

Commentary:

## A Critical Examination of Plaintiffs' Experts' Damage Analysis: An Important Defensive Tactic After *Daubert* and *Kumho*

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Securities class action defendants have always had two broad lines of defense available to them: liability and damage issues. For a number of reasons, the principal focus of these defense efforts has been the liability side. First liability issues are raised and resolved by the court or jury before damage issues, which are frequently not reached due to a settlement. Second, the pleadings standards of the Private Securities Litigation Reform Act, as interpreted in the various circuits, necessarily direct defense counsel (and the district court) to scrutinize allegations on liability issues in order to explore the quickest and easiest "exit strategy" available to a defendant.<sup>2</sup> Finally, damages issues are usually more complex than liability issues, and are expensive to litigate due to the high cost of retaining a credible expert from a relatively small pool of economists who have the sophistication and experience to perform such an analysis.

Thus, most of the recent judicial and critical commentary in the securities litigation field has focused on liability issues. Because the law governing the trial court's role in assessing expert testimony has changed so dramatically since the U.S. Supreme Court's decision in *Daubert v. Merrell Dow Pharmaceuticals* (1993), we expect that the "new frontier" in securities class action litigation will likely be the battle over expert damages testimony.

Before *Daubert*, competing damages experts (like experts giving other economic testimony) were generally allowed to testify as to their contrary theories, with little judicial intervention. The result was largely to leave the trier of fact to sort out the experts' bases and methodologies, and let the most persuasive among the experts prevail. By tightening the control to be placed by federal judges on the use of expert testimony, *Daubert* discouraged judges from automatically referring all "expert battles" to a jury. *Daubert* placed the courts in a position of scrutinizing the scientific bases for

expert testimony, with the goal that only "legitimate" scientific disputes, not "junk science," be placed before the trier of fact.

The impact of *Daubert* on damages issues in securities litigation has not been fully manifested. We expect, though, that federal courts (and state courts in jurisdictions which have adopted Federal Rule of Evidence 702,<sup>3</sup> on which that decision was based) will be compelled to scrutinize more closely damage expert methodologies. Whether that process will be of greater benefit to the defense side or the plaintiffs' side remains to be seen, but a closer attention to the assumptions and reasoning of a damages expert should at least theoretically result in a reduction in the number of the more "extreme" damages calculations at either end of the spectrum. It is a real possibility then that a thorough application of the *Daubert* factors could bring plaintiff and defense damage analysis closer together, with a potential to produce somewhat more rational analysis of settlement and litigation risk issues. Whether this occurs, of course, will depend on the rigor and consistency with which the courts apply these factors.

In this article, we recount the factors set forth in *Daubert* for reviewing the admissibility of expert testimony. We discuss some of the authorities which have been decided since *Daubert* on issues pertaining to the sufficiency of expert testimony on damages and valuation issues. We then consider the opinion in the *Executive Telecard* litigation as an illustration of the *Daubert* analysis in the context of class action securities litigation.<sup>4</sup> Finally, we identify securities litigation damages issues which may be likely subjects for *Daubert* motions in the future.

### I. The *Daubert* Factors

The Supreme Court in *Daubert* abandoned the "general acceptance" test of *Frye v. U.S.* (1923), for the admissibility of expert testimony. The Court held that the *Frye* test had been superseded by the adoption of Federal Rule of Evidence 702, which provides that an expert may testify as to "scientific, technical, or other specialized knowledge" if it "will assist the trier of fact to understand the evidence or to determine a fact in issue." The requirement of "assistance to the trier of fact," which the Court also described by the term "fit," is one "primarily of relevance." By way of example, the Court stated that an expert's testimony about the phases of the moon would assist the trier of fact if there was a question of whether it was dark one night, but that testimony would not be of assistance if it were offered to show that a person was likely to have behaved irrationally that night as the result of a full moon.

After undertaking this basic "assistance" inquiry, the trial court must then determine whether the offered evidence is reliable. It must consider:

- Whether the expert's theories or techniques can be and have been tested. The Court noted that the criterion of the scientific status of a theory is its "falsifiability, or refutability, or testability."
- Whether those theories or techniques have been subject to peer review or publication. Of this factor, the Court observed that publication is not a *sine qua non* of admissibility, and conversely, publication does not prove reliability. But publication increases the likelihood that faulty methodologies will be detected.
- The theory or technique's known or potential rate of error.
- Whether a theory or technique is "generally accepted" within the appropriate scientific community. The Court pointed out that a known theory which has received little support should rightly be viewed with skepticism.

