EVOLVING LEGAL STANDARDS
FOR ADMISSIBILITY OF
TESTIMONY BY FINANCIAL
EXPERTS: CASE LAW UPDATE

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I. EVOLVING STANDARDS OF FINANCIAL EXPERT TESTIMONY

A. Preface - Daubert for those not fluent in legalese.

1. The Beginning

_Daubert v. Merrell Dow Pharmaceuticals, Inc.,_ 509 U.S. 579 (1993) is the current pre-eminent United States Supreme Court case regarding the admissibility of expert testimony. This case stands for the rule that a trial judge must ensure that scientific evidence or testimony is both relevant and reliable before the evidence or testimony may be admitted. This is known as the trial court’s gatekeeping function, and the determination of relevance and reliability is often made at what is now commonly referred to as a “Daubert hearing.”

The Supreme Court identified five factors for trial judges to consider when making their relevance and reliability determination:

a. Can the theory or technique used in forming the expert’s opinion be tested, and has the theory or technique been tested?

b. Has the theory or technique been the subject of peer review?

c. What is the known or potential rate of error?

d. Do standards exist that control the use of the theory or technique?

e. Is the theory or technique widely accepted in the relevant community?

These factors are not the only factors that a trial judge may consider when deciding whether or not to admit expert testimony. Furthermore, the factors do not all have to be satisfied before expert testimony will be admitted.

2. The Expansion

_Daubert_ dealt specifically with scientific expert testimony. In 1999, through its opinion in _Kumho Tire Co., Ltd. v. Carmichael_, 526 U.S. 137 (1999), the Supreme Court extended the trial courts’ gatekeeping function to all forms of expert testimony whether scientific, technical, or based on some other form of specialized knowledge. The court emphasized that the “Daubert” factors may not always apply to all types of expert testimony, and that they were only meant to be helpful, not definitive.

The Supreme Court, in _Kumho Tire_, also concluded that trial judges should have broad discretion to decide how to determine whether or not particular expert testimony is reliable, because the object of the trial court’s gatekeeping function is “to make certain that an expert … employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field.” This conclusion also serves

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1 Where? – the halls of justice.
to emphasize the Supreme Court’s holding in *General Elec. Co. v. Joiner*, 522 U.S. 136 (1997), which said that a trial judge’s decision regarding the exclusion of expert testimony will only be reviewed for an abuse of discretion. Translated from legalese, this means that a trial judge has almost unlimited leeway when deciding whether or not to admit expert testimony so long as she does not completely ignore all guiding principles, such as the Rules of Evidence or the Daubert factors.

3. The Rule

The current Federal Rule Evidence 702 ultimately governs the use of expert testimony in federal lawsuits. In fact, the *Daubert* court was interpreting a prior version of Rule 702, when it introduced the Daubert factors. Rule 702 was amended in 2000 to conform more closely to the Daubert ruling. The rule currently states that:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

The underlined portion was added in 2000 and the Committee Notes state that this change was made in response to Daubert. According to the Committee, “[t]he amendment affirms the trial court’s role as gatekeeper and provides some general standards that the trial court must use to assess the reliability and helpfulness of proffered expert testimony.”

4. The State Reaction

Neither the Federal Rules of Evidence nor Daubert technically bind the state courts. However, most states have either adopted the same standard or a modified standard comparable to Daubert. Some states still continue to use their own standards or adhere to the old federal test known as the Frye “general acceptance” test. Some notable states that do not adhere to the federal standard are California, New York, Pennsylvania, and Florida.

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2 *Frye v. United States*, 293 F. 1013 (D.D.C. 1923) was essentially the predecessor to *Daubert* regarding the admissibility of expert testimony based on novel scientific concepts. The court in *Frye* held that the courts would admit testimony based on a scientific principle or discovery, so long as that principle or discovery is “sufficiently established to have gained general acceptance in the particular field in which it belongs.” *Daubert* did not overrule the “general acceptance” test, but instead included “general acceptance” as one of the non-exclusive and non-determinative Daubert factors.

B. WHEN and WHY? When Expert Testimony is Relevant to Assist the Jury.

Notice that Federal Rule of Evidence 702 starts with the caveat “if scientific, technical, or other specialized knowledge will assist the trier of fact,” then an expert may testify. Whether or not the knowledge will assist the jury to understand the evidence or determine a fact in issue is the crux of a trial judge’s inquiry into relevance. An expert may submit a report based on perfect information and using a well regarded methodology, but such a report is still inadmissible if it will not assist the jury.

1. Examples of cases where expert testimony was EXCLUDED because courts held that the expert testimony would not assist the jury.

   a. Expert testimony excluded because it would not assist the jury, because the damage estimate was based on a different claim than the one the plaintiff succeeded in proving.

      In Kempner Mobile Elecs., Inc. v. Southwestern Bell Mobile Sys., 428 F.3d 706 (7th Cir. 2005), the court said that the expert testimony could not assist the jury to determine the issue of damages because of the inconsistency between the expert’s assumptions and the claim. In this case, a retailer submitted multiple fraud claims to the jury and prevailed on one of its claims. The trial court then excluded the retailer’s expert testimony on damages. The court noted that the expert report was inconsistent with the claim upon which the retailer prevailed. The expert’s report was based on the assumption that the retailer could have sold both the defendant’s products and another supplier’s products. However, the retailer prevailed on the theory that the retailer would have sold for the other supplier, and not the defendant, but for the defendant’s fraudulent statements.

   b. Expert testimony excluded because it “parroted” lay witness testimony.

