

AICPA National Forensic Accounting Conference on Fraud & Litigation Services

The Role of the CPA and Expert in Alternative
Dispute Resolution
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The Context: The Vanishing Civil Trial

- The number of federal court civil trials has fallen.
- Anecdotal evidence suggests the same in state court.
- Result: arbitration and mediation have become more important.

Forms of Alternative Dispute Resolution (ADR)

- Mediation: voluntary, non-binding, resulting in agreement.
- Arbitration: voluntary, binding, resulting in an award.
- Attack on arbitration award: rare and almost never successful. But, mistakes happen. See this recent franchise termination case.¹

Your Role: Persuade by Teaching

- Independence.
- Fair consideration of the data.
- Arbitrators and mediators want (and need) your help.

Formal Roles of the Expert in ADR

- Mediation:
 - Few lawyers prepare for mediation.
 - Submit your confidential report to the mediator.
- Arbitration:
 - Consulting expert?
 - Testifying expert?
 - Difference: will you testify?²

Independence

- Engagement
- Work
- AICPA Special Report 03-1

Credibility

1. Review and rely on proper underlying data.

Credibility (cont'd.)

2. Conform with learned treatises and the law.

- For example, only net profits only are recoverable, not gross profits without deduction of expenses.
- Some cases hold that fixed overhead expenses should not be deducted in calculating lost profits. Be ready to take a position and explain “fixed” expenses to the panel. See Dunn on *Recovery of Damages for Lost Profits*, at sec. 6.

Proper Underlying Data

- Disclose all communications with counsel, opposing counsel, written and oral, and others.
- Disclose all data considered and relied upon.
- Review every piece of data that you can afford to get your hands on, including records held by third parties.

Proper Underlying Data (cont'd.)

- What is proper data?
 - Yes -- A comparison of plaintiff's experience before and after the wrong.³
 - No – management projections.⁴

War Story I :: The Olive Oil Case

Your reliance on management projections: do you really want to do that?

Attacks on You and Your Work

- This may be ADR, but the opposing lawyer will cross-examine vigorously.
- Generally, you face two lines of attack: your credentials and the factual bases for your opinions.

Your C.V. :: Qualifications

- Educational degrees
- Specialized training
- Licenses
- Practiced in the field for some time
- Taught in the field
- Published in the field
- Belong to professional organizations in the field
- Previously testified as an expert on this subject

Presentation of the Study

- Summarize the two results: yours and theirs.
- Announce your theme (e.g., you considered all data).
- Keep it simple. See the “Example of A Damages Study” (*Manual on Scientific Evidence*, pp. 328-29).
- Use one relevant jury instruction. See the sample lost profits instruction (from Arizona).

Presentation of the Study II

- An arbitration is not federal court.
 - *Daubert* won't apply.⁵
 - Direct exam should be expansive.⁶

Issues to Consider Before Testifying: Scope of Work

- What is the scope of your work?
- Will you critique the other expert? Or do your own study?
- Will you write a report?⁷
- Will you test or review source documents?
- Will you see all of the documents? Or only some? Why?

Issues to Consider: Loss Causation

- Will you address loss causation (the often overlooked issue)?
- Often the client will ask you to assume causation.
- But, the tribunal will award only damages that arise from the alleged wrongful conduct.
- Although the rules of evidence do not apply in arbitration (or mediation for that matter), adopting the client's assumptions undermines your independence and credibility.⁸

Loss Causation II

- Aiken's Damage Truism (ADT): Lawyers pay little attention to the damage case.
- Corollary to ADT: Lawyers (and experts) pay even less attention to loss causation.
- Set yourself apart (if you can): The *Reference Manual on Scientific Evidence* lists reference guides that include reliable methods approved by courts, including multivariate regression analysis.

Loss Causation: the Problem

- Fraud and securities cases illustrate the problem.
- Was the drop in share price (for example) due to the misrepresentation?
- Or changed economic circumstances, new firm-specific or industry-specific facts, conditions, or other events?⁹

Issues to Consider Before Testifying: Draft Reports

- Are draft reports discoverable (and what are “drafts”)?
- Many firms include the policy in the engagement letter.
- Many courts hold that opposing counsel may discover draft reports.¹⁰
- ABA House of Delegates Res. No. 120A (Aug. 2006) calls for protection of draft expert reports.
- The solution: get an agreement. You can add value here.