The Court emphasized that these factors should be used in a "flexible" manner by the trial courts, which should focus "solely on principles and methodology, not on the conclusions that they generate."<sup>5</sup>

The Court expressly limited its holding to "scientific" expert testimony.<sup>6</sup> With that limitation, there was some ambiguity as to whether *Daubert* should be applied to the economic analysis used to substantiate damages in securities litigation although most assumed it would be, as discussed below. However, in *Kumho Tire Co. v. Carmichael* (1999), the Supreme Court clarified that *Daubert* applied to all scientific, technical or other "specialized knowledge" expert testimony. This holding, of course, should be thought unremarkable, given that Federal Rule of Evidence 702 lists scientific, technical and specialized knowledge as the subjects for that Rule's inquiries. The *Kumho* Court took particular care to re-emphasize the flexible nature of the *Daubert* inquiry. It held that it could "neither rule out, nor rule in, for all cases and for all time the applicability of the factors mentioned in *Daubert*, nor can we now do so for subsets of cases categorized by category of expert or by kind of evidence. Too much depends upon the particular circumstances of the particular case at issue."<sup>7</sup> In fact, the trial courts were given "broad latitude" to make a selection of the appropriate *Daubert* factors to use in a particular case.<sup>8</sup>

The Court in *Kumho* explained that it did not wish to denigrate the importance of the *Daubert* gatekeeping function:

The objective of that requirement is to ensure the reliability and relevancy of expert testimony. It is to make certain that an expert, whether basing testimony upon professional studies or personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field.<sup>9</sup>

## II. Application of the *Daubert* Factors to Economist Experts

In the six years since *Daubert* was decided, a small group of cases has used the *Daubert* factors to weigh the admissibility of expert testimony in several fields which present some analogous techniques to those used in setting damages in securities litigation (*e.g.*, valuation of businesses and other property, the reliability of financial statements and other issues). Although *Kumho* was not decided until 1999, many courts and commentators<sup>10</sup> have assumed that the *Daubert* factors would apply to the testimony of a social scientist like an economist.<sup>11</sup>

In *Ullman-Briggs Inc. v. Salton/Maxim Housewares Inc.* (N.D. Ill., Sept. 16, 1996), a fraudulent transfer case, an expert was offered to testify as to the value of a business. Plaintiff, a company's exclusive sales representative, initiated the litigation for breach of contract when, shortly after the representative entered into the exclusive sales agreement, the company terminated the agreement. In the meantime, the company sold its assets to a new company. The sales representative then obtained a judgment against the old company, which was unable to pay it. The sales representative sued the new company for fraudulent transfer of the old company's assets at less than their reasonably equivalent value.

Plaintiff's expert offered testimony as to the value of the old company. He worked for a venture capital firm which had been retained by the old company's parent to find a buyer for the old company. The court identified that its task was to determine whether plaintiff's expert had used a scientifically valid methodology in arriving at a valuation of the company. It applied the *Daubert* factors over the objection that *Daubert* only applied to scientific experts noting that "while business evaluation may not be one of the traditional 'sciences,' it is nevertheless a subject area that employs specific methodologies and publishes peer-reviewed journals."<sup>12</sup> The court observed that the expert did not work for the unit of the venture capital firm which actually evaluated

businesses, but instead worked for the unit which represented clients attempting to sell their businesses. The expert admitted that he was a dealmaker rather than a business valuation expert, and that while he relied on an internal evaluation report of the old company in forming his expert opinion, he did not take any part in preparing the valuation report. Further, the court opined that, as a dealmaker, his interests were in maximizing the old company's sale value. The *Ullman-Briggs* court found the expert's conclusions to be no more than a "hunch." The court concluded that the expert did not employ a valid methodology for arriving at a valuation commenting that "[a]n expert who supplies nothing but a bottom line supplies nothing of value to the judicial process" and barred his testimony.<sup>13</sup>