      In Gary Price Studios, Inc. v. Randolph Rose Collection, Inc., 2006 WL 1319543 (S.D.N.Y. May 11, 2006), an expert’s testimony was excluded because it would “simply parrot” the testimony that the plaintiff was expected to give at trial. This was a copyright infringement action, based on the defendant’s infringement of sculptures created by the plaintiff, an artist. The expert, a CPA, had no experience in the creation, marketing, or licensing of sculptures. In his second approach to determining the proper measure of damages the expert asked the plaintiff what the artist thought the proper licensing fees would have been based on the artist’s experience. The expert adopted this number as the “Lost Licensing Fee” measure of damages without subjecting the artist’s estimates to any further scrutiny. The court said that simply adopting the artist’s contentions on these core

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4 The expert’s first approach is discussed in Section D(3)(a).
questions of fact was “an unacceptable usurpation by an expert witness of the role of the jury in finding the facts based upon the testimony of a party.”

c. Expert testimony excluded because the expert could not show any basis for his conclusions.

In Storage Tech. Corp. v. Cisco Sys., Inc., 395 F.3d 921 (8th Cir. 2005), the court concluded that an expert’s testimony was “so uninformed and baseless that it could not assist the jury in the task of fixing damages.” In this case the plaintiff claimed that a technology company, NuSpeed, raided its employees and misappropriated its trade secrets. The defendant then acquired NuSpeed for $450 million. The plaintiff’s expert claimed that the $450 million paid for NuSpeed was a “proper valuation of the damages to Storage Technology and due to it for the trade secret appropriation, corporate raiding, and breach of contract.” The court noted that the expert made no attempt to allocate the price paid for NuSpeed to any other tangible or intangible assets that were not associated with the plaintiff’s former employees, even though only about one third of NuSpeed’s employees were former employees of the plaintiff. In fact the expert’s deposition testimony indicated that he did not attempt to make any allocation of the purchase price to any of NuSpeed’s specific assets.

C. WHO? Qualified is not Synonymous with Educated.

A witness qualified by “knowledge, skill, experience, training, or education, may testify.” A person must have only the relevant level of expertise to enable him or her to give a responsible opinion on the subject.

1. Examples of cases where expert testimony was ADMITTED despite challenge to expert’s qualifications.

a. Expert testimony on pricing admitted due to experience in the relevant field, even though the experts academic credentials were in another field.

In Advocare Int’l, L.P. v. Horizon Labs., Inc., 2006 WL 176573 (N.D.Tex. Jan. 24, 2006), the court allowed the testimony of the defendant’s expert on the market price of raw materials in the nutritional supplement industry and the use of Certificates of Analysis in that industry. The plaintiff argued that the expert did not complete any coursework on raw materials pricing, did not compare the costs of the exact raw materials at issue in the case, and did not review other relevant materials and was therefore not qualified to testify. The court noted that the proposed expert has a biology degree from USC, holds doctorates in Naturopathy and Natural Health from the (unaccredited) Clayton College of Natural Health, and completed a significant portion of a Ph.D. program for molecular biology and biotechnology at the University of Tulsa. Most importantly however the court noted that the expert had worked, for the past nine years, in various capacities for a distributor to the food and nutritional supplement industries. The court concluded that the expert’s “relevant experience [was] sufficiently extensive to provide a reliable basis for his opinions.” The issues raised by the plaintiff did not affect
the expert’s status as an expert witness, but were proper grounds for cross-examination.

b. Expert testimony admitted regarding damages after the expert’s educational credentials were challenged.

In *Tuf Racing Prods., Inc. v. Am. Suzuki Motor Corp.*, 223 F.3d 585 (7th Cir. 2000), the plaintiff presented its own accountant as its damages expert. The defendant argued that the accountant was not qualified because he did not have a degree in economics, statistics, mathematics, or some other academic field bearing on the calculation of damages. The court stated, “Anyone with relevant expertise enabling him to offer responsible opinion testimony helpful to judge or jury may qualify as an expert witness.” The court noted that the expert was not offering an opinion based on science, but accounting. The accountant calculated the discounted present value of the lost future earnings the plaintiff. According to the court this calculation was well within the competence of a CPA.

In *Johnson & Johnson Vision Care, Inc. v. CIBA Vision Corp.*, 2006 WL 2128785 (S.D.N.Y. 2006), plaintiff Johnson & Johnson Vision Care, Inc. (JJVC) sued CIBA Vision Corp., alleging that CIBA engaged in false advertising in competitively advertising its O²Optix lenses against JJVC lenses. JJVC presented a damages expert who was a CPA with experience in conducting financial and economic analyses of products in the marketplace. CIBA objected on a number of grounds, but most significantly on the fact that: (a) the expert had never studied the eye care field before; and (b) he had not personally published any studies. The court rejected both of these arguments. First, because the financial analysis concerned macroeconomic elements, rather than the intricacies of one particular market, the analysis was sufficiently reliable under *Daubert*. Second, even though the expert himself was not published, he had textual support for his opinions. Thus, his opinion was reliable and admissible.

c. Expert’s testimony admitted and excluded based on a sentence-by-sentence analysis of the expert’s declaration.

In *Marco Island Cable, Inc. v. Comcast Cablevision of the S., Inc.*, 2006 WL 1722342 (M.D. Fla. June 22, 2006) the court partially excluded an expert’s testimony based on a paragraph-by-paragraph and sentence-by-sentence analysis of the expert’s Declaration. The plaintiff proffered the expert as a “certified public accountant with significant utility regulatory experience in the field of cable television.” The court found that much of the expert’s testimony went beyond his expertise into areas such as antitrust and engineering. The court finally concluded that the expert was qualified to testify only to the matters contained in “paragraphs 1-5, 6(2), 7-14, 15-22, 29-30, [and] 40-41 of his Declaration.”
d. CEO’s testimony regarding damages excluded because he testified to matters outside of his expertise.

