Forensic Analyst Expert Report and Expert Testimony Guidelines

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INTRODUCTION

The forensic analyst (analyst) may be retained to provide consulting expert or testifying expert services related to business valuation, damages analysis, transfer price analysis, forensic accounting, and other issues. The analyst may be retained by the legal counsel representing any party in the litigation or other controversy matter. The analyst is retained in the dispute because of specialized expertise in business and security valuation, transaction pricing and structuring, transaction financing, company solvency and insolvency, acquisition due diligence, transactional fairness, and related corporate finance issues.

The analyst may be asked to serve as either a consulting expert or a testifying expert in matters related to commercial litigation (including tort claims and breach of contract claims), taxation, condemnation and eminent domain, family law, antitrust, bankruptcy, fraud and misrepresentation, and other types of claims. The consideration of each of these different types of litigation matters is beyond the scope of this discussion. As a representative type of litigation matter, this discussion focuses on the analyst's role as a testifying expert in a bankruptcy litigation matter.

In a bankruptcy proceeding, the analyst may be called on to value the debtor company assets, properties, or business interests. Such valuation issues often arise in a bankruptcy proceeding with respect to (1) the solvency of the debtor company at various points in time prior to the bankruptcy filing; (2) the value of the creditors' security interests; (3) the protection of creditors and of other parties; (4) the fairness of any proposed debtor in possession (DIP) sale or purchase transactions regarding assets, properties, or business interests; (5) the value of collateral for any DIP financing; (6) the reasonableness of a proposed plan of reorganization; and (7) many other reasons.

In these instances, the analyst is typically asked to prepare an expert report. And, the analyst is typically asked to provide expert testimony. The analyst is not the client's counsel. Nonetheless, the analyst cannot serve the information interests of the client—or of the judicial finder of fact—if the analyst's expert testimony is not admitted. Therefore, the analyst who agrees to accept a testifying expert engagement should have a basic understanding of the judicial rules related to the admissibility of expert reports and expert testimony.

BANKRUPTCY-RELATED LITIGATION CLAIMS

Disputes regarding the value of debtor company assets (tangible and intangible) and debtor company securities (debt and equity) are commonplace in a bankruptcy proceeding. Therefore, analysts are often asked to prepare valuation-related expert reports and to provide valuation-related expert testimony within the bankruptcy environment.

For example, a valuation dispute may involve an avoidance action regarding the allegation that the debtor company received less than reasonably equivalent value in exchange for a transferred property.

A valuation dispute may involve the allegation that the debtor company was insolvent at the time of a property transfer, a capital expenditure, a loan payment, or a dividend distribution.

A valuation dispute may involve an allegation regarding:

1) the allowed amount of a creditor's claim or
2) whether a secured creditor has adequate protection for its secured position.

A valuation dispute may relate to whether (and on what terms) the DIP may buy or sell property, abandon a property, or reject a lease.

A valuation dispute may involve whether the DIP can enter into an intellectual property license (or other commercialization agreement) or whether the DIP can reject an inbound or outbound intellectual property license.

And, a valuation dispute may occur over whether a proposed plan of reorganization should be confirmed by the court.

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This discussion summarizes what the analyst should know about the standards that govern the admissibility of expert reports and expert testimony in the bankruptcy court.

A valuation dispute may relate to an action to revoke the confirmed plan of reorganization for the failure to disclose material information regarding the debtor company value.

This discussion is intended to provide practical guidance to the analyst who provides consulting expert or testifying expert services in a bankruptcy dispute. This discussion summarizes what the analyst should know about the standards that govern the admissibility of expert reports and expert testimony in the bankruptcy court.

Again, the analyst is not the client's counsel. Accordingly, the analyst should rely on legal advice from the client's counsel related to expert reports and expert testimony.

Nonetheless, the analyst who provides professional services in the bankruptcy environment should generally be aware of the bankruptcy court guidelines related to expert reports and expert testimony.

JUDICIAL PRECEDENT AND ADMINISTRATIVE RULINGS

The admissibility of all expert testimony is governed by the principles of the Federal Rule of Evidence (FRE) Rule 104(a). Under Rule 104(a), the party that offers the evidence has the burden of establishing, by a preponderance of the evidence, that the expert testimony is admissible.

FRE Rule 702 provides the standards for the admissibility of valuation, damages, forensic accounting, and other expert opinion evidence in the bankruptcy court (as well as in other courts).

The analyst who is engaged to serve as a testifying expert in a bankruptcy proceeding should be aware of the following Rule 702 expert testimony guidelines:

> 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.

