credentials in relation to his or her opinions. "Experts" open themselves up when they seek to render opinions and testify on issues in which they lack any meaningful training and true expertise. This was the case in *Rothe Dev. Inc v. DOD*, which was a case where the defendant produced two experts who were PhD economists and who employed

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[43] *Nutrasweet Company v. X-L Engineering Company,* 227 F3rd 776 (7th Cir. 2000).
[44] *Bank Brussels Lambert v. Credit Lyonnais,* 2000 WL 1762533 (S.D.N.Y.).
[45] *Grzanka v. Pfeifer,* 301 N.J. Super. 563, 580 (App. Div. 1997).

econometric analysis to reach their conclusions.[46] The plaintiff produced two experts, one with just a bachelor's degree and the other with a law degree. Both acknowledged they were not economists and had no training in the field of econometrics. The court ruled they were not qualified to serve as experts, whereas the defendant's experts were allowed to testify.

Expert's Knowledge of Relevant Facts

It is important that the damages expert be familiar with the relevant facts of the case. One way for a defendant to challenge a plaintiff's expert is to point out that he or she was not aware of important facts, facts that could change his or her opinion. Sometimes an expert is not fully informed of the relevant facts because he or she was not given a budget necessary to conduct a proper review. Some attorneys think that this is an appropriate cost-saving measure. If, however, an expert is not given all relevant facts that would affect his or her ultimate opinion, this "cost-saving" can be disastrous. This was the case in *United Phosphorous v. Midland Fumigant, Inc*. In this case the court found that an expert's (Dr. Richard Hoyt) lack of knowledge of relevant facts, including deposition testimony, violated *Daubert* standards.

> *The court determines, based upon the foregoing, that Hoyt violated a fundamental principle of economics when he failed to consider in his report the actions of Midland in estimating a value for the Quick-Phos trade name. Hoyt did not read any of the depositions (notably Fox, Lynn, or Estes) before he rendered his report. Consequently, he was required to evaluate the Quick-Phos trade name with little knowledge about the facts of the case, and no knowledge about the underlying admissions from Midland's president and sales managers. The court finds that such ignorance of undisputed facts violates Daubert's requirement that an expert report and opinions must be based upon "scientific knowledge."*[47]

Many state courts have typically taken similar positions on expert testimony as their federal counterparts. For example, in New Jersey, in order for an expert's testimony to be admissible, the expert "must be able to identify the factual bases for their conclusions, explain their methodology, and demonstrate that both the factual bases and the methodology are scientifically reliable."[48]

Retaining attorneys need to be very careful when they try to control costs by limiting what their experts can review. One practice that is

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[46] *Rothe Dev., Inc. DOD,* 107 F. Supp. 3d 183 *, 2015 U.S. Dist. LEXIS 72925.
[47] *United Phosphorous Ltd. v. Midland Fumigant, Inc.,* 173 F.R.D. 675 (D. Kan. 1997).
[48] *Kemp v. State,* 174 N.J. 412, 434 (2002).

fraught with potential problems is providing the expert with only excerpts from depositions rather than the whole deposition. It is often the case that depositions may focus on issues that are unrelated to damages. Sometimes attorneys try to choose the parts that they think are relevant for the expert's needs. This practice puts the expert in a position of being asked if he or she only read what the retaining attorney wanted him or her to read. In the long run, it is usually better to simply give the whole deposition to the expert and let the expert decide what is relevant to damages.

Court-Appointed Experts

When a court is presented with two conflicting sets of analysis by two different experts, it may have trouble determining whether one or both expert's analysis is reliable and meets the *Daubert* threshold. For example, some econometric analysis can be convoluted and difficult for a trier of the facts who may lack training in statistical analysis to understand. Under Federal Rule of Evidence 706, the court has the right to select a court-appointed expert to shed light on issues the court finds relevant. While federal courts have the right to make such a selection, they typically do not do so in commercial lawsuits. This contrasts with other types of litigation in state courts such as matrimonial lawsuits, where court-appointed experts are commonplace.