Another business valuation expert's testimony was excluded in *Frymire-Brinati v. KPMG Peat Marwick* (7th Cir. 1993), a case decided a month after *Daubert*. *Frymire-Brinati* was an accounting malpractice case against a firm which had allegedly improperly certified the financial statements of a company to which the plaintiffs loaned money. The claimant's expert accountant contended that the defendant over-valued the company's investment in several real estate limited partnerships. Using a discounted cash flow analysis, the expert said that the accounting firm should have valued the partnerships at zero, because these projects were new and had low or negative cash flows to date. In doing that assessment itself, the Seventh Circuit held that the expert's testimony did not pass muster under *Daubert* in light of the expert's concession that "he did not employ the methodology that experts in valuation find essential" and because it made the critical error of failing to "consider potential cash flows (for example, what the office building will produce after occupancy) and not simply historical cash flows."<sup>14</sup> The Seventh Circuit found that the trial court was obliged to, but did not, make a preliminary assessment as to the validity of the methodology underlying the testimony before permitting the expert to testify.

Issues of damages in "business tort", anti-trust and other similar disputes have been a frequent source of rulings on the sufficiency of expert damages testimony. One often-cited case on these issues is *Target Market Publishing Inc. v. ADVO Inc.* (7th Cir. 1998). The parties in *Target Market* had entered into a joint venture, starting with a one-year contract, to direct mail an advertising publication called Select Auto, in which auto dealers would receive exclusive advertising rights. The parties first began to market Select Auto in Cleveland, but sales faltered. Efforts to market the publication in other metropolitan areas likewise failed, and ADVO withdrew from the joint venture, with five months left on the contract. Target Market sued ADVO for breach of contract and breach of fiduciary duty.

To prove its lost profits, Target Market introduced the report of an expert who concluded that had ADVO performed as promised, the Select Auto venture would have returned \$1.4 million in profits by the end of the contract. Upon reviewing the expert's report, the trial court concluded that Target Market would be unable to show that its damages exceeded the \$50,000 jurisdictional minimum.<sup>15</sup> In making his estimate, Target Market's expert assumed that Select Auto would penetrate into 49 marketing zones, with each zone enlisting 14 advertisers, all of whom would pay full price for their ads. The Circuit Court deemed these projections unrealistic because (1) the number of subscribers in Cleveland had dropped from 15 at the beginning of the contract to three at the time ADVO pulled out; (2) as of the first seven months of the contract, Target Market's share of the profits was only \$1,300; (3) the efforts to introduce Select Auto into New Orleans, Baton Rouge, San Antonio, and Austin were unsuccessful; and (4) no efforts were undertaken to introduce it in other markets.

Target Market also argued that its projections should be accepted because they were more conservative than a per-zone profit estimate made by one of the ADVO's own executives.<sup>16</sup> The Circuit Court commented that the ADVO executive's profit projections were generated to identify a target profit and not a projection of actual results. Further, the court noted that the executive's projection was based on the assumption that all advertisements would be sold for full price, while elsewhere in that marketing plan, it was assumed that it would be necessary to sell ads at reduced prices in new markets to attract advertisers. For these reasons, the Circuit Court held that the expert's damage analysis was unreliable, and in the absence of a suitable damage analysis, Target Market could not show that it was entitled to recover more than the jurisdictional minimum amount on its claim. The Circuit Court emphasized that both *Daubert* and the Federal Rules of Evidence compel the trial court to exclude "speculative" expert testimony as a matter of law and affirmed the district court for doing so, but encouraged the court to do so more explicitly than it did in its written opinion here.

Citing *Daubert*, another court in reviewing *de novo* a magistrate judge's ruling likewise excluded an expert's lost profits report in *Lithuanian Commerce Corporation Ltd. v. Sara Lee Hosiery* (D.N.J. 1998). In that case, plaintiff Lithuanian Commerce Corporation (LCC) was a Lithuanian distributor for pantyhose manufactured for defendant Sara Lee Corporation. LCC contended that Sara Lee damaged its business by: (1) donating pantyhose to Russia, some of which were sold in Lithuania through the black market at lower prices than pantyhose sold by LCC; and (2) supplying allegedly defective pantyhose made in Mexico free of charge

after LCC complained about the donations to Russia. LCC brought a suit for breach of contract, fraud, and various related common law and statutory torts arising out of these incidents.

