

Conclusion

Scientific experts can form an important arrow in your trial quiver. The identification and development of scientific experts lends itself to dynamic and creative thinking that can both invigorate and augment your trial strategy.

FINANCIAL DAMAGES EXPERTS

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Financial damages experts are unusual in that their expertise and testimony are used in almost all types of litigation—contract cases, tort cases (including personal injury), family law cases, statutory tort cases like securities, antitrust and discrimination actions, appraisal and other corporate valuation cases, and many others. Moreover, the damage theories and expertise used to calculate damages in one type of case can often be applied to establish damages under a totally different legal theory. As an example, the manner of calculating lost profits damages in a contract case can usually be applied to establish lost profits in an appropriate tort or patent case—or in any case where counsel can make a substantive claim to recover lost profits as an element of damages. Damages are damages, so to speak, and while

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they cannot be removed from the context of the substantive legal theory giving rise to the right to such damages, many legal theories share the same financial damages concepts. This subchapter explores the uses of financial damages experts, the various types of such experts, the challenges in presenting such experts, and typical areas of focus and controversy when such experts are presented.

Uses of Financial Damages Experts

Financial damages experts pose unique challenges because their uses are so varied. They are retained to testify about a wide variety of damage calculations in myriad types of cases. Financial damages experts consult and testify about the following types of damages, among others:

- Lost earnings or profits (gross, net, before/after tax, etc.);
- Profits earned by the liable party;
- Lost revenues or lost income streams;
- Lost wages or earnings;
- Value of an intangible asset lost or damaged (e.g., a trademark, a business or product line, natural resources, contract rights);
- Historical consequential damages, such as increased costs, overcharges, underpayments, costs of cover, warranty claims, reinsurance claims, increased borrowing or capital costs, or trading losses;
- Reasonable royalty amounts;
- Net loss on the purchase of an asset, particularly in the context of securities fraud claims;
- Damages allocation, particularly in class action settlements;
- Settlement fairness, particularly in class actions or other matters requiring court approval like bankruptcy settlements and wrongful death settlements; and
- Compliance with damages limitations or caps.

Moreover, as society and the economy become more complex—or perhaps as lawyers become more creative—the cases in which financial damages experts are needed appear to be growing. Financial damages experts often testify in the following types of cases, among others:

- Contract cases;
- Tort cases;
- Securities and other statutory tort cases;
- Stock appraisal actions;
- Divorce/equitable distribution actions; and
- Business valuations.

This section first identifies two general categories into which financial damages can be grouped and discusses the advocacy issues raised by each category. Then, this section examines several of the most significant legal theories pursuant to which financial damages experts are used to establish damages. Incorporated into the discussion of each theory is an analysis of the most frequent measures of damages for each theory.

Two General Categories of Financial Damages

While the types of financial damages that can be proven through expert testimony are quite varied, it can be useful for the advocate to view them as falling into two categories for advocacy purposes: (1) calculations of historical damages using historical data, simply to make computations of what did happen (but should not have); and (2) calculations of projected (or “what if”) damages using hard data to make an estimate of that which did not happen (but which should have). Each category generates its own controversies, disputes, and issues, but usually they differ and require that counsel’s attention be focused on different areas and concerns.

Historical losses include the amount of an overcharge in a contract case or antitrust case, rescission damages in securities cases (where the amount paid is simply returned), repair or replacement costs in breach of warranty cases, payments due under reinsurance treaties for historical claims, or the costs of buying replacement products or supplies in a Uniform Commercial Code (UCC) breach of contract case.

When litigating a case involving historical damages, an attorney often must address which specific items (costs, charges, etc.) are properly included in damages, which items should be excluded, and how to summarize, organize, and present an often significant amount of data or computations.

The classic example of projected (or “what if”) damages is lost profits that, as discussed below, can be awarded in contract cases, tort cases, patent cases, and many other types of cases. Lost future income in personal injury or death cases is a similar example. Asset valuations of intangible assets, like stock, royalty streams, or other income-producing assets, are in many ways similar in that they require a projection of an income stream (and then a way to value it).

For trial counsel, it is useful to view projected damages as more of an estimate than a pure calculation. Viewed in that light, they also present another set of advocacy issues for each side’s counsel: those arising from the judgments made by the damages experts in making the estimate. These issues are explored in some detail at the end of this subchapter.

Contract Damages

Contract law has for years allowed recovery of expectation damages and consequential damages.² Although these calculations are simple in some cases (the amount of an unpaid account receivable being a stark example), in other cases they are often quite complicated. Financial damages experts are routinely used to establish expectation and consequential damages.