Issues to Consider: Communications

- The rules of evidence do not apply in arbitration or mediation.
- The American Arbitration Association rules and most arbitrators respect the laws of privilege. AAA R-31(c).
- In arbitration, the parties have no right to discovery, but most arbitrators will allow for expert and other discovery.
- So, reach agreement on (or understand) how you will manage and retain emails and other communications.¹¹

Example of a Damages Study (1)

Reference Manual on Scientific Evidence

Appendix: Example of a Damages Study

Plaintiff SBM makes telephone switchboards. Defendant TPC is a telephone company. By denying SBM technical information and by informing SBM's potential customers that SBM's switchboards are incompatible with TPC's network, TPC has imposed economic losses on SBM. TPC's misconduct began in 1996. SBM's damages study presented at trial at the end of 1998 proceeds as follows (see Table 4):

1. Damages theory is compensation for lost profit from TPC's exclusionary conduct.
2. SBM would have sold more units and achieved a higher price per unit had SBM had access to complete technical information and had SBM not faced disparagement from TPC.
3. SBM would have earned profits before tax in 1996–1998 in millions of dollars as shown in column 2 of Table 4, based on an analysis of lost business and avoided costs.

Example of a Damages Study (2)

4. SBM's actual profits before tax are shown in column 3. Column 4 shows lost earnings. Column 5 shows the factor for the time value of money prescribed by law, with 7% annual simple interest without compounding. Column 6 shows the loss including prejudgment interest.
5. For the years 1999 through 2003, column 2 shows projected earnings but for TPC's misconduct.
6. For the same years, column 3 shows projected actual earnings.
7. Column 4 shows SBM's future earnings losses. Column 5 shows the discount factor based on a 4% annual after-tax interest rate, obtained by applying SBM's corporate tax rate to TPC's medium term borrowing rate. TPC has an AA bond rating. Column 6 shows the discounted future loss. At the bottom of the table is the total loss of economic value, according to SBM's damages study, of \$1.237 billion.

Example of a Damages Study (3)

Reference Guide on Damages

Table 4. SBM's Damages Analysis (in Millions of Dollars)

| (1) Year | (2) Earnings but for Misconduct | (3) Actual Earnings | (4) Loss | (5) Discount Factor | (6) Discounted Loss |
|-------------|--|---------------------------|-------------|---------------------------|---------------------------|
| 1996 | \$187 | \$34 | \$153 | \$1.21 | \$185 |
| 1997 | 200 | 56 | 144 | 1.14 | 164 |
| 1998 | 213 | 45 | 168 | 1.07 | 180 |
| 1999 | 227 | 87 | 140 | 1.00 | 140 |
| 2000 | 242 | 96 | 147 | 0.96 | 141 |
| 2001 | 259 | 105 | 153 | 0.92 | 142 |
| 2002 | 276 | 116 | 160 | 0.89 | 142 |
| 2003 | 294 | 127 | 167 | 0.85 | 143 |
| Total | | | | | 1,237 |

Table 5. TPC's Damages Analysis (in Millions of Dollars)

| (1) Year | (2) Earnings but for Misconduct | (3) Mitigation with Earnings | (4) Loss | (5) Discount Factor | (6) Discounted Loss |
|-------------|--|---------------------------------------|-------------|---------------------------|---------------------------|
| 1996 | \$101 | \$79 | \$22 | \$1.21 | \$27 |
| 1997 | 108 | 85 | 23 | 1.14 | 26 |
| 1998 | 115 | 81 | 34 | 1.07 | 36 |
| 1999 | 123 | 98 | 25 | 1.00 | 25 |
| 2000 | 131 | 108 | 23 | 0.87 | 20 |
| 2001 | 140 | 119 | 21 | 0.76 | 16 |
| 2002 | 149 | 130 | 19 | 0.66 | 12 |
| 2003 | 159 | 143 | 16 | 0.57 | 9 |
| Total | | | | | 171 |

Example of a Damages Study (4)

Defendant TPC presents an alternative damages study in the same format (see Table 5). TPC argues that SBM's earnings but for the misconduct, before and after trial, are the numbers in column 2 of Table 5. TPC believes that the number of units sold would be lower, the price would be lower, and costs of production higher than in SBM's damages study. TPC further argues that SBM failed to mitigate the effects of TPC's misconduct—SBM could have obtained the technical information it needed from other sources, and SBM could have counteracted TPC's disparagement with vigorous marketing. Column 3 displays the earnings that TPC believes SBM could have achieved with proper mitigation. TPC argues that future losses should be discounted at a 14% rate determined from SBM's cost of equity and debt; SBM is a small, risky corporation with a high cost of funds. According to TPC's damages study, total lost value is only \$171 million.