LCC offered the testimony of an expert economist who assumed that LCC would remain in that relationship with Sara Lee for approximately 20 years in Lithuania, Estonia, and Latvia. The economist made that assumption based on the fact that there were three Sara Lee distributors with which it had a relationship of over 20 years, and LCC exceeded the normal level of performance required of Sara Lee distributors. The court rejected this conclusion because it was based on a misrepresentation of testimony from Sara Lee's market manager. While that manager had testified that LCC performed "above average," that performance referred to secondary duties such as sharing information and paying bills, and not to sales performance. Furthermore, the court did not believe that the longevity of domestic distributors, who did not have to pay taxes and import duties, could be suitably compared with the possible longevity of LCC.

The court also found the expert's testimony improperly relied for its sales volume figures on a survey of pantyhose consumption by American women, when LCC's own documentation showed that women in the Baltic republics consumed significantly fewer pairs of pantyhose per year. Finally, the court rejected as speculative the assumption that the plaintiff controlled 10 percent of the markets in all three Baltic republics and that its market share of the Lithuanian market would increase 10 percent annually. The court concluded that all of these faulty assumptions warranted exclusion of the expert's testimony, either under *Daubert* or without applying that standard,<sup>17</sup> reversing the magistrate judge's original evidentiary determination to the contrary.

Finally, in *In re Phosphide Anti-Trust Litigation* (D.Kan. 1995), the trial court excluded the testimony of an expert economist as to the damages allegedly suffered by a class of plaintiffs resulting from defendants' price-fixing conspiracy in the aluminum phosphide industry.<sup>18</sup> The witness purported to apply an accepted analytical model called a "before and after" model, in which the price of the commodity during the class period is compared with what the competitive price for the item would have been absent the anticompetitive conduct. He concluded that the competitive price during the period of the conspiracy was the price which prevailed during a selected ten month period following the conspiracy, and that the sole cause of the price difference was the conspiracy itself.

Relying extensively on a critical analysis of the plaintiffs' expert's report by defense expert,<sup>19</sup> the court viewed plaintiffs' expert's comparisons as inappropriate. First

of all, the plaintiffs' expert did not perform any analysis of phosphide prices before the alleged conspiracy, resulting in the expert ignoring the "before" component of a "before and after" model. Additionally, he could not offer any supportable theoretical basis for his selection of a "lag period" between the Department of Justice's investigatory subpoenas to the defendants and the beginning of the pricing period which had been selected by the expert as "normal pricing" for comparison.<sup>20</sup> The court could not see why the stable prices in the period selected by the plaintiffs' expert were "normal" in an industry characterized by declining demand during the purported conspiracy period and declining prices from 1980 to the present. The defense expert further faulted the plaintiffs' expert's work because it did not perform any analysis of demand and supply figures in selecting the price comparison period.<sup>21</sup> The court acknowledged that in excluding plaintiffs' expert testimony it might very well strip plaintiffs "of their ability to recover damages from admitted conspirators." It went on to note, however, that the problem is one of plaintiffs' making when "class counsel and their expert have charted an aggressive course with respect to their damage calculations, one which, under *Daubert* was not without foreseeable risk." In other words, proof of liability does not guarantee an award of damages where the theories underlying damage estimates are of questionable validity.<sup>22</sup>

The cases discussed above are not securities class action cases. Damages analysis in a business-to-business dispute such as a breach of contract or anti-trust matter present somewhat different and, in some respects, more straightforward issues than those presented in analyzing damages allegedly suffered by a class of shareholders. However, the cases discussed here are instructive to the extent that they show a greater willingness on the part of courts after *Daubert* to examine the reliability of experts' bases and methodologies used in calculating damages as a gatekeeper and not simply to allow the jury to test the credibility of the testimony. Under a *Daubert* analysis, the use of overly-long periods for calculating damages, inappropriate performance comparison with other businesses or entities and unfounded "sole or primary" causation theories should not be acceptable. The analogy of these rulings in conclusions to securities damage issues is readily apparent.

### III. The *Executive Telecard* Decision

*In re Executive Telecard Limited Securities Litigation* (S.D.N.Y. 1997) is still the leading reported case applying a *Daubert* analysis to damage testimony in a securities fraud class action.<sup>23</sup> The plaintiffs in *Executive Telecard* brought a suit under Section 10(b) of the Securities Exchange Act of 1934, asserting that Executive Telecard (EXTL) and its

directors and officers omitted various facts regarding the company's financial condition and failed to disclose that a convicted felon with history of securities violations was advising the company during the class period. EXTL was a "small cap" company in the telecommunications industry.