Expectation damages often include lost profits.³ An award of lost profits typically requires a showing that the profits can reasonably be determined, that profits were contemplated by the parties to the contract, and that the lost profits can be causally related to the breach.⁴ Since most jurisdictions require that such profits be capable of “reasonable determination” and then proven with “reasonable certainty,” a financial expert can be pivotal to recovery of lost profits. For example, in a dispute over failure timely to construct a factory, economists were used to testify to \$845,000 in lost profits based on statistical evidence.⁵ In a case involving the breach of a strategic alliance agreement in which the parties had agreed to jointly serve certain customers, the court sifted through the competing damages testimony of an accountant for one party and an economist for the other before awarding \$8 million in lost profits.⁶ In a case involving an established business and a wealth of applicable historical data as to use, a financial analyst’s testimony was sufficient to support an award of \$247,000 in lost profits in a breach of franchise agreement case.⁷ Of course, use of a damages expert does not guarantee an award. In a case alleging lost profits arising from breaches of various cable TV contracts, both industry executives and Certified Public Accountants (CPAs) testified to the alleged lost profits arising from breaches of various cable TV contracts, although the lost profits claim was ultimately rejected.⁸

Contract expectation damages can also include the value of the asset or assets being sold pursuant to the allegedly breached contract. Sometimes, these assets are intangible, such as a trademark,⁹ a business that can be sold

2. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 344.

3. See, e.g., U.C.C. § 2-708.

4. See *McDermott v. Middle East Carpet Co.*, 811 F.2d 1422 (11th Cir. 1987) (applying Georgia law); *Kenford Co. v. County of Erie*, 493 N.E. 2d 234 (N.Y. 1986); *Chas. R. Combs Trucking, Inc. v. Int’l Harvester Co.*, 466 N.E. 2d 883 (Ohio 1984).

5. *McDermott*, 811 F.2d at 1427–28.

6. *Honeywell Int’l Inc. v. Air Prods. & Chems., Inc.*, 858 A.2d 392, 425–34 (Del. Ch. 2004).

7. *Burger King Corp. v. Barnes*, 1 F. Supp. 2d 1367 (S.D. Fla. 1998).

8. *Schonfeld v. Hilliard*, 218 F.3d 164 (2d Cir. 2000).

9. *Nestle Holdings, Inc. v. Comm’r*, 152 F.3d 83 (2d Cir. 1998).

in the marketplace,¹⁰ a natural resource,¹¹ or a contract right. Where the asset is intangible, financial experts such as CPAs, financial analysts, business valuation experts, or economists can be and often are used to value the asset.¹² For example, in a case involving contracts to supply cable television programming, the court allowed a CPA to testify about the market value of the programming contracts.¹³ There is also law to the effect that the owner of intangible assets is competent to testify as to their value,¹⁴ but from counsel's viewpoint as an advocate, competence and persuasiveness are two very different things. Often, an expert's valuation is more persuasive, especially if the opposing side has retained a testifying expert.

Consequential damages awarded for a breach of contract include not only easily calculated items like cover costs, but also other costs such as increased administrative costs, maintenance costs, borrowing costs, or costs of capital. As to these types of consequential damages, financial experts are routinely used (and may be required) to establish the amount of increased costs. For instance, an expert's testimony helped the plaintiff to obtain a \$116 million verdict in a breach of energy contract case,¹⁵ to obtain an award of the costs of new financing in a case against the Federal Savings and Loan Insurance Corporation (FSLIC) alleging breach of a bank assistance agreement,¹⁶ and to obtain an award of damages for additional operational/administrative costs and costs of borrowing in a case involving the breach of a contract to expand a cement plant.¹⁷

Tort Damages

As in contract cases, tort damages can also require complex financial analysis, and a financial expert is often invaluable (if not outright required) to prove those damages. Tort cases can involve some of the same types of damages as contract cases—such as lost profits—but also use additional damages measures.

As in the contract cases, lost profits, sales, or earnings claims are regularly presented through the testimony of an accountant, an economist, a

10. *Indu Craft, Inc. v. Bank of Baroda*, 47 F.3d 490 (2d Cir. 1995).

11. *Central Dover Dev. Corp. v. Town of Dover*, 680 N.Y.S.2d 668 (App. Div. 1988).

12. An appraiser is often used to value a tangible asset, for example, real property.

13. *Schonfeld*, 218 F.3d at 183.

14. *Commerzanstalt v. Telewide Sys., Inc.*, 880 F.2d 642 (2d Cir. 1989).

15. *Tractebel Energy Mktg. Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89, 107–08 (2d Cir. 2007).

16. *Bluebonnet Sav. Bank v. United States*, 266 F.3d 1348 (Fed. Cir. 2001).

17. *Havens Steel Co. v. Randolph Eng'g Co.*, 813 F.2d 186 (8th Cir. 1987).

financial analyst/Master's Degree in Business Administration (MBA), or similar financial expert. In a tortious interference case, for example, lost profits of \$1 million were awarded based on the analysis and testimony of a CPA specializing in plaintiff's industry.¹⁸ In a civil contempt action for violation of the automatic stay in bankruptcy, extensive expert testimony established lost profits.¹⁹

In personal injury cases, future lost earnings or lost earning power damages are an "amorphous area combining law and economics,"²⁰ where experts, usually economists, "are commonly used by plaintiffs to present their case."²¹ For example, in a wrongful death case, an economist testified about future lost earnings damages for five decedents.²² This approach is not limited to wrongful death cases—economists are also called on to determine future lost wages claims for injured plaintiffs.²³

In addition, consequential damages are also available in tort, particularly for business torts and fraud. Thus, where a tort case calls for damages that include lost profits, lost earnings, and consequential losses, the damages can often be most effectively proven using a financial expert.

