

*Thought Leadership*

# Daubert Challenges: Background, Applications and Considerations

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*Given the prevalence of Daubert challenges in the current litigation environment, it is important for forensic analysts to understand the rules set forth in the Daubert Trilogy cases and the current application by the courts. This discussion summarizes the Daubert rules articulated in the Daubert Trilogy cases, reviews the treatment of Daubert challenges in two recent court decisions, and summarizes best practices to withstand a Daubert challenge. These issues are important given the increase in Daubert challenges to financial expert witnesses following the 1999 decision in Kumho Tire Co. v. Carmichael.*

## INTRODUCTION

In 1999, the Supreme Court provided its decision in *Kumho Tire Co. v. Carmichael*,<sup>1</sup> the third case in the “*Daubert* Trilogy” of cases. The third decision clarified the *Daubert* criteria that were applicable to all types of expert testimony in federal jurisdictions.

As a result, many states also adopted the *Daubert* standard from this decision. Following the decision in 1999, *Daubert* challenges to forensic analysts increased in every year from 2001 to 2009.<sup>2</sup>

During 2011, *Daubert* challenges to financial expert witnesses decreased to the lowest level in six years. Despite this fact, the number of challenges in 2011 was still significantly above the number of challenges in 2000. The leading cause for the exclusion of all or part of an expert witnesses’ opinion is consistently a lack of reliability.

Given the prevalence of *Daubert* challenges, it is imperative that financial experts understand the rules set forth in the *Daubert* Trilogy cases, current application by the courts, and best practices to withstand challenges.

This discussion provides the following:

1. Summarizes the *Daubert* rules articulated in the *Daubert* Trilogy cases
2. Reviews two recent judicial decisions that involved *Daubert* challenges

3. Reviews best practices that allow the forensic analyst to withstand a *Daubert* challenge

## DAUBERT TRILOGY BACKGROUND

The *Daubert* standard is a rule of evidence regarding the admissibility of expert witnesses’ testimony during U.S. federal legal proceedings. The *Daubert* Trilogy cases refer to the three U.S. Supreme Court cases, which established a standard for admissibility of scientific testimony in courts of law in the United States.

The *Daubert* Trilogy includes the following cases:

- *Daubert v. Merrell Dow Pharmaceuticals*<sup>3</sup>
- *General Electric Co. v. Joiner*<sup>4</sup>
- *Kumho Tire Co. v. Carmichael*

The Supreme Court’s decision in *Daubert v. Merrell Dow Pharmaceuticals* confirmed the trial judge’s role as a “gatekeeper” in regard to the admissibility of expert testimony. In addition, the *Daubert* decision established that expert testimony will be subject to a two-pronged analysis based on the following:

1. Reliability
2. Relevance

In determining reliability of an expert witnesses' theory or technique, the court applied four factors:

- Testing—can the theory or technique be tested, or has it been tested?
- Peer Reviews—has the theory been subjected to peer review or publication, which aids in determining flaws in the method?
- Error Rates—are there established standards to control the use of the technique?
- Acceptability—is the technique generally accepted in the relevant technical community?



The court noted that these factors were illustrative and not a definitive checklist. Federal Rules of Evidence (FRE) Rule 702 states that, to be relevant, expert testimony must assist the trier of fact to understand the case.

In *General Electric Co. v. Joiner*, the Supreme Court determined that the federal courts of appeals must apply an abuse-of-discretion standard when they review a trial court's decision to admit or exclude expert testimony. The Supreme Court ruled that the standard applies as much to the trial court's decisions about how to determine reliability as to its ultimate conclusion.

In *Kumho Tire Co. v. Carmichael* the Supreme Court ruled that the trial court's "gatekeeping" function regarding the admission of expert testimony not only applies to scientific experts, but all "technical" or "other specialized" experts.

## INCREASE IN DAUBERT CHALLENGES

In 2011, PricewaterhouseCoopers (PwC) reviewed published court opinions to determine the number of *Daubert* challenges for the period of 2000-2011.