In *LifeWise Master Funding v. Telebank*, 374 F.3d 917 (10th Cir. 2004), the court excluded the testimony of the plaintiff’s CEO because he was not qualified as an expert to testify about the damages model used to calculate damages. The court noted that the CEO could have testified regarding his personal knowledge and experience as CEO of the business, and he could have testified regarding a straightforward damages model. This is in fact what the trial court invited the CEO to do. However, the plaintiffs sought to have the CEO testify about a damages model that involved moving averages, compounded growth rates, and S-curves. The court found that the damages model used was well outside the CEO’s area of expertise and excluded the testimony.

D. WHAT? Reliable Expert Testimony.

1. The expert’s testimony must be based upon sufficient facts or data.

   a. Expert’s testimony excluded when the conclusions were blindly based on sales projections provided by client and failed to account for other obvious explanations for lost sales.

   In *Sunlight Saunas, Inc. v. Sundance Sauna, Inc.*, 427 F.Supp.2d 1022 (D. Kan. April 5, 2006) the court excluded an expert’s testimony on lost profits because it was not based on a sufficient factual basis. The expert based his entire opinion on the assumption that the sales projections provided by the plaintiff were true, without gathering any other evidence to confirm the validity of the projections. The expert also failed to even address other obvious factors that may have contributed to lower than projected sales, such as increased foreign competition and loss of key employees. The court called the expert’s methodology “a house of cards,” saying that while the expert’s opinion might be mathematically correct, “he has not shown that it is sound or reliable, or generally accepted in the field of economics.”

   b. Expert testimony admitted even though the sample of data used was smaller than normal.

   In *Halterman v. Legato Software*, 2006 WL 889496 (N.D. Cal. April 5, 2006) the trial court admitted testimony from two experts even though the conclusions were based on a small non-random sample of data. This was a “whistle-blowing” case in which the plaintiff claimed that he was wrongfully terminated for reporting discrepancies in his employer’s SEC filings. The experts were provided with the same data the plaintiff was given access to while he was employed. The information consisted of a sample of 2% of the defendant’s “Installed Base Reports.” The reports included financial and chronological information for some of the defendant’s products. The experts admitted that they would usually not use such a small sample size. However, the court admitted their testimony saying that the data was sufficiently reliable because the defendant gave it
to the plaintiff during his employment, and that the experts drew some meaningful conclusions from the data. The court concluded its analysis of this issue by saying that it was within the province of the jury to determine the weight to give to the expert opinions that were based on smaller than normal sample sizes.

c. **Expert testimony excluded because the expert did not follow his own practice of verifying financial data.**

In *Cooper v. Travelers Indemnity Co.*, 113 Fed.Appx. 198 (9th Cir. 2004) the expert used the data provided to him by the plaintiff. The expert testified that in his professional practice as an economist he would normally verify client-provided data before relying on it. The court excluded the experts testimony because the expert did not follow his own practice of verifying the data provided by the plaintiff. The court said that based on the expert’s testimony regarding his normal practices, this not the type of data on which experts in economics would normally rely.

d. **Expert testimony excluded because there is too large of an analytical gap between his reliance on underlying documents and his conclusion.**

In *Royce Homes, L.P. v. Neel*, 2005 WL 428431 (Tex. App.—Waco 2005, pet. denied), the plaintiff, the Neels’ family, sued Royce Homes, L.P., for construction defects in their home. As their expert, the Neels hired a general contractor who, without taking any measurements, conducted a visual examination of the property and estimated a damages number. The expert claimed his damages number arose in part from a report from a structural engineer that he had received. However, the court found his testimony unreliable because, in part, he was unable to connect the information in the report to his opinion. Thus, although he was entitled to rely on other documents in forming his opinions, he must also show how those documents support his expert opinion. Otherwise, there is too great a leap between the underlying evidence and his opinion.

2. **The expert’s testimony must be the product of reliable principles and methods.**

a. **Expert’s testimony admitted when the expert used defendant’s own methodology to estimate plaintiff’s damages, even though expert noted that the methodology was flawed.**

In *Cardiac Pacemakers, Inc. v. Aspen II Holding Co., Inc.*, 2006 WL 1071886 (D. Minn. April 21, 2006) the plaintiff’s expert, a CPA, presented two reports on the measure of damages in the case.

The plaintiff in this case alleged that the defendant misappropriated the plaintiff’s trade secrets and used the secrets against the plaintiff by advising the plaintiff’s clients what to pay for the plaintiff’s products. The clients would pay the defendant a fee based on the amount of money the client saved due to the advice based on a cost-savings
analysis done by the defendant. The plaintiff’s expert used the defendant’s methodology to calculate the amount of money saved as a measure of the amount of money the plaintiff would have earned, but for the actions of the defendant.

The defendants claimed that the expert’s methodology was flawed, because he admitted that the methodology was flawed, he failed to account for other factors besides the defendants conduct, and the method was not generally accepted or subject to peer review. The court said that while the expert did note that the cost-savings analysis was flawed in a number of ways, he attempted to correct the flaws. In fact, the corrections to the defendant’s methodology resulted in a damage number that was $5 million lower than if the expert had used an uncorrected version of the defendant’s methodology.

b. Expert testimony excluded because he did not use the same level of intellectual rigor as an expert in the field would have used.