Damages in Securities and Other Statutory Actions

Financial damages experts are often invaluable in cases that arise under certain types of remedial statutes, including the securities statutes, the antitrust laws, the racketeering statute, and the employment discrimination laws, which often require detailed and complex calculations. This is particularly so in class action cases, which almost always involve class members whose damages are calculated using different dates, time frames, or prices.

18. *G.M. Brod & Co., Inc. v. U.S. Home Corp.*, 759 F.2d 1526 (11th Cir. 1985).

19. *Elder-Beerman Stores Corp. v. Thomasville Furniture Indus., Inc.*, 206 B.R. 142 (Bankr. S.D. Ohio 1997), *aff'd in part, rev'd in part*, 250 B.R. 609 (Bankr. S.D. Ohio 1998), *appeal denied*, 201 F.3d 440 (6th Cir. 1999).

20. *Aldridge v. Baltimore & Ohio R.R. Co.*, 789 F.2d 1061, 1067 (4th Cir. 1986), *on rehearing* 814 F.2d 157 (1987), *on remand*, 866 F.2d 111 (1989).

21. *Mecca v. Lukasik*, 530 A.2d 1334, 1339 (Pa. Super. 1987).

22. *Id.* at 1338–40.

23. *See Delmarva P&L Co. v. Burrows*, 435 A.2d 716 (Del. 1981) (future lost earnings awarded where plaintiff could not work due to brain damage from his injury); *Aldridge* 789 F.2d at 1066–67 (future lost earnings award in Federal Employer's Liability Act (FELA) injury case). *Aldridge* highlights the debate over whether future lost earnings must be reduced to present value, and whether doing so requires a concomitant increase for inflation. Regarding this important debate as to the rules for calculating lost earnings damages, *see St. Louis Southwestern Railway v. Dickerson*, 470 U.S. 409 (1985). Determining such a present value generally should not be attempted without an expert.

For example, section 11(e) of the Securities Act generally provides for use of a complex damages calculation involving the difference between the amount paid for the security (not exceeding the public offering price) and either (1) the security's value when the suit is filed, (2) the price at which it was sold if sold presuit, or (3) the price at which it was sold postsuit if sold postsuit but prejudgment (if that reduces the damages from the damages as measured when suit was filed).²⁴ Section 12 provides for a rescission (i.e., refund) remedy, as well as damages.²⁵ In litigation under Securities and Exchange Commission Rule 10b-5, a comparison of the price paid or received with the value of the security is made to estimate damages.²⁶ Moreover, since the Private Securities Litigation Reform Act, there is now an additional cap on damages (with an exception) based on the market price of a security, providing that the damages "shall not exceed the difference between the purchase or sale price . . . and the mean trading price of that security during the 90 day period beginning on the date [the misstatement or omission is corrected]."²⁷

These types of damages can theoretically be calculated by a lay person. However, the volume of calculations required often makes the use of an accountant or other expert desirable from a clarity and persuasiveness standpoint, particularly in class actions. Even if the damages involve simple calculations that are just voluminous, the expert can more easily provide his conclusions in a summary table or chart under Federal Rules of Evidence 705 and 1006.

Under the antitrust laws, a plaintiff is entitled to "recovery of actual damages," a very open-ended approach that has given rise to a broad range of damage theories and calculations.²⁸ As a result, financial damages experts are used to calculate antitrust damages under a variety of measurements. For example, an economist was recently used to determine the underpayment to scrap metal generators resulting from an antitrust conspiracy by brokers of the metal,²⁹ and the expert's testimony supported class damages of \$11 million. Similarly, a financial expert was used to determine the lost profits of a sawmill operator resulting from a competitor's antitrust

24. 15 U.S.C. § 77k.

25. 15 U.S.C. § 77e.

26. *Alley v. Miramon*, 614 F.2d 1372, 1387 (5th Cir. 1980) (discussing measure of damages under section 10(b) of Securities Exchange Act, 15 U.S.C. section 78j(b), and Rule 10b-5).

27. 15 U.S.C. § 78u-4(e).

28. 15 U.S.C. § 15.

29. *In re Scrap Metal Antitrust Litig.*, 527 F.3d 517 (6th Cir. 2008).

violations.³⁰ Such experts have also been useful in calculating and explaining racketeering damages³¹ and are used to calculate future lost wages in some discrimination cases (using models similar to those used in the personal injury lost earnings cases).

Damages experts also can help prove damages in patent infringement cases, where damages should be “adequate to compensate for the infringement” but “in no event less than a reasonable royalty.”³² Financial experts are routinely employed in infringement cases to testify about the infringer’s profits, the patent holder’s lost profits,³³ and a reasonable royalty.³⁴

Stock Appraisal Actions, Divorce/Equitable Distribution Actions, and Other Business Valuations

Most corporate law statutes grant appraisal rights in certain circumstances. In an appraisal, the fair value of the shares is determined and paid to stockholders dissenting from mergers or other corporate actions.³⁵ Such cases are often focused exclusively on the financial analysis, and in many circumstances, the determination of fair value involves a classic battle of the experts involving investment bankers, financial analysts, accountants, and others.