Defense Expert as a Testifying Expert, Not Just a Consultant

There is one view within the defense bar that contends that a defendant should not put his own expert on the stand for damages. The idea is that if the defendant gives alternative damages testimony (even though that testimony may put forward a lower damages value), such testimony might lend credence to the claim that there really are damages. There is also the concern that if a jury hears two damages amounts – a higher one from the plaintiff and a lower one from the defendant's expert – then they may simply average the two, particularly if they cannot decide which is more appropriate. Yet the strategy of failing to call a defendant's damages expert can prove disastrous. One of the classic examples of this was the *Texaco v. Pennzoil* case, in which the defense decided not to put on its own damages expert and relied on attacking the plaintiff's damages analysis.[49] When the jury found the defendant Texaco liable, there was no damages testimony for

[49] *Texaco Inc. v. Pennzoil Co.,* 729 S.W. 2nd 768 (Tex. App. 1987), cert. dismissed, 485 U.S. 994 (1988).

the jury to consider other than the plaintiff's presentation. The huge award that resulted underscored the drawbacks of this strategy.

> *Our problem in reviewing the validity of these Texaco claims is that Pennzoil necessarily used expert testimony to prove its losses by using three damages models. In the highly specialized field of oil and gas, expert testimony that is free of conjecture and speculation is proper and necessary to determine damages. (cite omitted) Texaco presented no expert testimony to refute the claims but relied on its cross examination of Pennzoil's experts to attempt to show that the damages model used by the jury was flawed. Dr. Barrows testified that each of his three models would constitute an accepted method of proving Pennzoil's damages.*[50]

The fact that the ultimate award, which included punitive damages, resulted in the bankruptcy of Texaco underscores the risk of not calling a damages expert.

Another case in which the court highlighted the failure of the defendant to present alternative damages testimony is *Empire Gas Company v. American Bakeries Co.*

> *A great weakness of American Bakeries' case was its failure to present its own estimate of damages, in the absence of which the jury could have no idea of what adjustments to make in order to take into account American Bakeries' arguments. American Bakeries may have feared that if it put in its own estimate of damages the jury would be irresistibly attracted to that figure as a compromise. But if so, American Bakeries gambled double or nothing, as it were; and we will not relieve it of the consequences of its risky strategy.*[51]

The success of the defense's use of an expert was seen in *Associated Indemnity Co. v. CAT Contracting Inc.,* a case in which the court followed the analysis of the defense's expert in molding its damages award.[52] The Court of Appeals of Texas reversed a prior seven-figure award and instead awarded an amount that was a fraction of the original award. In this case, a construction joint venture sued a surety. The court was impressed by the argument of the defense's expert: The plaintiff's own financial history should be used to measure losses rather than just the industry averages used by the plaintiff's damages expert. The defense's expert testified as to what the lost incremental revenues were and what the profit margins associated with

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[50] *Texaco Inc. v. Pennzoil Co.,* 729 S.W.2d 768 (Tex. App. 1987), cert. dismissed, 485 U.S. 994 (1988).

[51] *Empire Gas Company v. American Bakeries Co.,* 840 F2d 1333, 1342 (7th Cir. 1988).

[52] *Associated Indemnity Co. v. CAT Contracting, Inc.,* 918 S.W. 2d 580 (Tex. App. 1996).

these revenues would be. The court then used these amounts, rather than the computations of the plaintiff's expert, to arrive at a damages award.