In *Lantec, Inc. v. Novell, Inc.*, 306 F.3d 1003 (10th Cir. 2002), the court excluded the offered expert testimony because the expert did not use “the same level of intellectual rigor that characterizes an expert in the field of economics and industrial organization.” The expert based his explanations of the worldwide market for network operating systems on the limited knowledge he gained while speaking to actual technical experts when the expert’s consulting firm was in the process of purchasing a new network operating system. The court said that these conversations, and the anecdotal evidence they produced, did not rise to the level of reliable and scientific interviews, as the plaintiffs characterized them.

c. Expert testimony excluded because the experts were unable to explain why they used certain variables and because they were unable to explain why their results differed from the results from other accepted methodologies.

In *Lippe v. Bairnco Corp.*, 99 Fed.Appx. 274 (2nd Cir. 2004) the plaintiffs offered the reports and testimony of two experts regarding damages. The court noted that minor flaws in reasoning or slight modifications of otherwise reliable methods do not automatically render an expert’s testimony inadmissible, but instead go to the weight of the testimony. However, in this case the court found that the proffered testimony went well beyond minor flaws and modifications. The court pointed out one of the expert’s inability to explain why or how he chose variables such as price/earnings multipliers, income projections, and comparable companies. The second expert also failed to explain why the results of her “comparable companies” analysis differed from her discounted case flow analysis, after she admitted that they should yield similar results. After disclosing that these were just a sample of the flaws in the experts’ reports, the court approved the trial judge’s decision to exclude the testimony.
3. The expert witness must apply the principles and methods reliably to the facts of the case.

   a. Expert testimony excluded because methodology could not be reliably applied to the facts.

   In *Gary Price Studios*, which was previously mentioned, the court excluded the expert’s first method of calculating damages that applied a loss of production rationale to the artist’s decreased output of sculptures. The claim was that the infringement “diminished the [artist’s] view of the profitability of new works, thereby reducing the incentive to create new works.” The court excluded this testimony because the methodology was “simply inadequate to support the conclusions reached.” The court took the view that “the average-per-year productivity loss theory advanced by [the expert] cannot be tested within the context of the mysterious ebb and flow of an artist's creative powers.”

   In *Wyndham Int'l, Inc. v. Ace American Ins. Co.*, 186 S.W.3d 682 (Tex. App.—Dallas, no pet. h.), Wyndham sued its insurance carriers for losses resulting from September 11th, which they alleged caused massive cancellations throughout 163 of its properties nationwide. The insurance companies objected to Wyndham’s expert, a CPA, on the grounds that his opinions were unreliable because: (a) he relied on statistics provided by Wyndham that were not verified; (b) he extrapolated these statistics without showing a “scientifically valid mathematical formula” supported such an extrapolation; and (c) he failed to account for factors that may have mitigated damages, including rebookings by the same customers. The court excluded his testimony on each of these bases, warning that financial experts must: (a) ensure that they rely on proper financial information; (b) when extrapolating said information, ensure that the underlying information supports the extrapolation; and (c) be careful to consider alternative causes or mitigating factors for their client’s damages.

   b. Expert testimony excluded for failure to consider the relevant facts of the case.

   In *Nebraska Plastics, Inc. v. Holland Colors Americas, Inc.*, 408 F.3d 410 (8th Cir. 2005) the plaintiffs submitted damages testimony estimating future losses. In this case the defendant supplied the pigment for PVC fencing sold by the plaintiff. The fencing was defective because it weathered abnormally. This subjected the plaintiff to warranty claims from its customers. The expert calculated the losses that were expected due to future warranty claims. However, the expert calculated the losses based on the assumption that every pound of fencing that was sold would be the subject of a warranty claim. The court excluded the testimony because it did not apply to the specific facts of the case, namely that warranty claims were only filed for 3.5% of the fencing produced, and that the defect only occurred in certain climates and was more prevalent in certain colors of fencing than others. The court said, “An expert opinion that fails to consider the relevant facts of the case is fundamentally unsupported.”
c. Expert testimony admitted when expert explained his reliance on certain facts and the opposing party did not show that the assumptions were utterly inappropriate.

In *Fresenius Medical Care Holdings, Inc. v. Baxter Int’l, Inc.*, 2006 WL 1390416 (N.D. Cal. May 18, 2006) the court admitted testimony from an expert even though he based his conclusions on facts that were in dispute. This was a patent infringement case in which the patentee asserted that it was owed a reasonable royalty for the infringement of its patents. The alleged infringer’s expert estimated the amount of a reasonable royalty based on the incremental profit difference between the infringing product and a comparable non-infringing product. The patentee disputed the conclusion that the product was comparable and non-infringing. The court said that the expert’s report clearly set out the facts supporting his conclusion that the products were comparable, and the patentee failed to show that this conclusion was “utterly inappropriate or divorced from the facts of the case.” The court concluded that “when, as here, the parties’ experts rely on conflicting sets of facts, it is not the role of the trial court to evaluate the correctness of facts underlying one expert's testimony.”

In *Aventis Envtl. Sci. USA LP v. Scotts Co.*, 383 F. Supp. 2d 488 (S.D.N.Y. 2005), a complex antitrust case relating to sale forecasts and profit margins for an over the counter pesticide, the court held that the expert’s financial pedigree was sufficient to make his profit margin speculations reliable under *Daubert*. Because such projections are inherently speculative, the court must only ensure that the expert opinion is based on reliable information and uses a reliable methodology. If so, objections about speculation do not go to the admissibility of the expert opinion, but rather only to the weight that the jury should give the evidence.