The results of the study indicated an increase in *Daubert* challenges, to all expert witnesses, from 253 challenges in 2000 to a record high in 2010 of 879, followed by a decrease to 778 in 2011. The study noted that of the 6,919 total *Daubert* challenges from 2000-2011, 1,208 were challenges to financial expert witnesses.

The number of *Daubert* challenges to financial experts rose each year from 2001 through 2009, but decreased in both 2010 and 2011. However, the number of *Daubert* challenges in 2011 remained substantially higher than in 2000.

In 2011, 54 percent of all *Daubert* challenges to financial experts were successful at excluding the expert's testimony (in whole or in part). The 2011 rate was above the 12-year average of 45 percent, and it was the highest level since 2005. The leading reported cause for exclusion of all or part of an expert witnesses' opinion is consistently a lack of reliability.

## RECENT DAUBERT COURSE CASES

The following sections summarize two recent cases, which involved *Daubert* challenges related to the reliability of the expert's opinions.

### *BOLTAR, LLC v. COMMISSIONER OF INTERNAL REVENUE*

In *Boltar, LLC v. Commissioner of Internal Revenue*,<sup>5</sup> the case was heard in U.S. Tax Court and involved the estimation of the fair market value of certain real property for a charitable contribution deduction case related to a conservation easement.

Prior to the trial, respondent filed a motion *in limine* to exclude the petitioner's expert report and

testimony as neither reliable nor relevant under the Federal Rules of Evidence (FRE) and *Daubert*.

## Case Background

In 2003, Boltar claimed charitable contribution deductions of \$3,259,000, of which \$3,245,000 related to the donation of the subject easement. In addition to the return, an appraisal report was attached, which intended to support the amount claimed for the charitable contribution deduction.

The appraisal report assumed that the highest and best use (HABU) of the property was a 174 unit condominium project. However, as of the date of valuation, the subject property was zoned as single-family residential. In addition, the report did not consider the highest and best use of the property after the easement was granted.

The Service's valuation engineer concluded that the HABU of the subject property was for "development of single-family detached residential homes, but not until the surrounding properties are developed."

Based on this assumption, the Service's valuation engineer estimated the fair market value of the subject easement to be \$42,400.

## Court's Findings

According to the court, the "task of the appraisers was to determine the fair market value of the 8-acre parcel and the contiguous parcels owned by Boltar before and after easement was granted." The court concluded that Boltar's experts failed to apply "realistic or objective assumptions."

Additionally, Boltar's experts did not determine the HABU of the subject property after the easement was granted by considering the potential for a single-family residential development. Also, the experts were presented with several factual errors underlying their analysis of the subject property, but they did not prepare alternate scenarios to reflect the actual facts of the property.

The report was determined to be "too speculative and unreliable to be useful." As a result, the court concluded that Boltar's expert report was not admissible under FRE Rule 702. This was because it was "not the product of reliable methods and the authors have not applied reliable principles and methods reliably to the facts of the case."

## VICTORY RECORDS, INC. v. VIRGIN RECORDS AMERICA, INC.

In *Victory Records, Inc. v. Virgin Records America, Inc.*,<sup>6</sup> which was heard in U.S. District Court, the

plaintiff sought damages for the defendant's alleged interference with its multi-album recording, publishing, and merchandising contract.

Virgin filed a motion *in limine* to exclude the expert testimony of Victory's proposed damages expert, a music industry accountant.

## Case Overview

Victory claimed that the sales of a band's second and third album would have been substantially higher and that the band would have released a fourth album with similar success, except that the alleged interference by Victory caused lower album sales.

Victory sought several million dollars in compensatory damages and \$25 million in punitive damages. The analyst calculated lost profits using the "before and after" method and the "yardstick" method.<sup>7</sup>

While both methods have been accepted in previous music industry tortious interference cases, if the principal assumptions underlying the analyst's opinions lack the reliability expected by experts in the field, the lost profits calculations do not satisfy FRE Rule 702.

The analyst determined the projected sales for the second album assuming no alleged tortious interference under his "before and after" method. The analyst used the number of units the plaintiff shipped to the stores for the second album and added the number of downloaded tracks, and then applied the rate of return that the first album earned.