Rule 702 was enacted in 1973 as part of the Federal Rules of Evidence. However, it was not until about 20 years later that the U.S. Supreme Court confirmed that Rule 702 governs the admissibility of expert testimony in the federal courts.

Prior to the adoption of Rule 702, the admissibility of expert testimony was generally governed by the standards developed by a 1920s federal appellate court decision, *Frye v. United States.*[1]

In the *Frye* decision, the defendant in a murder case wanted to admit expert testimony. The expert testimony related to the fact that the defendant had passed a lie detector test that proved his innocence.

The appeals court affirmed the trial court decision to refuse to admit the lie detector test evidence; this was because such lie detector tests had not yet gained sufficient scientific standing.

The *Frye* decision established the judicial standard for the proponents of scientific evidence for the next 70 years. That standard concluded that the theory upon which the expert opinion was based must be sufficiently established so as to have gained "general acceptance" in the particular scientific field.

In the *Daubert v. Merrell Dow Pharmaceuticals, Inc.* decision,[2] the U.S. Supreme Court concluded that the so-called *Frye* standard no longer governed expert testimony admissibility in the federal courts.

The *Daubert* decision concluded that whether the expert's theory or methodology was "generally accepted" was just one of the factors that the trial court should consider in determining whether to admit the expert testimony evidence.

In the *Daubert* matter, the plaintiff parents sued the defendant manufacturer of antinausea drugs. The antinausea drugs were alleged to cause birth defects. The defendant pharmaceutical company moved for summary judgment based on the affidavit of a credentialed expert.

The defendant submitted peer-reviewed studies that were based on human patients who had taken the drug. The studies concluded that there was no link between the drugs and the occurrence of birth defects.

The plaintiffs responded with affidavits from experts who relied on (1) animal studies and (2) a reanalysis of the epidemiological studies on which the defendant's expert had relied.

The trial court ruled the plaintiffs' experts' tests to be inadmissible under the *Frye* standard. The trial court concluded that these tests were not "generally accepted."

The Supreme Court reversed the trial court's decision, concluding that FRE 702 (not the *Frye* decision) governed the admission of expert testimony. The Supreme Court concluded that the *Frye* standard was at odds with the more liberal FRE.

In the *Daubert* decision, the Supreme Court established three expert testimony principles:

1) The trial judge has the task of ensuring that the expert testimony both (a) rests on a reliable foundation and (b) is relevant. This task is the judge's so-called "gatekeeping role."

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2) Faced with a proffer of expert scientific testimony, the trial judge should make a preliminary assessment as to whether the expert's underlying reasoning or methodology (a) is scientifically valid and (b) can be properly applied to the facts at issue. This inquiry is a flexible one, and its focus should be solely on principles and methodology, and not on the expert's conclusions.
3) The expert's conclusions should be properly challenged through (a) cross-examination, (b) the presentation of contrary evidence, and (c) judicial instructions regarding the burden of proof.

The *Daubert* decision established a nonexclusive checklist for federal courts to apply in order to determine the admissibility of expert opinions. Accordingly, in a valuation dispute in a bankruptcy engagement, the analyst should select the valuation approaches and methods, perform the valuation analyses, and prepare the expert report in order to pass this *Daubert* admissibility checklist.

THE *DAUBERT* TESTS FOR THE ADMISSIBILITY OF EXPERT TESTIMONY

The analyst who is engaged to testify in the bankruptcy court should be familiar with the following five so-called "*Daubert* tests":

1) Whether the expert's technique or theory can be or has been tested—that is, whether the expert's theory can be challenged in some objective sense, or whether it is simply a subjective, conclusory approach that cannot be reasonably assessed for reliability
2) Whether the expert's technique or theory has been subjected to peer review and publication
3) The known or potential rate of error of the expert's technique or theory when it is applied
4) The existence and maintenance of standards and controls
5) Whether the expert's technique or theory has been generally accepted in the scientific community[3]

Also, according to FRE 702, the expert testimony should "assist the trier of fact to understand the evidence or to determine a fact in issue."

In the *Kumho Tire Co. v. Carmichael* decision,[4] the Supreme Court extended these principles to technical, nonscientific expert testimony. In the *Kumho* decision, the Supreme Court concluded that the trial court properly excluded testimony by an expert on tire failure because that expert's methodology was unreliable.