II. VALUATION OF MINORITY INTERESTS IN BUSINESS ENTITIES AND ESTIMATING DAMAGES (LOST PROFITS) FOR PROFESSIONAL CORPORATIONS AND ASSOCIATIONS

A. Valuation of Minority Interests in Shareholder Oppression Cases.

1. Minority Shareholder Oppression

Claims for minority shareholder oppression have only recently gained limited acceptance in the realm of corporate law. This claim is made by minority stakeholders in non-publicly traded business entities; mainly close corporations, limited partnerships, and limited liability companies. Regardless of the actual entity involved, these cases are generally referred to as minority shareholder oppression cases.

A claim for minority shareholder oppression typically involves squeeze-out or freeze-out techniques such as: termination of the minority shareholder’s employment with the company; retention of earnings by the company, e.g., payment of salaries and benefits to the majority shareholders rather than the distribution of dividends shared by all shareholders; removing the minority shareholder from an opportunity to participate in corporate decision-making; or issuing more stock at unreasonable prices to further dilute
the minority shareholder’s interest.

Courts have crafted many types of equitable solutions to remedy the effects of oppressive conduct by majority owners, including forced buy-outs of the minority by the majority, receivership, forced dividends, forced reduction in director and officer salaries, and other injunctions. These solutions are substitutes for the forced dissolution of the company, which is perceived as an extreme remedy. Perhaps the most common remedy seems to be a forced buy-out of the minority shareholder’s interest by the majority or the company itself. This solution is especially useful when the company itself is still viable, but the stakeholders can no longer get along.

2. Valuing a Minority Interest

a. Fair Value vs. Fair Market Value

As court ordered buyouts in shareholder oppression cases became a more frequent remedy under state statutes and the common law, the issue of how to value the minority shareholders interest has become more and more complicated. See, e.g., Davis v. Sheerin, 754 S.W.2d 375, 381 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (holding that a court-ordered buyout at “fair value” was appropriate, but failing to define fair value). Courts frequently fail to define fair value, which renders valuation of minority interests in a closely-held corporation “more an art than a science.” Balsamides v. Protameen Chems., Inc., 734 A.2d 721, 729 (N.J. 1999).

What has become clear, however, is that there is a bright line that differentiates fair value from fair market value. Some courts reached this conclusion as a judicially-fashioned remedy, Balsamides, 734 A.2d at 733, while others relied on guidance from the legislature. When construing the term “fair value” under shareholder dissent or appraisal statutes, courts have held that because the legislature chose not to use the term “fair market value,” the meaning of fair value and fair market value cannot be regarded as synonymous. See, e.g., Matthew G. Norton Co. v. Smyth, 51 P.3d 159, 163 (Wash. Ct. App. 2002) (interpreting Washington’s statute); Royals v. Piedmont Elec. Repair Co., Cause No. 97 CVS 720, 1999 WL 33545516, at *12 (N.C. App. 1999) (interpreting North Carolina’s statute); and Devivo v. Devivo, Cause No. CV980581020, 2001 WL 577072, at *4 (Conn. Super. Ct. 2001) (interpreting Connecticut’s statute).

Courts have measured fair value of minority equity interests in two ways. The majority view is a pro rata distribution, which awards the minority shareholder its proportionate share of the value of 100 percent of the equity in the company, without any discount for minority circumstances and, in the absence of extraordinary circumstances, without any discount for lack of marketability. See, e.g., Peublo Bancorporation v. Lindoe, Inc., 63 P.3d 353, 363-69 (Colo. 2003); Matthew G. Norton Co., 51 P.3d at 165 (basing Washington’s decision for pro rata valuation on its adoption in the 8th Circuit, Georgia, Illinois, Kentucky, New Jersey, and other jurisdictions); Adv. Comm. Design, Inc. v. Follett, 615 N.W.2d 285, 290-91 (Minn. 2000).
The minority view is that the fair value of a corporation is equivalent to its fair market value, except for two discounts which may be applicable: the marketability discount and the minority shareholder discount. See, e.g., Hayes v. Olmstead & Assocs., Inc., 21 P.3d 178, 180 (Or. Ct. App. 2001); and Shriner v. Sheehan, 773 N.E.2d 833, 843 (Ind. Ct. App. 2002). Due to the fact that a minority interest in a closely-held corporation is illiquid and because shareholder oppression involves a minority shareholder, both discounts are frequently applicable in the context of a claim for shareholder oppression. See, e.g., Douglas K. Moll, Shareholder Oppression and “Fair Value”: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation, 54 DUKE L.J. 293, 295-310 (2004) (discussing the discount problem in relation to closely-held corporations).

Regardless of whether a court adopts the majority or minority view, the unifying theme of these decisions is that courts have broad discretion to determine fair value of minority stock interests. Compare Adv. Comm. Design, Inc., 615 N.W.2d at 289-90 (holding that the state’s statute gave the court flexibility and discretion to choose a pro rata valuation); with Balsamides, 734 A.2d at 734 (holding that its discretion allows application of a marketability discount, despite the majority view); and Shriner, 773 N.E. 2d at 843 (holding that, in the absence of parties contractually choosing a valuation method, the court has the discretion to choose a fair market value buyout). Thus, a court is usually entitled to use the valuation method of its choice, leaving substantial room for financial experts to persuade the court that the majority or minority view is most appropriate in the circumstances of each particular case.

b. Timing

The majority of courts fail to address the second important question: what is the proper date for a financial expert to value the corporation? Should the value be measured at the date of the filing of the lawsuit or at the date of the allegedly oppressive acts? Courts tend to simply gloss over the timing issue and instead rely blindly on the valuation date used by the financial expert they prefer. See, e.g., Balsamides, 734 A.2d at 725 (referring to the valuation date as “the time that [the experts] were using,” without any further inquiry).