Lost Profits Jury Instruction

CONTRACT 19 Damages for Lost Profits

[*Name of plaintiff*] [also] seeks to recover damages for lost profits. To recover damages for present or future lost profits, [*name of plaintiff*] must prove:

1. That it is reasonably probable that the profits would have been earned except for the breach;
2. That the loss of profits is the direct and natural consequence of the breach; and
3. The amount of lost profits can be shown with reasonable certainty.

If future lost profits are reasonably certain, any reasonable basis for determining the amount of the probable profits lost is acceptable. However, the amount of lost profits cannot be based on conjecture or speculation.

In determining whether and to what extent [*name of plaintiff*] proved lost profits, you must subtract the costs and expenses [*name of plaintiff*] would have incurred from the gross revenue [*name of plaintiff*] would have received if the contract had not been breached.

Source: Restatement (Second) of Contract s § 351, comment (b) (1979) (foreseeability of lost profits in general); Judicial Council of California Civil Jury Instructions (2003-04), CACI No. 352; Federal Jury Practice And Instructions(Civil §§ 86.04 and 86.05 (1987).

War Stories II :: The Pill Case

- Critique or independent damage study? The steep costs of no alternative study for the defense.

Examination Techniques I

- Command the room. Step off the lectern or stand up.
- Control the pace.
 - Use a glass of water.
 - Stop the examiner – raise your hand.
- Teach. Refer to visuals.
- Stay cool. You are in command.

Examination Techniques II

- Help your examiner with the direct. Give the main points and signposts.
- See Checklist for Direct Examination.
- Speak plainly. No jargon.¹²
- Concede the obvious. Be consistent.

Endnotes

1. See *Birmingham News Corp. v. Horn*, 901 So.2d 27 (Ala.2004)(review of arbitration award on a claim for wrongful termination of franchises that granted recovery of both lost profits damages and the loss in value of the franchises where normal rule of course is that the award for loss of a business is the value of the business, not lost profits; court held award to be an improper double recovery).

Endnotes

2. Generally speaking, the specially retained expert who will testify at trial or hearing is accessible to discovery. Experts who will not testify are off limits. Non-testifying experts fall into two categories: the specially retained consultant and the informally consulted expert. The first category is subject to discovery if there are exceptional reasons to allow discovery. The protection for informally consulted experts is absolute. The opposing party may not learn even the identity of the expert retained but not expected to testify.

Endnotes (cont'd.)

3. *Lee v. Park*, 16 A.D.3d 986, 793 N.Y.S.2d 214 (2005)(plaintiff's past profits are a basis for projecting future lost profits damages).

4. In *Wyndham international, Inc. v. Ace American Insurance Co.*, the Texas Court of Civil Appeals affirmed an order granting summary judgment to defendants who successfully moved to exclude the plaintiff's expert's testimony in an insurance coverage action, which left the plaintiff with no other means of proving its damages. The plaintiff in Wyndham, a hotel chain, had sued its insurers to recover \$66 million in business interruption losses arising from the September 11 attacks. To prove its losses, the hotel chain engaged a certified public accountant who based his opinion entirely on forecasted monthly hotel revenues prepared by the hotel's employees. The court of appeals, however, found those forecasts to be inadequate, noting that the employees were not required to use any objective standards in compiling this data and did not follow an established economic model or use a consistent reference point. In addition, the forecasts were not reviewed by employees competent to estimate lost income.

Endnotes (cont'd.)

5. The horror stories arising from *Daubert* are many. See, e.g., *Craftsman Limousine, Inc. v. Ford Motor Co.*, 363 F.3d 761, 777 (8th Cir. 2004)(court excludes financial expert testimony, which failed to consider all relevant factors).

Endnotes (cont'd.)