The plaintiffs offered as an expert witnesses an investment advisor and securities analyst who performed two separate damages analyses. His first calculation used the ten days following the disclosure of the facts underlying EXTL's misstatements and omissions in a Barron's article to ascertain the company's "true value." The expert compared that "true value" to the Standard and Poor's Long Distance Telephone Index (the Telecom Index), and determined that the class damages were \$18.5 million.

In a second analysis, the plaintiffs' expert used an alternative damage measure called a constant ribbon" method. In that analysis, the expert compared EXTL's stock price for the ten days following the publication of the Barron's article with the 10 days preceding a ruling from the district court that EXTL's proxy statement had failed to disclose the ex-felon/consultant's role in management. Comparing those two stock periods yielded a difference of \$2.48 per share, or 35.5 percent. The expert adjusted that number downward to 30.8 percent to reflect various market factors in telecommunications and other stocks, and applied the 30.8 percent "overvalue" factor to a "proportional decay model"<sup>24</sup> to arrive at the total damages figure of \$14.6 million after deducting \$400,000 to account for ineligible purchases.

The *Executive Telecard* court started its analysis with the basic legal principles of setting damages in securities fraud cases. The general rule is that damages in such cases are measured by the difference between the price at which a stock is sold and the price at which it would have been sold absent the alleged misrepresentations or omissions.<sup>25</sup> A defendant may raise a "negative causation" defense under Section 11 (e) of the Securities Act,<sup>26</sup> i.e., argue that some other influence separate from the alleged misrepresentation created the downward movement in the stock. The court stated that to perform an analysis of those "negative causation" issues, an expert must identify and eliminate that portion of the price decline which results from forces which are not related to the misrepresentations or omissions. It categorized those forces into: "(1) company risk-the unique risk that is peculiar to the particular stock at issue, and (2) market risk-the risk associated with market-wide variations generally."<sup>27</sup>

The *Executive Telecard* court found the expert's opinion was inadmissible under the *Daubert* factors<sup>28</sup> for two general reasons. First, the court found that the expert

failed to conduct an "event/study" to determine whether EXTL's stock price decline was accompanied by any factors specific to the company other than the alleged fraud. As one example of the expert's omissions, the expert conceded that he did not consider the effect on the share price of EXTL's spin-off of one of its divisions, which was purportedly the subject of some shareholder concern at the time. The court examined the expert's deposition testimony and found it ambiguous regarding whether movement in EXTL's share price was attributable to any factors other than the alleged fraud. In the absence of such a distinction between the fraud and non-fraud causes of the company's stock price movements,<sup>29</sup> the court deemed the expert's conclusions to be unreliable.<sup>30</sup>

The second defect found by the *Executive Telecard* court was the expert's reliance on the Telecom Index.<sup>31</sup> It held that the comparison to the Telecom Index, which was comprised of large telecommunications companies, was inappropriate for a more volatile "small cap" stock like EXTL. It noted that EXTL did not trade on its purported earnings per share, but rather moved in accordance with the market's expectations and perceptions of its long-term economic prospects. The court believed that there were a substantial number of "small cap indices" which should have had a greater correlation with EXTL's price. Use of the Telecom Index only served to overstate plaintiffs' damages by comparing a decline in EXTL's stock price with the significantly more stable prices of large cap telecommunications stocks.

The rejection of plaintiffs' damage analysis in the range of \$14-\$18 million was an unqualified victory for the defendants. However, the court allowed the litigation to proceed over defendants' arguments that the evidence showed that the class had suffered no damages. The defendants moved for summary judgment, asserting that the class damages were zero because EXTL's stock price did not decline in the ten days following a decision by the court in *Krauth v. Executive Telecard Ltd.*,<sup>32</sup> holding that a proposed EXTL proxy statement which failed to disclose convicted felon Bertoli's role in management was a material omission in violation of Section 14(a) of the Securities Exchange Act of 1934. The court rejected this argument for three reasons. First, it noted that the disclosure in the *Barron's* article which followed the district court's opinion by several weeks was more comprehensive than the opinion and therefore the plaintiffs' expert was correct in determining that the disclosure begin with the opinion and full dissemination was made in *Barron's*. Second, the court did not accept the defendants' argument that because the stock did not move in that ten day period, there were no damages. It is possible, the court commented, that the price at which EXTL's stock may have sold during that period would have been higher than it actually was absent the misrepresentations. Finally, the court was reluctant to resolve this issue on summary

judgment in the context of a class action brought by fiduciaries to enforce the rights of the absent members. The court therefore granted plaintiffs a reasonable time to obtain either a new damages expert or a new report from its present expert addressing the issues raised in the opinion.