Many of these appraisal cases express the view that “[t]here is no inflexible test for determining fair value as [v]aluation is an art rather than a science.”³⁶ Accordingly, appraisal cases often include several financial experts and competing valuation approaches. For example, in *M.G. Bancorporation, Inc. v. Le Beau*,³⁷ three separate financial experts provided opinions as to the fair value of the business (and therefore the amount of damages to

30. *Confederated Tribes of Siletz Indians of Oregon v. Weyerhaeuser Co.*, 411 F.3d 1030 (9th Cir. 2005), *vacated*, 549 U.S. 312 (2007), *on remand*, 484 F.3d 1086 (9th Cir. 2007) (the Ninth Circuit initially upheld a \$26 million lost profits damages award based on plaintiff’s economic model but the award was vacated by the Supreme Court).

31. *See* *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1139–40 (5th Cir. 1988).

32. 35 U.S.C. § 284; *see also* *Rite-Hite Corp. v. Kelley Co.*, 56 F.3d 1538 (Fed Cir. 1995).

33. *See* *DSU Med. Corp. v. JMS Co., Ltd.*, 296 F. Supp. 2d 1140, 1144–58 (N.D. Cal. 2003) (a CPA with a doctorate in finance testified as to the patent holders’ lost profits); *Muniauction Inc. v. Thomson Corp.*, 502 F. Supp. 2d 477 (W.D. Pa. 2007), *rev’d in part*, 532 F.3d 1318 (Fed. Cir. 2008).

34. *See* *Cargill Inc. v. Sears Petroleum & Transp. Corp.*, 388 F. Supp. 2d 37 (N.D.N.Y. 2005) (competing academic experts were offered to establish royalties and other damages).

35. *See* DEL. CODE ANN. tit. 8, § 262(h).

36. *Casey v. Amboy Bancorporation*, 2006 WL 2287024, at *3 (N.J. Super App. Div. Aug. 10, 2006).

37. *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513 (Del. 1999).

be awarded) using various market comparison approaches and a discounted cash flow approach.³⁸ Similarly, *Casey v. Amboy Bancorporation* involved not just a half dozen different financial experts, including a court-appointed expert, but also numerous competing valuation methodologies, including the discounted cash flow approach and the comparable earnings approach.³⁹ In many of these cases, the debate is as much about the applicability of the expert's model (e.g., valuation by market comparisons versus valuation by cash flow) as it is about the other judgment calls that must, of necessity, be made in the analysis.⁴⁰

Equitable distributions in divorce cases sometimes require business valuations similar to stock appraisals. For example, in *Steneken v. Steneken*, the court upheld an equitable distribution award based on the trial court's valuation of one spouse's closely held business.⁴¹ In *Steneken*, the New Jersey Supreme Court approved valuing a business using the capitalized earnings method, the market comparison method, or the cost (apparently book value) method, which are to be applied with "flexibility."⁴² In support of these valuations, an accountant, a business valuation expert, and an appraiser testified. In another divorce situation, three accounting experts (one court-appointed) were used to value the husband's medical practice for equitable distribution purposes.⁴³ Thus, financial damage experts can be useful in statutory appraisal cases and equitable distribution cases, in addition to other cases where the value of a business must be determined. In many ways, this damages analysis is similar to valuing intangible assets in contract and tort cases.

Types of Financial Damages Experts

The selection of a financial damages expert is a critical determination made by counsel and the client in the planning and execution of a case. The selection of an expert is typically driven by the type of damages, the relevant industry, and the complexity of the issues at hand. Financial damage experts often include, but are not limited to, professionals with one or more of the following credentials: CPA, Ph.D. economist, MBA with finance

38. *Id.* at 518–26.

39. *Casey*, 2006 WL 2287024, at *8–20.

40. *See* *Doft & Co. v. Travelocity.com, Inc.*, No. Civ.A. 19734, 2004 WL 1152338 (Del. Ch. May 20, 2004).

41. *Steneken v. Steneken*, 873 A.2d 501 (N.J. 2005).

42. *Id.* at 505.

43. *Agarwal v. Agarwal*, 2009 WL 1650161 (N.J. Super. App. Div. June 15, 2009).

concentration, Certified Valuation Analyst (CVA), and actuary. This section addresses each of these credentials, explaining what standards govern opinions proffered by experts with these credentials, and providing guidance about the types of cases in which these credentialed experts are most helpful.

CPA

CPA is the statutory title of qualified accountants in the United States who have passed the Uniform Certified Public Accountant Examination (a four-part test provided on a state-by-state basis) and have met additional state education and experience requirements for certification as a CPA.⁴⁴ Some CPAs have completed an additional test and demonstrated professional experience to be Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants (AICPA). A CPA with an ABV has demonstrated knowledge and training in business valuation. This knowledge and training can be useful in measuring economic damages, including diminution of business value and lost profits. Many CPAs provide attest services, such as audits of financial statements, or go on to be financial analysts, controllers, or even chief financial officers at corporations. However, some may decide to specialize in litigation support and are used by counsel as damages experts.