6. The Federal Rules of Evidence do not require testifying expert witnesses to disclose the bases of their opinions during direct examination. Rule 705 provides that an “expert may testify in terms of opinion or inference and give reasons therefore without first testifying to the underlying facts or data, unless the court otherwise directs.” The rule goes on to say that the “expert may in any event be required to disclose the underlying facts or data on cross-examination.” In some cases, counsel may wish to simplify the direct examination for the jury. But, in nearly any arbitration or mediation, take the opportunity for an expansive direct examination that discusses the underlying facts or data. The panel will accept your conclusions much more readily.

Endnotes (cont'd.)

7. Following the 1993 Amendments to the Federal Rules of Civil Procedure, parties are required to submit reports from experts who may testify at trial. The rule does not apply to employee expert witnesses whose duties do not involve regularly providing expert testimony. These reports are to be signed by the expert witness and contain, among other things, a complete statement of the expert's opinions and "the data or other information considered by the witness in forming the opinions." Of course the rule does not apply in arbitration, but convention holds. Often, in arbitration, parties present their experts' direct testimony through the report; cross-examination follows.

Endnotes (cont'd.)

8. See, e.g., *JMJ Enter., Inc. v. Via Veneto Italian Ice, Inc.*, 1998 WL 175888, *10 (E.D.Pa. April 15, 1998)(excluding expert under Rule 403 where plaintiff was “simply presenting their unrealistic hopes through the mouth of an expert His sales projection is presented as a simple underlying component of his conclusion. A jury may not appreciate the importance of the unsupported sales projection in [the expert’s] conclusion.”); but see *Wash Solutions, Inc. v. PDQ Manufacturing, Inc.*, 395 F.3d 888 (8th Cir. 2005)(prelitigation profit projection is an appropriate basis on which to calculate lost profits damages)(Missouri law).

Endnotes

9. In one recent securities case, *Dura Pharmaceutical v. Broudo*, 125 S.Ct. 127 (2005), Justice Breyer referred to the “tangle of factors” that can affect stock prices. He noted the likelihood that other factors caused a loss increase as the time between purchase and sale of the security at issue increase.

Endnotes (cont'd)

10. See, for example, *Regional Airport Auth. V. LFG, LLC* (LEXIS 21035 (6th Cir. Aug. 17, 2006)).
11. Many courts allow discovery of *any* document, work product or not, that is provided to a testifying expert before his opinion is fully formed. See, for example, *Intermedics, Inc. v. Ventritiex, Inc.*, 139 F.R.D. 384 (N.D.Cal.1991) (holding that all communications from counsel to a testifying expert related to the subjects about which he will testify are discoverable). If the expert is given privileged material to review, the question arises whether such material was considered and therefore must be disclosed to the adverse party. The Advisory Committee Note to Rule 26 suggests that any such material is discoverable even though it may have been privileged. But, the courts are not uniform. That uncertainty is important here because the AAA rules and the common law require that arbitrators respect the law of privilege. The expert and lawyer need to work together to minimize the risks posed by mishandling this issue. For some time, even before the adoption of the 1993 rules, the Ninth Circuit, for example, has been aligned with the majority pro-disclosure approach to work product that has been disclosed to testifying experts (see the *Intermedics* case above). The majority approach interprets Rule 26(b)(4)(b) in a manner favoring disclosure of nearly all materials furnished to a testifying expert witness. For that reason, some favor the retention of a consulting expert witness (whose materials (and identity) cannot be discovered).

Endnotes (cont'd.)

12. “Use of private language soon becomes habitual, even desirable, and so most experts forget how to talk about their subjects in colloquial, everyday words and phrases.” Lansford, “How Jurors Respond to Complex Commercial Cases,” 19 *Litigation* No. 4 (Summer 1993), at 53.

References

- *Manual on Scientific Evidence*, Federal Judicial Center.
- *Reference Guide on Estimation of Economic Losses in Damages Awards*, Prof. Robert E. Hall and Victoria A. Lazear (in *Reference Manual on Scientific Evidence* (2d ed. 2000)), Federal Judicial Center (www.fjc.gov).
- *Litigation Services Handbook: The Role of the Financial Expert* (Roman L. Weil et al. eds. (4th ed. 2007)).
- *Recovery of Damages for Lost Profits*, Robert L. Dunn (6th ed. (2005)).