In cases where the defendant believes that the plaintiff has mitigated his damages and, therefore, has not really incurred any net damages, it is best for the defense to put on its own damages expert to demonstrate the point. In these cases, if the analysis is sufficiently thorough and convincing, the court may ignore the plaintiff's damages presentation and deny an award based on the testimony of the defense's expert. The defense may be able to reduce the effectiveness of the plaintiff's damages presentation by showing that while its actions may have resulted in some lost profits, the plaintiff was able to substitute other business, which resulted in profits being essentially unchanged from prior years. Such a result occurred in *Alcan Aluminum v. Carlton Aluminum of New England, Inc.*[53]

Discovery of Nontestifying Experts

An opposing counsel may not be able to gain access to the file, such as through a deposition, of a nontestifying expert; access to the individual may be impossible as well. The work of nontestifying experts is usually considered privileged and not subject to discovery. An exception occurs when opposing counsel can demonstrate a need for discovery to gain access to information or materials that are not available from other sources.[54] This was the case in *Delcastor, Inc. v. Vail Assoc., Inc.,* where the court concluded that important data involving a construction site that was destroyed would not be available other than through access to a nontestifying expert's report.[55] However, in *Hartford Fire Ins. Co. v. Pure Air on the Lake Ltd.,* the court concluded that the defendant did not prove to the court's satisfaction that it could not gain access to relevant information through other sources beyond what was available through the plaintiff's nontestifying witness.[56]

Quantitative Research Evidence on the Benefits of Calling a Defense Expert

Dr. Robert Trout, of Economatrix Research Associates, Inc. and Lit-Econ, conducted a study that attempted to measure the impact of economic testimony on damages awards. His 1991 study found that when only the plaintiff

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[53] *Alcan Aluminum v. Carlton Aluminum of New England, Inc.,* 35 Mass. App. 161, 617 N.E. 2d 1005 (1993) *review denied,* 416 Mass. 1105, 621, N.E. 2d 685 (1993).

[54] Steven Babitsky and James J. Mangraviti, Jr., *Writing and Defending Your Expert Report* (Falmouth, MA: Seak, 2002).

[55] *Delcastor, Inc. v. Vail Assoc., Inc.,* 108 F.R.D. 405 (D. Colo. 1985).

[56] *Hartford Fire Ins. Co. v. Pure Air on the Lake Ltd.,* 154 F.R.D. 202 (N.D. Ind. 1993).

called a damages expert, the average award was $418,355 ($720,173 in 2009).[57] However, when the defendant also presented his own damages expert to counter the plaintiff's damages expert, the average award was less than a quarter of the plaintiff's only expert alternative – $98,567 ($169,677 in 2009). Dr. Trout summarized the results of his analysis as it relates to the benefits of the defendant calling his own damages expert in this way:

> *The findings concerning the use of economists suggest that a reasonable strategy for the defense counsel should be to use an economic expert whenever the plaintiff uses an economic expert, except in cases where the defense's economic expert testimony might increase the chance that liability would be found against the defendant or support the testimony of the plaintiff's economist.*[58]

Treatment of the Relevant Case Law

This book focuses on the methods of conducting a damages analysis. It does not focus on the relevant case law. It should not be inferred that this is an unimportant issue. The case law provides a framework within which losses can be presented in court. Readers, however, are directed to other fine works in this area for a discussion of the issue. One of the leading books in this field is Robert Dunn's *Recovery of Damages for Lost Profits*.[59] Another is William Cerillo's *Proving Business Damages*.[60] These works are used in this book to provide guidance on the court's position concerning the methods of measuring damages.

Legal Damage Principles

In measuring damages, experts should be familiar with the basics of legal damage principles. This section touches on some of the major relevant principles. For a more in-depth discussion, readers are encouraged to pursue the abundant sources available.

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[57] Robert R. Trout, "Does Economic Testimony Affect Damage Awards?," *Journal of Legal Economics* 41 (March 1991): 43–49.
[58] Ibid., 47.
[59] Robert L. Dunn, *Recovery of Damages for Lost Profits,* 6th ed. (Westport, CT: Lawpress, 2005). This classic book has not been updated through a later edition due to the death of Mr. Dunn.
[60] William A. Cerillo, *Proving Business Damages,* 2nd ed. (New York: John Wiley & Sons, 1991).