CPAs hold various expert roles depending on the practitioner's expertise. Such services may include the computation of economic damages, analysis of complex financial, governmental, or cost accounting data, analysis of the varying results from the interpretation and application of accounting principles, quantification of damages due to intellectual property infringement, and the valuation of a business or stock values. According to the AICPA,⁴⁵ litigation services are consulting services provided by CPAs and their employees, and, therefore, require adherence to the Statement on Standards for Consulting Services (SSCS). In addition to the SSCS, a CPA engaged in litigation services must comply with the general standards of the accounting profession contained in the AICPA Code of Professional Conduct. CPAs must also adhere to the professional standards set by their respective states and any standards governing other professional organizations to which the CPA may belong.

44. See DEL. CODE ANN. tit. 24, § 107 (Certificate and Permit Requirements for Certified Public Accountants).

45. AICPA MEMBER INNOVATION TEAM, LITIGATION AND APPLICABLE PROFESSIONAL STANDARDS (2009), available at <http://fvs.aicpa.org>.

Economist

As discussed, counsel may decide to use an economist, who will often hold a Ph.D. in economics. Economists may provide expertise in cases involving antitrust matters, production economics, analysis of market conditions and the impact on a company's financial performance, commercial damages, damages resulting from the infringement of intellectual property (copyright, patent, trademark, or trade secret infringement), cost performance issues, cost structures, and transfer pricing. Economists may also provide reports and testimony regarding lost earnings, lost profits (including the likelihood of loss and costs associated with the disruption in economic activity experienced by a business), and economic research. Economists tend to be used more frequently in cases requiring economic modeling, forecasts, statistical analyses, and market assessments, whereas accountants tend to be used more in matters involving the analysis of accounting or cost data and any tax implications. The two roles can be highly complementary, especially in cases that involve substantial data processing in response to an economic theory of damages, such as wage and hour dispute issues. In large cases, it is not uncommon for counsel to use both economists and accountants to determine the methodology and quantification of damages.

Expert with an MBA

The core courses in an MBA program are typically designed to introduce students to the various areas of business such as accounting, finance, marketing, human resources, operations management, etc. Many MBA students select an area of concentration as part of their graduate program and focus approximately one-third of their studies in this area.

Practitioners with an MBA may be selected in matters requiring expertise dealing with complex financial analysis, financial futures trades, analysis of various financial planning scenarios, corporate and structured finance issues, and financial projections. MBAs may give expert witness testimony in cases concerning fraudulent conveyances, guarantees, holders of interest, interest-rate risk, lease lending, letters of credit, lender liability, as well as other aspects of finance.

Valuation Expert

Valuation experts can hold several different credentials, including the ABV, the CVA, and the Accredited Valuation Analyst (AVA). The National Association of Certified Valuation Analysts (NACVA) is the governing body that certifies CVAs to perform business valuations. CVAs must pass a two-part

exam to test knowledge and applied experience. Counsel may call on CVAs to provide expertise in cases determining the fair value of a business or the valuation of specific assets (intangible and tangible) in dispute, such as investment portfolios or the value of a security in security litigation cases.

Actuary

An actuary deals with the financial impact of risk and uncertainty. Actuaries evaluate the likelihood of events and quantify the contingent outcomes to minimize losses, both emotional and financial, associated with uncertain undesirable events. Actuaries typically have mathematical backgrounds and must pass a series of examinations to gain full professional status.

Actuaries are often brought on as experts involving actuarial disputes, including pricing and reserving practices of insurance companies, benefit plan provisions and corresponding benefit quantification in an employer setting, personal injury or wrongful death cases, and actuarial appraisals. While the overall dispute may involve broader issues (e.g., the price paid by one insurer for another), the role of the actuary is to focus on issues that fall within his area of expertise.

Financial experts may also act as the trier of fact, when the case involves complex accounting or financial issues that the financial expert's background equips him to understand and the parties agree to resolution by an expert arbitrator. Often in this role, the expert will serve as an arbitrator and will determine financial remuneration between parties. The arbitrator may resolve disputes over variances in the calculation of accounts receivable, accounts payable, accrued expenses, customer liabilities, or other working capital considerations. For example, parties often consider the role of an arbitrator in purchase or merger agreements in the event the parties are unable to agree on the final working capital calculation.

Challenges of Presenting the Financial Expert

One significant challenge in presenting any financial expert is the variation in jurors' and judges' knowledge of and comfort with math. Some potential jurors (and judges) start out hating and avoiding even basic arithmetic. Others may like numbers, and still others may be fascinated by them. This divergence creates a tension in how the financial damages testimony is presented—a problem made worse by what the Federal Reserve and other agencies call limited financial literacy in major parts of our society.⁴⁶

46. See 2008 Report of the President's Council on Financial Literacy, available at www.jumpstartcoalition.org/PACFL_ANNUAL_REPORT_1_16_09.pdf; FEDERAL RESERVE

In a jury trial, given the different levels of financial knowledge and sophistication among jurors, gearing the presentation toward the lowest common denominator is probably unavoidable in most circumstances. Brilliant expert testimony on financial damages that goes over the heads of all but one or two jurors is not likely to be effective. An expert and presentation appropriate for an introductory college course is often the default choice in these cases, and the presentation is often geared to counsel's best guess as to the likely level of financial knowledge of the jury.