The sales figure reflected the low end of the analyst's sales projections for the second album. The analyst also calculated a median and high end based on album sales by another, comparable, rock band. To determine projected sales for the third and fourth albums, the analyst reduced the projected sales of the second album by 25 percent and 35 percent, respectively.

To determine profit per projected unit for all three albums, the analyst applied a per-unit profit based on the first album as the low end, a 10 percent and 15 percent increase in the low end profit for a mid and high end, respectively.

The court noted that the basis for the analyst's lost profits analysis for the second album (and therefore the third and fourth albums) was essentially a Victory internal projection.

Under the "yardstick" method, the analyst based his analysis on a sample size of one. The previously accepted "yardstick" method applied in a music

industry tortious interference case used a set of eight comparable bands.

The selection of a single band was ultimately found to be based on the CEO and owner of Victory as opposed to the analyst's expertise.

Lastly, the analyst did not consider possible alternative explanations for the drop in sales for the second album. The analyst's report states, "The decline in sales of the second album, given the heightened marketing push of Victory, was so substantial that it cannot be explained by general marketing trends in the industry. It can only be attributable to the actions taken by [the band] after the wrongful intervention of Virgin."

## Court's Findings

According to the court, if a party's internal projections rely on its "say-so" rather than on statistical analysis, they are unreliable under *Daubert*. Additionally, the analyst did not offer an explanation within his report for concluding that Victory's internal projections provided an acceptable foundation for his analysis.

The analyst did not provide a discussion regarding the appropriateness of selecting a single band to use as a "yardstick." The court noted that "in order to satisfy the scientific sampling standard [the analyst's] samples should have been chosen using some method that assures the samples are appropriately representative of the [plaintiffs'] business."

Finally, the analyst relied on a single outcome, failing to consider alternative explanations. There was evidence that the plaintiff wanted the second album to surpass sales of another band and that it went to extreme measures to try and increase sales, which resulted in negative controversy for the band. The analyst was not aware of these incidents during the preparation of his report.

Based on these findings, the court found that Victory failed to satisfy the burden of demonstrating that the analyst's testimony satisfied FRE Rule 702 and excluded his testimony.

## CONSIDERATIONS

While the following list is not intended to be exhaustive, certain procedures can be implemented to withstand *Daubert* challenges, including the following:

- Assess the valuation methodology:
  - Proven or tested
  - Peer reviewed

- Generally accepted in the business valuation profession
- Assess the underlying assumptions:
  - Provide detailed support and explanation
  - Fit the facts of the case
  - Consider alternative scenarios
  - Understand the standards for the given industries
- Assess the data
  - Use acceptable sources
  - Ensure reliability

## SUMMARY AND CONCLUSION

Following the Supreme Court's decision in *Kumho Tire Co. v. Carmichael*, there has been a steady and significant increase in the number of *Daubert* challenges to financial experts.

Despite the recent decrease in the number of *Daubert* challenges, forensic analysts should expect that challenges will remain an issue in the future.

It is incumbent on forensic analysts to understand the rules set forth in the *Daubert* Trilogy cases and also to determine best practices to withstand such challenges.

### Notes:

1. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999).
2. *Daubert Challenges to Financial Experts: A Yearly Study of Trends and Outcomes, 2000-2010*, PriceWaterhouseCoopers, 2011.
3. *Daubert v. Merrell Dow Pharmaceuticals, Inc.* 509 U.S. 579 (1993).
4. *General Electric Co. v. Joiner*, 522 U.S. 136 (1997).
5. *Boltar, LLC v. Commissioner of Internal Revenue* 136 T.C. No. 14, 136 T.C. 326 (2011).
6. *Victory Records, Inc. v. Virgin Records America, Inc.*, 2011 WL 382743 (N.D. Ill. Feb. 3, 2011).
7. The "before and after" method examines past profits in estimating future profits and the "yardstick" method examines the profits of closely comparable businesses in estimating future profits.

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