The *Kumho* decision established three additional criteria for the admissibility of expert testimony:

1) The *Daubert* "gatekeeping" function (requiring an inquiry into both relevance and reliability) applies not only to scientific testimony, but to all expert testimony.
2) The *Daubert* framework was intended to be flexible, and not all of the factors listed in the *Daubert* checklist need apply to every form of testimony.
3) The trial court's review of expert testimony should focus on both (a) the expert's methodology and (b) the expert's conclusions.

The analyst should understand that whether valuation expert testimony is admissible in the bankruptcy court is governed by FRE 702—as interpreted by *Daubert* and *Kumho.* State courts, however, may apply different expert testimony admissibility tests. For example, some state courts still rely on the old *Frye* test.

The analyst should also understand that an important factor that the finder of fact will consider is whether the expert is qualified to perform the subject valuation.

According to the U.S. Court of Appeals: "For an expert's testimony to be admissible under [FRE 702] … it must be directed to matters within the witness' specific, technical, or specialized knowledge and not to lay matters which a jury is capable of understanding and deciding without the expert's help."[5]

Valuation professional training and valuation professional credentials are important factors that the court may consider with regard to valuation-related expert testimony. However, practical valuation experience is probably the most important factor that the finder of fact will consider. This is because courts seem to give a great deal of weight to the opinion of a forensic analyst who has valued similar assets or securities in the past.

In addition, in order to be admissible, the expert's valuation testimony should be based on a reliable methodology and on generally accepted procedures—and not simply presented for client advocacy purposes.

For example, in the *United Phosphorus, Ltd. v. Midland Fumigant, Inc.* decision,[6] the U.S. District Court concluded that both (1) the valuation testimony offered by an economics expert that a trade name had no value and (2) the expert's analysis regarding the trademark valuation failed to satisfy the "evidentiary reliability" standard for expert testimony.

Accordingly, the District Court concluded that the economics expert's testimony should not be admissible. In *United Phosphorus,* the District Court noted that:

1) the expert's valuation analysis was prepared solely for litigation purposes and
2) the expert applied a valuation methodology developed solely for the purposes of that litigation.

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As reported in the *United Phosphorus* decision, the District Court concluded that:

1) the expert's valuation opinions and valuation analysis had not been subjected to peer review and
2) there was no objective, verifiable evidence to indicate that the valuation methodology applied by the expert was accepted by any other economist.

ANALYST CONSIDERATIONS RELATED TO BANKRUPTCY COURT EXPERT TESTIMONY

The analyst should be aware of the elements of the *Daubert* standard with respect to any proposed expert testimony in bankruptcy court. And, while the analyst is not an attorney, the analyst should generally be aware of the legal framework for valuation (and related) testimony provided by judicial precedent, the Bankruptcy Code, and the Bankruptcy Rules.

For example, as a general guideline for bankruptcy purposes, valuations are performed as of the date of the disputed transaction or the property transfer, and not with the hindsight benefit of subsequent events.

In addition, generally accepted accounting principles (GAAP) or other accounting principles may be informative to the analyst. However, GAAP account balances typically do not reflect the current value of the debtor company's asset, property, or business interest for bankruptcy purposes.

Moreover, whether the valuation involves a single debtor company asset or the entire going-concern business enterprise, the courts often conclude that an actual arm's-length sales price is generally the best indication of value.

It is usually important for the analyst to generally understand the disputed issue and the legal rules that will be applied to decide that issue. As articulated by the bankruptcy court in the *Brandt v. nVidia Corp.* decision, "the question to be answered is value to whom and for what purpose."[7]

Accordingly, in a bankruptcy assignment, the analyst should have an understanding of:

1) the purpose and objective of the valuation;
2) an adequate description of the valuation subject; and
3) the appropriate valuation date, standard of value, and premise of value.

The above-mentioned *Brandt v. nVidia Corp.* decision[8] illustrates the importance of considering the purpose of the valuation in the context of a fraudulent conveyance claim.

In the *nVidia Corp.* matter, the subject dispute involved whether an entity that purchased substantially all of the debtor company assets had paid a reasonably equivalent value for those assets. The bankruptcy trustee attempted to prove that the purchaser paid too little, while the purchaser defended the amount paid as being reasonable.

The *nVidia Corp.* case involved several complex valuation issues, such as: the value of a settlement of pending patent litigation, the value of a highly skilled assembled workforce, and the value of the company trademarks.

In his expert testimony, the trustee's forensic analyst offered a buy-side valuation analysis. The valuation analysis was based entirely on the purchaser's internal documents regarding the debtor company value.