Proximate Causation and Reasonable Certainty

In order for damages to be recoverable, they must be *proximately caused* by the wrongful acts of the defendant. In addition, damages must be proven within a *reasonable degree of certainty*. A key word in the latter phrase is *reasonable*. By applying the modifier *reasonable,* the courts have acknowledged that it may not be possible to compute damages with 100 percent certainty. Therefore, a degree of certainty less than 100 percent is acceptable. It is here that the opinion testimony of an expert can be used to establish the reasonable limits of acceptability. In allowing a level of certainty less than 100 percent, courts recognize that, even for historical damages, the actions of the defendant may have permanently changed events such that one may never know exactly what would have transpired in the absence of such actions. For future damages, the course of events may not be known with certainty. If a 100 percent standard were adopted, damages might never be established. In addition, the defense would be able to take advantage of the fact that, through wrongful acts, it moved the plaintiff to a situation where it may never know the exact magnitude of its damages.

Occurrence of Versus the Amount of Damages

It is important to make the distinction between establishing the fact of damages within a reasonable certainty and the actual measurement of those damages.[61] The reasonable certainty is applied to the fact that the damages actually occurred. However, a lesser standard is applied to measuring the magnitude of the damages themselves. Here the courts have recognized the particularly difficult problem that arises in the measurement of damages that may have or will occur after the actions of the defendant may have permanently changed the course of events. The courts do not allow the defendant to benefit from the fact that its causation of the plaintiff's damages may render such damages unable to be proved within a 100 percent degree of certainty. If the occurrence of the damages is uncertain, however, then the plaintiff may not be able to recover such damages.

This reasoning is articulated in *Story Parchment Co. v. Paterson Parchment Paper Co.*[62] In this case, in which the plaintiff sought damages for antitrust violations of the defendant, the Supreme Court stated:

> *Where the tort itself is of such a nature as to preclude the ascertainment of the amount of damages with certainty, it would be a perversion of fundamental principles of justice to deny any relief to the injured person,*

[61] Robert L. Dunn, *Recovery of Damages for Lost Profits,* 6th ed. (Westport, CT: Lawpress, 2005), pp. 25–31.

[62] *Story Parchment Co. v. Paterson Parchment Co.,* 282 U.S. 555, 563 (1931).

> *and thereby relieve the wrongdoer from making any amend for his acts. In such case, while the damages may not be determined by mere speculation or guess, it will be enough if the evidence shows the extent of the damages as a matter of just and reasonable inference, although the result is only approximate. The wrongdoer is not entitled to complain that they cannot be measured with exactness and precision that would be possible if the case, which he alone is responsible for making, were otherwise.*

The theme of *Story Parchment Co.* has been echoed in many cases that followed it. One example of many potential ones is *Randy's Studebaker Sales, Inc. v. Nissan Motor Corp.* In its opinion the U.S Appeals Court for the Third Circuit stated:

> *Nissan also points out that Randy Larsen, the owner of Randy's, had no opinion regarding the number of cars he would have received or sold. While damage claims may not be speculative, they also do not have to be mathematically precise; it is sufficient if damages are proved to a reasonable certainty. And, while the defendant's wrongdoing created the uncertainty, it must bear the risk of that uncertainty and cannot complain.*[63]

State courts have also adopted this reasoning. For example, New York case law also seems to allow for a certain degree of uncertainty when it is clear that the plaintiff has been wronged by the defendant in an effort to try to make the plaintiff whole while also preventing the defendant from profiting from its wrongful conduct. As example is shown in *W.L. Hailey & Co. v. County of Niagara,* where the court stated:

> *When it is certain that damages have been caused by a breach of contract, and the only uncertainty is as to their amount, there can rarely be good reason for refusing, on account of such uncertainty, any damages whatever for the breach. A person violating his contract should not be permitted entirely to escape liability because the amount of the damages which he has caused is uncertain.*[64]

Reasonable Basis for the Damages Calculation

There must be a *reasonable basis* for the damages put forward. This basis is sometimes referred to as a *rational standard*. The courts may try to serve as a filter through which speculative presentations are prevented from being used by the jury to arrive at a damages award. The range of acceptability is