*Executive Telecard* has been discussed in more recent securities cases in the Southern District of New York. In *Goldkrantz v. Griffin* (S.D.N.Y., April 5, 1999), the court granted summary judgment for the defendants based on the failure of plaintiffs' expert to demonstrate that the movement in the company's share prices was motivated by the information which was allegedly not disclosed by the defendants. The defendants in *Goldkrantz* offered a study from an expert witness who evaluated all movements in the company's share prices during the class period. This study, which was an "events study" of the company's performance identified seven days in which the price moved greater than 4.41 percent (a figure selected by the expert as the statistically significant "residual return" based on a 95 percent confidence interval) and then found that (1) five of the seven days' movements related to identified news items unrelated to the specific event which the plaintiffs contended was not disclosed, and (2) the remaining two days occurred so far after the company's eventual disclosure of the non-disclosed event that the defense expert believed they could not have any connection to the non-disclosure. The defense expert also noted that the non-disclosed event was not mentioned during the class period in any magazine, newspaper report or analyst's report about the company.

The plaintiffs did not present a contrary report, but offered an expert who challenged some of the defense expert's assumptions, particularly about the 4.41 percent share price movement cutoff. The trial court found that these challenges to the defense expert report did not give rise to a sufficient question of fact to warrant trial. It concluded that the analysts' reports and the events study analysis confirmed that the movement in the company's share prices was driven by other factors, and not the non-disclosed event which was the subject of plaintiffs' complaint.

#### IV. Implications of *Daubert* for Damages Issues in Securities Class Action Litigation

Although *Daubert* has not yet resulted in a large body of case law on the issues of admissibility of expert damages analysis in securities class action litigation, the legacy of that case could result in a greater attention being paid to damages issues by trial courts at earlier stages of the litigation. Motions for summary judgment after expert discovery, and, at a later stage, motions *in limine*, could help defendants narrow (or in some cases, eliminate) the class damages figures offered by plaintiffs' experts.

Some of the issues which are likely subjects for *Daubert* motion practice are:

- **Class Period Analysis.** It is often common for plaintiffs to assert large class periods to increase the settlement value of the case. Damage analysis which is based on too large a class period could be challenged through a *Daubert* motion. This analysis is usually specific to the particular liability facts of the case, and focuses less on the expert's "four methodologies" than his or her underlying assumptions.
- **Estimating the Number of Damaged Shares.** There are a number of ways to estimate the amount of the shares affected by an alleged non-disclosure. As suggested above,<sup>33</sup> some analytical models (the "proportional decay" or "single trader" model) assumes that all shares have an equal probability of being traded within the class period. Other analytical models (the "accelerated trading model" or "two trader model") assume that shares which are traded once within the period are more likely to be re-traded. Further scholarly work and peer review may be needed to resolve the question of whether either or both of these theories meets the *Daubert* requirements.
- **Selection of a "True Value" for Shares, Absent the Non-Disclosure.** There are many different assumptions and comparisons which go into determining what the "true value" of a share would be in the absence of certain omissions or misrepresentations. An "events study" methodology contains many statistical elements and debates, including the selection of "significant" stock movements, the choice of corporate "events" to study, and the sufficiency of a single "event" for purposes of a study. Comparisons of stock indices and other performance measures with the movement of a particular company's stock create a host of other methodological and reliability questions. Again, scholarly publication and peer review may weed out some of the theories which are less reliable means to arrive at a stock's true value.
- **Alternative Causation Defenses.** These issues are in many respects simply the opposite side of the coin from the "true value" analysis. To the extent that a defense expert will want to attribute price movements to events other than those which are the subject of the litigation, the

expert will need to make certain assumptions in order to quantify the effect of those "other events" on price movement. This type of causation analysis can be the subject of scholarly debate, and case studies based on historical experience can bolster an expert's claim to a reliable method of inquiry.