The bankruptcy court rejected that analyst's methodology. This is because the methodology provided no objective evidence of the market value of the debtor company's business at the time of the transaction.

The bankruptcy court concluded that the purchaser's analysis of the debtor company value, based on expected post-acquisition strategic synergies, was not relevant—given that the market had already indicated a much lower value.

The *nVidia Corp.* decision reflects an important principle in fraudulent conveyance claims: whether "reasonably equivalent value" is given is to be determined from the standpoint of the creditors at the time of the debtor company property transfer.

That is, the relevant question is: whether the subject transaction "deplete[d] the debtor's estate of valuable assets without bringing in property of similar value from which creditors' claims might be satisfied."[9]

ANALYST EXPERT TESTIMONY GUIDELINES

The above-mentioned guidelines relate to valuation testimony presented before the bankruptcy court. However, there are also general guidelines that the forensic analyst should consider in every expert testimony situation.

Some of these analyst guidelines relate to potential vulnerabilities that the opposing legal counsel may attack in the expert's valuation (or damages, transfer price, or other) opinion.

The first thing that opposing counsel typically does is investigate the expert's résumé or curriculum vitae. Therefore, the analyst should check (and double check) his or her résumé. The analyst should ensure that the résumé is current and that it does not contain any misstatements.

Another thing that opposing legal counsel will typically do is review the analyst's prior testimony and any published writings. The analyst should anticipate questions concerning any prior statements that appear to be inconsistent with the current valuation (or other) opinion.

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The analyst should also determine whether he or she was ever contacted by the adverse party in connection with the subject bankruptcy case. The analyst should ensure that:

1) the analyst has no confidential relationship with the adverse party and
2) the analyst did not receive any privileged information.

The analyst should be knowledgeable about the facts related to the debtor company subject asset, property, or business interest (e.g., the valuation subject). Courts find the opinions of even a highly qualified expert to be unpersuasive when the expert is not sufficiently familiar with the specific facts of the case.

The analyst should be prepared to testify as to all of his or her opinions at the time of the deposition. The analyst should be prepared for deposition questions such as the following:

1) Have you reached any opinions or conclusions not contained in your expert report?
2) Have you been asked to form any other opinions?
3) Do you plan to offer any other opinions?
4) What additional work, if any, do you plan to perform related to this case?

Expert testimony may be excluded if the adverse party can show that the analyst was not prepared to state his or her final opinion at the time of the deposition.

The analyst should generally understand:

1) the requirements for the expert report contents and format and
2) the schedule for when the expert report should be completed and exchanged.

Federal Rule of Civil Procedure 26(a)(2) has specific requirements for expert report contents and for when the expert report should be submitted to the other side. The forensic analyst's expert report may be excluded if these rules are not followed.

For a valuation-related analysis, the analyst should be prepared to explain (1) the development of the valuation analysis (both the data selection and the methods applied) and (2) how to perform the calculations in that valuation analysis, and (3) how the value conclusion was reached. The analyst should be prepared for deposition questions such as the following:

1) Did you write the entire expert report yourself?
2) Did anyone assist you in the development of the valuation?
3) Does the expert report include any text that was written by your assistants?
4) Does the expert report include any analysis that was performed by your assistants?

The analyst should have sufficient knowledge about what information was relevant to be included in (or excluded from) the expert report. The expert report should include a list of all of the documents and testimony that the expert reviewed.

The analyst should be prepared to explain why he or she selected the information that formed the basis of the expert opinion.

The analyst should learn everything he or she can about the opposing expert's valuation (or damages, etc.) position. The analyst will typically have access to the opposing expert's report. In addition, the analyst should ask for the valuation (or damages, etc.) work papers that support the opposing expert's position. The analyst should consider whether his or her expert opinion would make sense to a layperson. Even if the subject valuation analysis is 100 percent correct, it may not be credible to a finder of fact if it is not understandable to a layperson.

ADDITIONAL EXPERT REPORT GUIDELINES

The forensic analyst will attempt to accomplish numerous objectives with the bankruptcy-related asset, property, or business interest valuation report. Of course, the analyst wants to persuade the report reader (whether the reader is a party to the bankruptcy proceeding, counsel to the parties, or the judicial finder of fact). And, the analyst wants to defend the subject asset, property, or business interest value conclusion.