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[63] *Randy's Studebaker Sales, Inc. v. Nissan Motor Co.,* 533 F.2d 510 (10th Cir. 1976).
[64] *W.L. Hailey & Co. v. County of Niagara*, 388 F.2d 746, 753 (2d. Cir. 1967).

still quite broad and the expert is allowed to adopt the damages methodology to fit the unique requirements of each case. As the Supreme Court of Kansas stated in *Vickers v. Wichita State University:*

> *As to evidentiary matters a court should approach each case in an individual and pragmatic manner, and require the claimant furnish the best available proof as to the amount of loss that the particular situation admits.*[65]

Foreseeability

Another important legal principle in the field of commercial damages is the *foreseeability rule*. In order to be recoverable, the damages must be foreseeable by the defendant at the time the defendant acted in a way that resulted in the damages. For example, in a breach of contract, the defendant must be able to foresee that when it breached the contract with the plaintiff, the defendant was going to cause the plaintiff to incur damages. This legal principle arises out of the very famous English case *Hadley v. Baxendale*.[66] This case is similar to many business interruption claims that occur today. It involves a mill owner who sued a shipper for lost profits due to the late shipment of an iron shaft necessary to run the mill. The court concluded that the lost profits were not recoverable, as they were not within the contemplation of the parties.

Foreseeability can become clear when the plaintiff explicitly communicates its anticipation of damages to the defendant at the time of the defendant's actions. In the absence of such direct communications, the courts are put in the position of determining what was *within the contemplation of the parties*. This means that if the defendant is capable of understanding how its actions might have an adverse effect on the plaintiff, then those actions are within the contemplation of the defendant. For example, if the defendant has contracted with the plaintiff to provide certain services or products, the defendant likely knows of the use to which the plaintiff may be putting such services or goods. The defendant may be further able to anticipate the impact on the plaintiff if the latter were to do without such services or goods. In such cases, the actual contract between the parties may provide some useful information for determining what is within the contemplation of the parties. Other evidence of this can come from testimony or knowledge of communications between the parties, where the use to which the plaintiff was putting the goods and services was communicated to the defendant. The plaintiff would ease its burdens of proof if, at the time he entered into the contract,

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[65] *Vickers v. Wichita State University,* 213 Kan. 614, 620, 518 P.2d 512, 517 (1974).
[66] *Hadley v. Baxendale,* 156 Eng. Rep. 145 (1854).

he explicitly advised the defendant of the anticipated damages should the defendant fail to complete his contractual obligations.

A clue to the reasonable foreseeability is the fact that a given transaction was commercial. Continuing with the contract example, the court may conclude that the defendant knew in advance that the plaintiff was using the goods or services for some commercial purpose in hopes of generating profits. Accepting this, a court may conclude that there would be a loss of profits if the contract were breached. It is even clearer if both parties were unambiguously aware of how the plaintiff used the goods or services provided by the defendant.

Collateral Transactions

A party may claim damages from a *collateral transaction* – a transaction contingent upon another. A party may claim that the failure of the defendant to perform the first transaction resulted in losses in another transaction that hinged on the performance of the first transaction. Damages resulting from such transactions may not be recoverable unless it can be demonstrated that the damages were foreseen and within the contemplation of the parties at the time of the agreement. The plaintiff may have a clearer case if he or she can demonstrate that the second transaction flows directly from the first; this is different from an indirect route in which the plaintiff argues that had he or she been able to enjoy the proceeds from the first contract, he or she would have pursued another venture (in turn, generating additional lost profits that he or she claims as damages). The plaintiff's argument is stronger if he or she can show that he or she gave the defendant notice of the dependence of the second transaction on the first. Such notice, however, may not be necessary in the case of a reseller where the seller knows the nature of the buyer's (reseller) business. Here, foreseeability is presumed given the nature of the buyer's business.