In a bench trial, the identity of the individual judge who will try the case is known well in advance in most jurisdictions. In this context, particularly with the rise of specialty courts and business courts, gearing the expert and presentation to the precise audience is more attainable and more important. A generalist judge on a state trial court or a federal district court typically hears from experts in a broad range of fields—almost certainly including medicine and probably including accounting. Thus—unless the judge has business credentials—while the theory and presentation can be sophisticated, the expert should educate the generalist judge on some of the concepts, be careful to define terms and acronyms, and, in short, probably should not be too much of an egghead. The expert and the presentation directed to a generalist judge as a fact finder is most often one appropriate for a graduate level course in the financial subjects at issue.

In a specialty court or business court, the considerations are different. The best-known example of such a court is probably the Delaware Court of Chancery; other examples are the federal bankruptcy courts and the business (or commerce) courts that have been established in other states.⁴⁷ In such courts, the level of financial sophistication is high. The courts' opinions rival many damages experts' reports, and some members of these courts write for scholarly journals on financial concepts.⁴⁸ Moreover, the court has probably heard and decided cases involving similar financial concepts and perhaps even the same damages models and concepts—something counsel and experts alike would want to know and take into consideration when putting on the case. In such a court, the financial experts probably do not have to be overly careful about terms and acronyms or spend much time giving the court background on the underlying concepts. However, they may well have to explain how the damages models and concepts at issue are

PERSONAL FINANCIAL EDUCATION INITIATIVES (2004), available at http://www.federalreserve.gov/pubs/bulletin/2004/autumn04_fined.pdf.

47. See National Center for State Courts, Specialized Courts—Business Courts and Complex Litigation, available at <http://www.ncsconline.org/WC/courttopics/StateLinks.asp?id=10>.

48. See *Henke v. Trilithic, Inc.*, No. Civ.A. 13155, 2005 WL 2899677, at *5–14 (Del. Ch. Oct. 28, 2005); *Elder-Beerman Stores Corp.*, 206 B.R. at 161–73.

the same as—or are different from—similar models employed in past cases that the court has considered. In addition, the financial expert should expect very sophisticated questions from the court. This expert and presentation is often one that would be appropriate for presenting and defending the analysis to the expert's peers, perhaps at the MBA or Ph.D. level.

In addition to gearing the expert and presentation to the trier of fact, trial counsel also faces substantial advocacy issues with regard to how to make the financial damages presentation simple, understandable, and clear. Often, an expert can present damages testimony via a summary or a set of conclusions.⁴⁹ Use of such summaries can keep the fact finder from being overwhelmed by the volume of data.

Moreover, if the damages involve numerous, repetitive calculations—lost profits calculations or claims calculations for multiple periods are good examples—there is a very real risk that the presentation will run on forever. This risk can be managed, and the presentation can be simplified, by picking one calculation to present thoroughly. The financial expert can go through one set of calculations in detail and then testify that the same methodology was employed in each set of calculations for the follow-on products, periods, or the like.⁵⁰ Moreover, grouping items in particular ways can simplify the presentation—for example, if a particular item or items of damages are disputed, spreading those items throughout the calculation makes it much harder to isolate them, while separating them and grouping them together makes their effect easier to see. This choice can have the effect of either highlighting or downplaying the disputed items.

Areas of Focus for the Advocate⁵¹ Presenting or Cross-Examining Financial Damages Experts

When calculating and presenting historical financial damages, the debate at trial is typically over whether an item (or items) should be included in the list of claimed damages or excluded from it. These are not usually items as to which the expert is exercising judgment; usually the controversy is over causation of that damage item, mitigation, or factual support for the

49. See, e.g., FED. R. EVID. 705, 1006.

50. Of course, if the methodology is slightly different, even in unimportant ways, the risks to credibility and on cross-examination have to be weighed against the benefit of simplification—often a difficult judgment call.

51. The expert, of course, does not act as an advocate; that role is typically reserved for counsel and, indeed, the ethics codes applicable to certain experts limit or prohibit them from taking on an advocacy role.

item. While not directly related to the use and role of the expert, the advocate's goal in this regard is typically to make clear through the expert the effect on total damages—and thus the award—of including or excluding such items.

In the calculation of other types of damages, experts must often make judgment calls. As will be illustrated below, the judgments made in some of these areas can significantly affect the total damages, and thus they play an important role in the outcome of the damages case. Counsel (and sometimes the client) are typically aware of and involved in these judgments, and when cross-examining an expert, some or all of the judgment areas provide fodder for cross-examination. Some significant examples of these areas of focus are explored below.

Earnings and Profits—Gross, Net, After-Tax, Etc.