Essentially, there are two valuation dates to choose from: the date that the lawsuit is filed (“date of filing”) and the date of the majority’s oppression of the minority shareholder (“date of oppression”). Currently, the date of filing is presumptively the correct date, unless extreme circumstances require the court to find that the valuation date should be earlier or later. See Hollis v. Hill, 232 F.3d 460, 472 (5th Cir. 2000). The adoption of the date of filing as the valuation date is reflected in the few state statutes that specifically authorize oppressed minority shareholders to elect to have their shares purchased at fair value. See, e.g., Douglas K. Moll, 54 DUKE L.J. at 367-8 (2004) (describing the statutes in New York and similar states).

Some legal scholars have argued, however, that the valuation date should be the date the majority engaged in oppressive acts, rather than the date of filing. The argument is that, in analogous shareholder dissent statutes, state legislatures set the valuation date as the date immediately prior to the act from which the shareholders dissent—i.e.,
the corporation’s value is measured at the time immediately prior to the proposal of the merger, sale of substantially all assets, or other fundamental corporate change. See, e.g., *Hansen v. 75 Ranch Co.*, 957 P.2d 32, 41 (Mont. 1998) (interpreting Montana’s Business Corporations act, which is nearly identical to the Model Business Corporations Act). Majority shareholder oppression has the same effect of preventing the minority shareholder from continuing to participate constructively in the corporation’s business. Some scholars therefore argue the valuation date ought be set at the date of corporate oppression. See, e.g., Moll, 54 DUKE L.J. at 373-81 (describing this argument in detail).

Only one court case supports this “date of oppression” valuation date, and even that case does so only indirectly. In *Hollis v. Hill*, one fifty-percent owner of a Nevada corporation sued his co-owner for shareholder oppression and requested a court-ordered buyout. 232 F.3d 460, 462-3 (5th Cir. 2000). The parties formed a financial investment and brokerage company in 1995 and co-existed smoothly (and profitably) for two years, until one co-owner, Hill, began undertaking a series of actions intent on freezing Hollis out of the business. These actions took place over February 1998 to November 1998. *Id.* at 463-6. Hollis waited until December 1998 to sue Hill, but the trial court accepted his experts’ valuation, which used February 1998 as the date of oppression. *Id.*

The Fifth Circuit held that the valuation date was the date of filing, but chastised the trial court for accepting a February 1998 date of oppression. Because the most severe acts of oppression took place after February, but before the filing, a February 1998 valuation date would unjustly benefit Hollis, who failed to take any remedial action for ten months. *Id.* at 472. Despite fixing the valuation date at the date of filing, scholars argue that this focus on the date of the most severe oppression supports a date of oppression valuation date. See, e.g., Moll, 54 DUKE L.J. at 378.

Because the majority of state statutes and cases presume that the date of filing is the proper valuation date, financial experts should use that date unless extraordinary circumstances or the peculiar facts of the case justify relying on the less preferred authority that authorizes valuing the corporation from the date of shareholder oppression.

**B. Can Professional Corporations Recover Lost Profits?**

The shareholders of professional corporations are also the employees and revenue source of the corporation. This dynamic commonly leads to the distribution of the corporate revenues to the employee/shareholders in the form of compensation for services rather than dividends in order to avoid double taxation. This method of distribution often leaves professional corporations with little to no net profits after the employee/shareholders’ compensation is deducted. As a result, courts have started encountering problems when calculating “lost profit” damages for professional corporations. The main issue has been whether or not to allow the shareholder/employee’s compensation to be used as a measure of the professional corporation’s profits, and the courts have split on this issue.
1. Disallowing the use of evidence of shareholder compensation as a measure of lost profits.


Lewis H. Kaminester, M.D., P.A. (Kaminester) sued the Southern Bell Telephone & Telegraph Company (SBTT) for breach of contract when it listed the wrong address for the professional association in SBTT’s telephone directory. Kaminester argued that because it was a corporation organized as a professional association whose sole officer is a physician, an exception should be made to the general rule that requires a corporation to deduct an officer’s compensation when computing net profits. The court rejected this argument holding that a professional should not be allowed to take advantage of the benefits of the corporate form and then be free to disregard the corporate form when it was economically advantageous, e.g., when claiming lost profits as damages.


Anesthesiologists Associates of Ogden, P.C. (AAO) sued the Hospital for breach of contract and won. The trial court awarded AAO just $14,883 in damages despite AAO’s claim for more than $1 million. The trial court held that the award represented the lost income of the corporation minus the expenses saved. It included the salaries of the anesthesiologists, who were the principal shareholders, as expenses saved rather than as lost profits.

The court of appeals reversed the trial court’s decision, relying mainly on the reasoning in the *Bettius* case (discussed below). The court of appeals cited three rationales supporting its conclusion that professional corporations should not be treated the same as other corporations when calculating damages: the shareholders in a professional corporation must be professionals, employees and shareholders in professional corporations are one and the same, and professional corporations calculate their net profits with different goals in mind. The court of appeals concluded that professional corporations are analogous to partnerships and their damages should be calculated accordingly.

The Supreme Court of Utah reinstated the trial court’s decision. The supreme court adopted the reasoning in *Southern Bell* (above) and rejected the trial court’s bases for treating professional corporations differently. The supreme court held that the rule stated by the court of appeals confused the professional corporation with its shareholders, when they are really separate entities. The court noted that the contract was not between the individual shareholders and the hospital, but between the corporation and the hospital. Also, none of the shareholders were joined as parties in the breach of contract suit. The court also stated that if the shareholders salaries were awarded to the corporation, then there was no guarantee the shareholders would actually receive their salary.
The supreme court also addressed the proposition that deducting shareholder’s salaries from lost profits will leave professional corporations with no remedy for breach of contract. The court did not disagree that this was the case. Instead, the court stated that the shareholders could have protected their interests through better planning. The court suggested that the professionals could have decided to form a partnership, or they could have entered into contracts with the professional corporation to pay their salaries regardless of profits.