Contract-Related Damages

Parties to a contract can incur damages in a number of ways. A buyer may lose profits due to the failure of a seller to deliver. Such a failure may cause the buyer to incur *incidental* and/or *consequential* damages. Incidental damages are those expenses that the buyer may incur from having to secure replacement goods. Consequential damages are those that the plaintiff may have incurred as a consequence of the defendant's failure to perform. Once again, the defendant must have been able to foresee these damages and the plaintiff must not have been able to avoid such damages by securing performance from other parties. This alternative performance is sometimes referred to as *cover*. The plaintiff, however, may be able to cover the transaction by securing the goods or services elsewhere but still incur damages. This would

be the case if the cover price were higher than the contract price. The damages would be the price difference plus any incidental damages.

The law carries with it a requirement that the plaintiff make efforts to mitigate its damages from securing alternative sources or cover. The situation becomes more problematic when the goods or services in question are unique and not readily available in the marketplace. Mitigation of damages is discussed in Chapter 6.

Contractually Related Liability Limitations

The seller may include provisions in the contract to limit its liability to the buyer. In a sale of goods, such as machinery, these provisions may limit the seller's obligations to repair the goods without any allowance for the recovery of consequential damages, including any lost profits. Courts have concluded that if the limitations are very extreme, they may be found *unconscionable*.

Breach of Covenant of Good Faith and Fair Dealing and Breach of Termination Clauses

Although the parties to a contract may have a contract period that is explicitly defined, the agreement may also provide for its termination under certain circumstances. If one of the parties exercises the termination provision, they may still be liable for damages if they violate the *covenant of good faith and fair dealing*. This was the court's conclusion in *Sons of Thunder, Inc. v. Borden, Inc*.[67] In this case the New Jersey Supreme Court agreed with the trial court's differentiation between obligations that are controlled by a termination provision and obligations that are governed by the covenant of good faith and fair dealing.

> *It seems to me that as a general rule where you have a contract that is terminable by its express terms, a party terminates, regardless of motive; however, that is separate from determining whether there has been good faith exercised in the performance of the contract; that you can look at good faith separate and apart from just looking at motive alone and pigeonholing it.*

The importance and extent of the obligations under the covenant of good faith and fair dealings varies with the laws of different states. The State of New Jersey places relatively greater emphasis on such obligations. The court made this clear in *Sons of Thunder*.

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[67] *Sons of Thunder, Inc. v. Borden, Inc.,* 148 N.J. 396; 690 A.2d 575, 1975.

> *In our state, it is the law that where a party to a contract follows an agreement or provision in a contract regarding the termination of that contract, its motives or reasons for terminating are irrelevant.…*
>
> *Now it is also the law in New Jersey that each party to a contract must deal fairly and in good faith with the other in their performance under the contract.*

Damages arising from a breach of the covenant of good faith and fair dealing can give rise to damages over a period that is not very clear. In *Sons of Thunder, Inc. v. Borden, Inc.* the trial court awarded an additional year of lost profits. Once a jury determines the relevant time period, the standard methodology for measuring lost profits that is set forth in this book applies. When the time period that a jury would find appropriate is unclear, one solution is for the expert to compute damages for various alternative time periods so that a jury can select the relevant damage period and associated amount.

Warranty-Related Damages

A breach of warranty is a contract-related claim. Under the Uniform Commercial Code, there are two types of warranties: express and implied. In an express warranty, the seller clearly delineates which characteristics of the goods that he sells are guaranteed. In an implied warranty, the promise is less clearly stated and a more general guarantee is given, such as general merchantability. The normal standard of warranty-related damages is the difference between the value of the goods as warranted and the value of the goods that were accepted. While this is an important area of commercial damages, it is not the focus of this volume.

Other Types of Damages Cases

A complete listing of all the different types of cases in which there is a claim for commercial damages is well beyond the scope of this section. However, it may be useful to highlight a few of the more common types that may give rise to a lost profits claim.