Because different cases or claims require that profits be measured in different ways, the issue of whether the appropriate type of profit is being measured arises in lost profits/lost earnings cases. For example, many consulting contracts require that the gross profit on a consultant-employee be paid to the consulting firm if the employee is hired away by the consultant's client.⁵² In addition, certain cases involving lost sales of a specific product have awarded lost profits as measured by revenues less only the variable costs associated with the product sold.⁵³ In other circumstances, particularly where a business as a whole is being valued, net profits, EBITDA (earnings before interest, taxes, depreciation, and amortization), or even after-tax profits are used.⁵⁴

Since gross profit, net profit, and after-tax profit can differ substantially, the type of profit to be calculated greatly affects the damages award. The advocacy issue for trial counsel is matching the earnings/profits calculation being made by the expert to the form of profits recoverable in the case. That type of profit may be explicit in the contract (in an easy case) or may be detailed by the relevant case law, or may require a decision by the trial court (in a difficult case).

52. Gross profit is generally the revenue produced, less only the variable costs attributable to the item sold—overhead costs are not used to reduce gross profit.

53. See, e.g., *Honeywell Int'l Inc. v. Air Prods. & Chems. Inc.*, 858 A.2d 392, 425–31 (Del. Ch. 2004), *aff'd in part, rev'd in part*, 872 A.2d 944 (Del. 2005).

54. In the context of lost wages, particularly in death or long-term disability cases, the question of whether after-tax earnings can and should be used has been a controversial one. See, e.g., *Delmarva Power & Light*, 435 A.2d at 721. This issue is arguably affected by whether the damages award itself is taxable.

Rates—Interest, Discount, Capitalization, Etc.

To determine the present value, at the time of trial, of a future income stream or of a business, an interest discount or capitalization rate is often used. Specific examples of the use of such rates are the determination of present value of a business in light of earnings,⁵⁵ and present valuation of lost wages/earnings in a personal injury case.⁵⁶

This is another area involving judgment, as the Delaware Chancery Court explained in *Henke, Inc. v. Trilithic, Inc.*, a case in which the court explored in detail the components used to estimate the discount rate in that case.⁵⁷ It is also an area in which the judgment made can dramatically affect the ultimate award. In that regard, *Casey* contains an extensive discussion of the discount rates—varying from 11 percent to 18 percent—proposed by the parties and experts in that case.⁵⁸

To illustrate the potential effect on an award, consider a perpetual income stream of \$100, representing the expected income from an asset continuing in perpetuity. If the rate used to determine the present value of that income stream is 5 percent, then the present value is \$2,000 ($100/.05$). Increasing the rate used for the present value from 5 percent to 6 percent reduces the present value from \$2,000 to \$1,667.

The decision about which rate to use, or the procedure to use to determine the rate, obviously varies from case to case. This issue is the subject of numerous opinions, including *Henke* and *Casey*, as well as many analytical articles. For counsel in a case that requires a present value calculation, the advocacy point is that small changes in the rate can lead to large changes in total damages. Thus, both the advocates and the experts (on all sides) can expect that the choice of rates used will be an area of focus and potential controversy.

Starting and Measuring Points

In making estimates of lost profits, lost sales, future lost wages, and many other items, the choice of a base or starting point is another decision that can significantly affect the damages award. Consider the lost wages claim in *Delmarva Power*, in which the future wage loss calculation was based only on the plaintiff's years of work in a high-paying deckhand job, omitting the years that he did not work or in which he worked in a restaurant.⁵⁹

55. See, e.g., *Casey*, 2006 WL 2287024, at *18–20.

56. See *St. Louis Southwestern Ry. Co. v. Dickerson*, 470 U.S. 409, 411–12 (1985).

57. *Henke, Inc.*, 2005 WL 3578094, at *9–10.

58. *Casey*, 2006 WL 2287024, at *8–20.

59. See *Delmarva Power & Light*, 435 A.2d at 720–21.

The parties debated at some length whether the use of those years was a fair choice or a distraction.⁶⁰ To illustrate the effect on the damages, consider a hypothetical plaintiff, who over the last five years had the following history:⁶¹ the worker earned \$100,000 as a deckhand (including overtime) last year, was intermittently employed at other jobs for two years (making \$10,000 each year), and was employed full time for the other two years in a restaurant (making \$50,000 each year). If last year's deckhand wages are used, they were \$100,000 annually, and 10 years of lost income totals \$1 million. However, if the average wages for five years are used, they are \$44,000 annually, and 10 years lost income is \$440,000. Similar variations can occur with businesses, particularly if business expansions or recessions occurred in the year or years used to measure the income or profits—rendering certain years at least arguably unrepresentative.⁶² Claims of cherry-picking—on the high side or the low side—are common with regard to such starting or measuring points.

There is usually some case law guidance in specific areas as to what constitutes a reasonable or comparable measuring point for calculation purposes, which will obviously be important in guiding the choice of a starting or measuring point.⁶³ However well the case law in a particular jurisdiction and type of case may (or may not) guide counsel, the advocacy concern and issue is that the choice of a starting or measuring point can significantly affect the damages calculation.

Indexes

When lost income, profits, wages, and the like have to be projected over several years, often the year-over-year increase is estimated by references to an index. For example, in *Amboy*, one of the debates was over the “earnings growth rate” of the business. The different experts used rates varying from 4.86 percent to well over double that, and testimony was presented that the “median earnings growth rate” for the type of business involved was 11.9 percent.⁶⁴ There was an extensive debate over what index (and modifications) to use in making this calculation.