2. **Allowing the use of shareholder/employee compensation as a measure of lost profits.**


   The Bettius case was filed because National Union Fire Insurance Company (“National Union”) failed to advance the funds required from it under an insurance policy. Due to National Union’s non-payment, the law firm, Bettius & Sanderson, P.C. (“Bettius”), was held in contempt for failing to comply with a court order, and Bettius’s failure to comply with the court order was reported by the press. Bettius sued National Union claiming that National Union’s breach of contract caused negative publicity for the law firm resulting in loss of clients and staff and eventually the dissolution of the firm. The firm sought compensation for the breach of contract in the form of lost profits.

   National Union argued that the compensation paid to its shareholders, who were also the lawyers at the firm, should be deducted from the corporation’s gross receipts to calculate net profits like other expenses. National Union contended that the lawyers formed the professional corporation for tax and liability purposes and, therefore, assumed all the characteristics of any business corporation.

   National Union’s arguments did not persuade the court. National Union assumed that business corporations and professional corporations were identical and formed for identical purposes. This assumption was clearly erroneous in the court’s view. In normal business corporations, the shareholders and employees are often different people, whereas the principals of professional corporations are required by Virginia law to be both shareholders and professional employees. Further, shareholders in commercial corporations derive dividends from their ownership, in contrast to shareholders in professional corporations who derive their compensation from the services they provide.

   The court said that while the distribution method used by professional corporations results in a net income for tax purposes that is almost always at or near zero, this fact should not be used as proof that the corporation is not making a profit. Treating a professional corporation’s net income as its net profit for proving lost profits would result in a rule that professional corporations could never show lost profits and thereby obtain a recovery when it was harmed by a wrongful act. On this basis, the court concluded that the compensation paid to principals in a professional corporation is relevant for the purpose of proving lost profits.

This is another suit by anesthesiologists against a hospital, but the lawsuit was not for breach of contract but for anti-competitive conduct. A.A. Pain Clinic won its lawsuit, but had trouble proving damages as a professional corporation.

The Supreme Court of Alaska noted the split in authority on the issue of including the principals’ compensation as part of lost profits. The Alaska court agreed with the *Bettius* case saying that it “better reflects the actual losses of a professional corporation.” The court also agreed that the rule “prevents a situation where a wrongdoer can avoid liability simply because of a technicality in the corporate structure.”

**III. RECENT CASES REGARDING PREJUDGMENT INTEREST**

Prejudgment interest is an element of damages determined by a court after a jury verdict awarding some amount of monetary damages. *See Terwilliger v. Terwilliger*, 206 F.3d 240, 249 (2d Cir. 2000). Frequently, the state legislature sets the rate of interest by statute. *See* TEX. FIN. CODE § 304.003(c) (setting the postjudgment and prejudgment interest rates in Texas at the Federal Reserve’s prime rate, with a floor of five percent and a ceiling of fifteen percent).

In federal court, however, there is no statute that sets the applicable interest rate. Rather, federal courts must exercise “reasonable discretion” when setting the interest rate. *See Forman v. Korean Air Lines Co., Ltd.*, 84 F.3d 446, 450 (D.C. Cir. 1996), cert. denied, 519 U.S. 1028 (1996). Thus, while the court may have a standard interest rate that it applies, argument may be heard over the applicable rate and the appropriate method of calculation. Also, there may be dispute over when the interest begins to accrue.

In a recent decision affecting rate and calculation issues, *McKesson Corp. v. The Islamic Republic of Iran*, 116 F. Supp. 2d 13 (D.D.C. 2000), the U.S. District Court for the District of Columbia addressed the applicability and calculation method for prejudgment interest relating to Iran’s expropriation of McKesson Corporation’s property during the Iranian Revolution. The McKesson Corporation was a major shareholder in Pak Dairy, an Iranian dairy corporation, and also provided Pak Dairy with substantial technical advice. After the revolution, when the state seized control of raw dairy products, McKesson was shut out of the dairy industry and denied dividends on its stock. *Id.* at 17-21. The Court held that Iran had expropriated McKesson property and that interest was due on the cost of the property. At McKesson’s urging, the Court applied the average prime rate over the years that interest had accrued (which, from 1982-2000, was nine percent). *Id.* at 40-41.

The larger issue, however, was whether that interest would be calculated as compound interest or simple interest. The case came to the Court from the Iran Claims Tribunal at the Hague, and the Claims Tribunal had only previously awarded simple
interest. The District Court therefore held that McKesson was entitled to 9% simple interest from 1982 to present. *Id.* at 42-44.

As for the date that interest begins to accrue, the defining issue is whether the federal court is hearing a claim based on state law or whether the plaintiff’s claim arises under federal law. If the federal court is hearing a state law claim, it must apply the law of the state in which it is located. For example, a Texas federal court presiding over a state law claim, applies the Texas rule on accrual, which is that prejudgment interest begins to accrue on the earlier date of when the petition was filed or one-hundred and eighty days after the plaintiff has given the defendant notice of his claim. See, e.g., *Johnson & Higgins, Inc. v. Kenneco Energy, Inc.*, 962 S.W.2d 507, 531-33 (Tex.1998); and *Primrose Operating Co. v. Nat’l Am. Ins. Co.*, 382 F.3d 546, 564-65 (5th Cir. 2004).