Distributor, Manufacturer's Representative, and Franchisee Relationships

Several contract cases arise involving the representations by a manufacturer or another goods or service provider. A *distributor* is similar to a *manufacturer's representative*. Both represent the manufacturer, but a distributor often takes possession of the goods and maintains an inventory of the products, while a manufacturer's representative augments the seller's

sales force without physically storing an inventory. Each may or may not have exclusive territories. A *franchisee* may be given the right to market a company's products within an exclusive territory. Disputes often stem from the termination of these agreements, with the terminated party claiming damages for lost profits under the agreement. These disputes may be caused by the franchisee or distributor failing to perform or the franchiser failing to live up to its obligations – neglecting to provide agreed-upon marketing support for the product, for example. The franchiser may contend that it terminated the franchisee because the latter did not properly market the product.

Despite the wide variety of these lawsuits, the methodology used to measure damages can be found within the framework described later in this book. The method usually involves constructing revenue projections and applying costs ratios to derive profits from projected revenues. In other instances, such as in the case of terminated franchisees, the damages analysis may involve employing business valuation techniques to place a value on a terminated franchisee that no longer exists.

Contracts to Provide Services

Other types of contract-related damages can arise from a failure to provide the contractually agreed-upon services. When these cases involve major figures in high-profile businesses, they tend to attract media attention. For example, movie stars who walk out on film agreements or authors who do not provide manuscripts both are failing to honor their contractual obligations. Publishers may simply demand the return of an advance. In the film industry, however, the analysis may be substantially more complicated, involving loss of invested capital or lost projected profits.

Construction-Related Contract Cases

Another common type of contract cases are construction cases. These often involve lawsuits for failure to complete construction on time or according to the specifications of the contract. "Delay damages" can come from many sources and can vary considerably from case to case. Other construction-based lawsuits may involve damages having to do with who pays for certain costs and whether cost overruns can be passed on to the builder. Still another type of construction lawsuit is one that involves damages related to the loss of bonding capacity. The loss of such capacity may limit the volume of work that a contractor can bid for. This may generate a claim for lost profits on the additional work that the plaintiff claims he or she would have been awarded had he had a certain bonding capacity. Obviously, such cases may require the damages expert to conduct a thorough analysis of the various economic factors that would influence such damages. This would

include an analysis of economic and industry conditions – for example, damages that may have been incurred during the transition period between the economic expansion that occurred in the 2000s and the subprime crisis and Great Recession of 2008–2009. The expert will have to try to fully take into account these varying economic conditions.

Noncompete Agreement Cases

Still another common form of contract-related damages cases is the type that involves covenants not to compete. Such cases may be based on provisions in a business sales agreement where an owner of a business agreed not to compete with the buyer for a period of time. Other cases involve professional service firms where individuals agreed not to compete for a certain period of time with an employer in exchange for certain consideration. The damages analysis can sometimes be complicated, as it may involve measuring the damages that result exclusively from the illegal competition. An important part of this analysis is isolating these specific damages. Cases may be more straightforward where a personal service provider – such as an attorney or a broker – competed by stealing specific clients or customers than in a situation where a firm improperly competes and is one competitor among several in the market. In such cases, the industry analysis may be quite important in assessing the change in the level of competition and the resulting damages.

Lost Profits Arising from Personal Injury

As noted earlier, economists play a prominent role in measuring damages in personal injury. These often involve projections of lost earnings over a work-life expectancy or a valuation of the services that an injured party or a decedent would have provided.[68] In a personal injury lawsuit, a business generally cannot claim damages due to the injuries of an employee. However, in cases where the employees were largely responsible for the profits of the business, such as in a small business with few employees and where the plaintiff was the prime force behind the generation of the business's profits, the profits of the business may become an important part of the damage measurement process.[69] An example: A president of a small business is involved in an accident that causes him not to be further involved in the business, and this, in turn, results in the closure of the business.