60. *Id.*

61. The numbers are hypothetical because the *Delmarva Power & Light* opinion does not contain the plaintiff's income history in this level of detail.

62. Another potential issue in this area is seasonality, in which a large percentage of sales or earnings occur in a particular season—such as the holiday season for a toy store.

63. See *McDermott v. Middle East Carpet Co.*, 811 F.2d 1422, 1427–28 (11th Cir. 1987) (finding that 1983 was a representative year for lost profits calculation given its similarity to the years being measured for lost profits in that case).

64. *Amboy*, 2006 WL 2287024, at *14–20.

For growth in business profits or income, measures of economic growth ranging from the increase in overall gross domestic product down to industry-specific growth indexes based on SIC (Standard Industrial Classification) codes—or even state and local growth indexes—have been used. In other circumstances, a price index (the Consumer Price Index (CPI) (national, state or local), Producer Price Index (PPI), or an index specific to the item involved) is used.⁶⁵ For example, in cases involving future lost wages, such as wrongful death or discrimination cases, the base wage is often inflated by an estimate of wage inflation (based on an index), plus an estimate of wage increases likely to have been given to the plaintiff based on promotions, seniority, and the like.

The choice of which index to use is another judgment item that can significantly affect the total damages. The case law in most areas provides at least some guidance as to what index (or indices) is sufficiently comparable for the task at hand. For example, in *Dobler v. Montgomery Cellular Holding Co.*,⁶⁶ the Delaware Court of Chancery held that use of a generic growth rate (gross domestic product (GDP) growth in that case) is “inherently flawed and unreasonable” and that industry-specific rates were more appropriate. Similarly, in *Nebula Glass International Inc. v. Reichhold, Inc.*,⁶⁷ the Eleventh Circuit Court of Appeals upheld a damages award based on product-specific revenue growth estimates. The advocacy point for trial counsel is that because there are potentially a wide range of indexes that could be used, this is another judgment that can have a significant effect on the total damages.

Use of Comparables

Earnings, lost profits, growth, and even asset values are often estimated by using comparables—data for a supposedly comparable company, industry, product, geographic region, or asset. The issue of whether the comparable data is, in fact, comparable to the circumstances in the case at bar is often hotly litigated. It goes without saying that counsel, often with expert assistance, will want to examine and possibly test the true comparability of the data being used to the damages case being tried.

65. Many of these are available for the U.S. Department of Commerce and industry associations (sales and economic growth), the Federal Reserve (economic growth and inflation), or the Bureau of Labor Statistics (wage growth and inflation).

66. *Dobler v. Montgomery Cellular Holding Co.*, No. Civ.A. 19211, 2004 WL 2271592, at *10–12 (Del. Ch. Sept. 30, 2004).

67. *Nebula Glass Int'l Inc. v. Reichhold, Inc.*, 454 F.3d 1203, 1218–19 (11th Cir. 2006).

Replacement Cost, Depreciated Value, Book Value, Fair Market Value, or Other Basis for Determining Cost of Assets

In various types of tort and insurance cases, the damages include the value of tangible assets—cars, buildings, houses, equipment—where the asset has been destroyed, lost, stolen, or damaged. The value of such an asset for damages purposes can differ based on the type of case or claim.

For example, fair market value is regularly used for many types of contract and tort damages:⁶⁸ “when a defendant’s breach of contract deprives plaintiff of an asset, the courts look to compensate plaintiff for the ‘market value’ of the asset.”⁶⁹ However, insurance claims will use the method of property valuation set by the policy—which may be replacement cost, depreciated value, or market value. In contrast, a stock purchase agreement may use book value if a single asset (out of many) is destroyed before closing. In other circumstances, the basis on which the asset is to be valued for damages purposes may be ambiguous and require judicial resolution.

While the substantive right answer will depend on the case, the contract, and the law, from an advocacy perspective, the answer becomes important because the approach used can have a significant effect on the damages award. This can be seen in the example of a hypothetical building destroyed by fire. It had been acquired for \$100,000 10 years earlier; has been depreciated for tax purposes by \$3,333/year (for a depreciated value of \$67,000); has a market value for the building alone of \$150,000; but will cost \$175,000 to rebuild. In this circumstance, the potential valuations range from a low of \$67,000 for depreciated value, to a market value of \$150,000, to a replacement value of \$175,000. In a tort case, to recover damages for the negligently caused fire, many jurisdictions will look to the market value, though in some, an argument could be made for replacement value. The damages on the fire insurance claim will be the replacement value if (but only if) the policy involved offers full replacement value coverage, but otherwise will be limited to whatever (probably lesser) value the policy involved covers.

For trial counsel, this is another area that calls for matching the damages expert’s approach with the valuation method required by the contract or the law applicable to the case at hand.

68. This is assuming the cost of repair exceeds the fair market value.

69. *Schonfeld*, 218 F.3d at 178.

Conclusion

Financial damages experts, including accountants, economists, MBAs, and financial analysts, are used in a wide range of cases to prove historical and projected financial damages. In offering such testimony, experts must often make judgment calls, which can significantly affect the damages calculation. For counsel, a key advocacy concern is the need to identify and vet the judgments being made in such areas.