However, if the plaintiff’s claim in federal court arises under federal law, there is no bright line for when interest accrues. Rather, federal courts seek to determine what is the most equitable date to ensure that the injured party is fully compensated. See, e.g., *Entergy Ark., Inc. v. Nebraska*, 358 F.3d 528, 557-58 (8th Cir. 2004). For example, in *American National Fire Insurance Company v. Yellow Freight Systems, Inc.*, 325 F.3d 924 (7th Cir. 2003), the court held that equity demanded that the insurance company, who had lost the use of their money paying on a claim in which a co-insurer was also liable, receive interest from the date that they satisfied the claim, even though they failed to sue their co-insurer until much later. Thus, rather than a hard and fast rule like federal courts governing state law claims, a federal court addressing a federal question balances the equities to determine when prejudgment interest should begin to accrue.

**IV. HOW? PRACTICAL CONSIDERATIONS MADE BY LAWYERS WHEN RETAINING EXPERTS**

**A. Qualifications.**

The first issue a trial lawyer faces when searching for an expert is to find someone who can give a reliable opinion regarding the subject matter of the case. Sometimes the subject is broad and a qualified expert is easy to find, but sometimes the subject is obscure and qualified experts are harder to locate. In order to help lawyers who are not always well versed in the material as a potential expert you should:

1. Know your qualifications; be honest if you cannot testify on a certain subject.

2. Help the lawyer understand the subject and why you are or are not qualified. Even if you are not an expert in an area, you probably have more knowledge than a lawyer who has approached you regarding that area.

3. Cultivate contacts with others who can testify in areas beyond your own expertise, and refer lawyers to them.
B. Know your own background information.

It is very likely that a lawyer has done thorough research on your background before even contacting you. And it is almost certain that the opposing counsel will do an even more thorough investigation. Do not let a lawyer know more about you than you do. Some suggestions in this regard are:

1. Keep your resume and/or curriculum vitae up to date and free of discrepancies.
2. Check up on yourself on the internet; know what is out there.
3. If you have testified before keep an updated list of the parties, law firms and other testifying experts involved all the cases in which you were involved.
4. Be prepared for tough questions, both personal and otherwise, from the lawyer hiring you and even tougher questions from his opposing counsel.
5. Above all, be honest.

C. Cultivate your teaching skills.

Expert opinions are meant to assist the jury. The most intelligent expert in the world is of little use if he cannot communicate his thoughts to the rest of the world. From the lawyer’s perspective, it is very hard to persuade a jury of your point of view if they cannot understand it in the first place. Some suggestions in this regard are:

1. Practice breaking down complex matters into simplified examples.
2. Use everyday terminology; and remember what you think of as everyday speech is often filled with jargon, and what you think of as technical jargon is normally incomprehensible to the outside world.
3. Practice public speaking when given the opportunity; become a conversationalist.
4. Stay up to date on developments in your field.
5. Pay attention to your appearance; your dress, hygiene, and demeanor will all be evaluated by a jury.

D. Working with the lawyer; understand her concerns.

There are many evidentiary issues that go along with presenting expert testimony.
For example, nearly all of the work of a testifying expert is discoverable. This can give rise to problems such as being forced to disclose privileged information (waiving privilege) or destruction of evidence (spoliation). For example, if an expert creates multiple drafts of his report every draft is discoverable. Attorneys appreciate the help of experts who:

1. Follow the attorney’s directions; especially regarding note taking, and other communications.

2. Use the phone rather than e-mail.

3. Take the attorney’s suggestions, but produce his or her own work.

4. Create one working draft and never send copies until the draft is finalized.
APPENDIX “A”

CHECKLIST FOR RETAINING A TESTIFYING EXPERT WITNESS

1. **Conduct due diligence:**
   - Review articles authored by expert
   - Review previous cases involving similar topic(s)
   - Review previous deposition and trial testimony

2. **Perform internal assessment:**
   - Run “conflicts” check
   - Follow up on all replies re: knowledge of expert

3. **Conduct detailed resume check:**
   - Note any discrepancies

4. **Meet with potential expert:**
   - Discuss note-taking procedures
   - Give broad overview of case
   - Assess appearance and demeanor
   - Elicit experience and knowledge
   - Discuss any resume discrepancies uncovered
   - Resolve discrepancies, if possible

5. **Ask tough questions before retaining the expert:**
   - Has the expert’s testimony been excluded/limited by a court?
   - Has the expert ever failed to be qualified?
   - Have expert’s opinions been subject of any written opinion?
   - Has expert been opposed before to other side’s expert?
   - Consider experts’ personal life - is there anything negative?
   - Does the expert have any substance abuse issues?
   - Is expert going through a contested divorce?
   - Has the expert ever been a party in any litigation?
   - Has the expert ever been sued by a client or former client?
   - Has the expert ever been subject to any criminal proceedings?
   - Has the expert ever been accused of breach of fiduciary duty?
   - Has the expert ever been fired from any position?
   - Has the expert ever been charged with sexual harassment?

6. **Discuss estimated fees and litigation budget:**
   - Determine expert’s hourly rates (and staff rates)
   - Agree upon range of estimated fees (total and each phase)
   - Do not confirm estimated range or budget in writing
   - Get assurances in the form of an oral commitment

7. **Draft retention letter or review expert’s draft:**
   - Scope of specific assignment is outlined
   - No conclusions or opinions are stated
   - Hourly fee and pay-as-you-go specified
   - No budget estimate is given
   - Specifies that payment is not contingent on outcome
   - Consider having lawyer or firm designated as “client”
   - Thoroughly read and review entire letter

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