[68] Ireland, Horner, and Rodgers, "Reference Guide for Valuing Economic Loss in Personal Injury, Wrongful Death and Survival Actions."
[69] *Ginn v. Penobscot Co.,* 334 A. 2d 874 (Me. 1975).

Here, the projected profits, along with other forms of compensation that the individual derived from the business (such as officer's compensation or other perquisites), might be relevant.[70]

The courts have usually drawn a distinction between cases where the profits of a business are a function of an individual's efforts and returns that are the product of the invested capital. In the latter case, where returns are more passive, the law of torts is less relevant.

Personal Injury and Corporate Damages Due to Loss of "Key Man"

It is not unusual that a company's success can be largely attributed to the efforts of one individual. This is sometimes referred to as the role of the *key man* in corporate finance. Corporate America is filled with examples of companies whose growth and success can be attributed to an individual who makes a far greater contribution than any other member of the company. It is logical, then, that a company can be significantly damaged if that individual dies or is impaired as a result of injury – he or she can no longer participate in the activities of the business. The courts have come to recognize this. Although the company itself may not be able to recover its lost profits, the injured party, who may be a controlling shareholder, may be able to individually recover such lost profits.[71]

Damages Resulting from Other Business Torts

A variety of tortious behaviors can cause recoverable damages in the form of lost profits. These can include tortious interference with business, fraud, and unfair competition. The varieties of each of these categories of business torts can be virtually limitless. While the case law is correspondingly voluminous, the methodology used to measure damages (such as lost profits) can be found within the chapters that follow. However, courts have found that "lost profits in a tort action are limited to those damages proximately caused by the defendant's wrongful conduct."[72] Such profits usually can be measured through a projection of *but for* profits and a comparison of such projected profits with the actual and "projected actual" profits. This will be described in detail in the chapters that follow.

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[70] Patrick Gaughan and Henry Fuentes, "Minimization of Taxable Income and Lost Profits Litigation," *Journal of Forensic Economics* 4IV (1) (Winter 1990): 55–64.

[71] *Lundgren v. Whitney's Inc.,* 94 Wash. 2d 91, 614 P. 2d 1272 (1980).

[72] *Horan v. Klein's-Sheridan, Inc.,* 62 Ill. App. 2d 455, 459, 211 N.E. 2d 116 (1965).

Summary

This chapter introduces the use of an expert to measure damages in commercial litigation. One of the first steps in this process is selecting the right expert. Given the diverse nature of business interruption cases, this expert needs to have a well-rounded background in the fields of economics, econometrics, and finance. This expert may also need to have knowledge of accounting. Because a wide range of expertise is often needed, it may be necessary to have a team of experts from which one expert testifies but relies on the work of other experts. In some cases, more than one expert may testify.

There are many sources of experts, the most common of which is referrals from colleagues. If that is not a fertile source of experts, then other sources, such as local universities or referral agencies, may be needed. Particularly in cases where the expert is not referred by a colleague, attorneys need to carefully review the expert's credentials. These credentials may include a terminal degree in the field, a PhD degree, and publications in the field. Publications may include books and refereed journal articles. Care must be applied when reviewing experts' CVs to ensure that they are accurate. For example, what is listed as a publication should be verified as a published work.

There are several ways to use damages experts. One is to have the expert author a report and serve as a witness. Another is to use the expert purely as a consultant but not as a testifying witness. This latter strategy is often used by defendants who do not want to give credence to the plaintiff's damages claims. Instead, they may want to use the expert to help cross-examine the plaintiff's expert. Research results, as well as the experience of several notable cases, raise serious questions about this strategy. In some cases it works well and in others it does not. The strategy for each case will vary and should be determined based on close consultation with the expert.

Damages experts should have a basic understanding of the relevant legal principles governing the measurement of damages in courts. These include the requirement that damages cannot be speculative or vague and totally uncertain. Although the law does not go so far as to require damages to be measured with certainty, the level of uncertainty cannot be extended so far that the resulting damage claim become speculative.

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