In order to accomplish these objectives, the content and the format of the expert report should demonstrate that the analyst:

1) understood the specific bankruptcy-related valuation assignment;
2) understood the subject debtor company asset, property, or business interest;
3) collected sufficient debtor company financial and operational data;
4) collected sufficient industry, market, and competitive data;
5) documented the specific economic attributes of the subject asset, property, or business interest;
6) performed adequate due diligence procedures related to all available data;
7) selected and applied all applicable income approach, market approach, and cost approach (for a property) valuation—or asset-based approach (for a business) valuation—methods; and
8) reconciled all value indications into a final value conclusion related to the subject debtor company asset, property, or business interest.

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The final (and arguably most important) procedure in the entire bankruptcy valuation analysis is for the analyst to defend the value conclusion in a replicable and well-documented expert report.

Whether defending the value of a tangible or intangible asset, a debt or equity security, or the debtor company business enterprise, the valuation-related expert report should:

- explain the subject bankruptcy valuation assignment;
- describe the subject asset, property, or business interest and the subject bundle of legal rights;
- explain the selection or rejection of all generally accepted valuation approaches and methods;
- explain the selection and the application of all specific analysis procedures;
- describe the analyst's data gathering and due diligence procedures;
- list all of the documents and data considered by the analyst;
- include copies of all documents that were specifically relied on by the analyst;
- summarize all of the qualitative valuation analyses performed;
- include schedules and exhibits documenting all of the quantitative valuation analyses performed;
- avoid any unexplained or unsourced valuation variables or analysis assumptions; and
- allow the report reader to be able to replicate all of the valuation analyses performed.

In order to encourage the reader's acceptance of the valuation-related expert report conclusion:

- the expert report should be clear, convincing, and cogent;
- the expert report should be well-organized, well-written, and well-presented; and
- the expert report should be free of grammatical, punctuation, spelling, and mathematical errors.

In summary, the effective (i.e., persuasive) bankruptcy-related valuation report should tell a narrative story that:

1) defines the analyst's assignment;
2) describes the analyst's data gathering and due diligence procedures;
3) justifies the analyst's selection of the generally accepted valuation approaches, methods, and procedures applied in the subject analysis;
4) explains how the analyst performed the valuation synthesis and reached the final value conclusion; and
5) defends the analyst's final value conclusion regarding the subject debtor company asset, property, or business interest.

SUMMARY AND CONCLUSION

Forensic analysts are often asked to provide consulting expert or testifying expert services in litigation or other controversy matters. The type of controversy matter may relate to commercial litigation, taxation, antitrust, family law, bankruptcy, and other types of claims. Analysts are retained as experts because of their specialized experience and expertise in financial valuation, transaction structuring, acquisition due diligence, deal financing, company solvency and insolvency, transactional fairness, and related corporate finance issues.

This discussion summarizes many of the issues that the forensic analyst should consider when preparing an expert report and providing expert testimony in any type of litigation matter. This discussion focused on bankruptcy-related matters as a representative type of litigation that the analyst may become involved in.

A well-prepared and articulate analyst can provide an important service to a party involved in a bankruptcy dispute. Such an analyst can also assist the client's counsel to (1) present the valuation (or other) aspects of the case in chief and (2) prepare to cross-examine the opposing expert.

The analyst is not the client's legal counsel. The analyst should not attempt to "practice law without a license." Accordingly, the analyst should always seek and rely on legal instructions from the client's counsel.

However, the analyst who agrees to provide testifying expert services in a litigation matter should be generally aware of the rules regarding the content and format of expert witness reports. And, the analyst should be prepared to present valuation, damages, transfer price, or other testimony that meets the judicial requirements for expert testimony.

However, before the analyst can help anyone, the analyst's expert testimony must be admitted. The analyst should consider the factors that the court will consider and then should analyze his or her expected testimony against those factors.

With this consideration, the forensic analyst should be able to tailor his or her expert report and expert testimony to ensure that the expert testimony admissibility thresholds are met.

[1] *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923).
[2] *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. at 593-94.
[3] See the FRE 702 comment citing *Daubert,* 509 U.S. at 593-94.
[4] *Kumho Tire Co. v. Carmichael,* 526 U.S. 137 (1999).
[5] *Andrews v. Metro North Computer Railroad Co.*, 882 F.2d 705, 708 (2nd Cir. 1989).
[6] *United Phosphorus, Ltd. v. Midland Fumigant, Inc.,* 173 F.R.D. 675, 686-87 (D. Kan. 1997).
[7] *Brandt v. nVidia Corp.,* 389 B.R. 842, 883 (Bankr. N.D. Cal. 2008).
[8] Ibid.
[9] See *Rubin v. Manufacturers Hanover Trust Co.,* 661 F.2d 99, 988 (2d Cir. 1981).