A thorough *Daubert* analysis of any of these issues will require courts, litigation counsel and insurers to both be familiar with and have ready access to expert opinions on the scholarly literature governing the methodology of damage analysis. Those experts who are able to test their analytical methods against historical stock performance data, publish their results in the appropriate professional journals and obtain the comments of their peers should ultimately be more successful in having their conclusions endorsed by the courts.

*Daubert* and the cases which follow it make clear that it is no longer sufficient for a party simply to offer an expert's report in order to raise a question of fact; the report must be well reasoned and supported by justifiable assumptions which can be explained to the court. In a post-*Daubert* environment, defendants and their insurers must insist that defense counsel be ready to advocate for the expert at the pretrial motion stage, and not merely to defend the expert against hostile cross-examination at trial. Being fully familiar with the expert's damage assumptions and methodologies, and where they fit within the "scientific" community of damages experts, will be increasingly more essential to defense counsel in presenting an effective challenge to competing, debatable damage analysis offered by a plaintiffs' expert.

### Notes

<sup>1</sup> Ms. Reardon and Mr. Reed are attorneys in Chicago who focus their practice on litigation management and coverage issue identification on behalf of insurers, including directors and officers liability insurers presented with securities litigation claims.

<sup>2</sup> In fact it may be error by the court not to do so. *Bryant v. Avado Brands Inc.*, No. 98-9253 (11th Cir., Sept. 3, 1999), on certification from Middle District of Georgia, held it was error for district court to fail to take notice of and to consider defendants' SEC filings in assessing assertions that material information was concealed from the market. In analogous situations, Courts of Appeals have found district courts to have erred for permitting discovery when by statute, defendants are to be free from discovery until there is a clearly articulated claim against them. See, e.g., *Gaines v. Davis*, 928F.2d705,706-7 (5th Cir., 1991); *Smith v. Reagan*, 841 F.2d 28, 30-31 (2nd Cir. 1988).

<sup>3</sup> Federal Rule of Evidence 702 provides as follows: "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."

<sup>4</sup> *Executive Telecard*, decided in 1997, is still the most detailed application of the *Daubert* analysis that we are able to identify in the context of securities class action litigation.

<sup>5</sup> 509 U.S. at 594.

<sup>6</sup> 509 U.S. at 590 n.8.

<sup>7</sup> 143 L. Ed. 2d. at 252

<sup>8</sup> Reading between the lines, it is a strong possibility that the Court's concerns about the overly-mechanical application of the *Daubert* factors were a more significant reason for the Court's acceptance of the case than was the applicability of those factors to non-"scientific" testimony (which, after all, is compelled by the language of F.R.E. 702).

<sup>9</sup> 143 L. Ed. 2d at 252.

<sup>10</sup> E.g., "Developments in the Law: Confronting the New Challenges of Scientific Evidence," 108 *Harv.L.Rev.* 1481, 1523-27 (1995); C. Hockett and F. Hinman, "Admissibility of Expert Testimony in Antitrust Cases: Does *Daubert* Raise a New Barrier to Entry for Economists?" *Antitrust* (Summer 1996) 40.

<sup>11</sup> Other pre-*Kumho* courts did not make that assumption, setting the stage for the Supreme Court to clarify the reach of *Daubert*. See, e.g., *Compton v. Subaru of America Inc.*, 82 F.3d 1513 (10th Cir. 1996) (*Daubert* applies only to scientific evidence). *In re Unisys Savings Plan Litigation*, 173 F.3d 145 (11th Cir. 1999), the Eleventh Circuit, which was reversed in *Kumho*, held over a strong dissent that the *Daubert* factors did not govern the admissibility of expert testimony offered to show the methods of evaluating the financial condition of insurance companies. On rehearing after *Kumho* was decided, the *Unisys* majority held that *Kumho's* application of the *Daubert* factors to that case did not change the result. 173 F.3d at 174.

<sup>12</sup> 996 U.S. Dist. LEXIS 13621, at \*9.

<sup>13</sup> 996 U.S. Dist. LEXIS 13621, at *Rosen v. Ciba-Geisly Corp.*, 78 F.3d 316, 319 (7th Cir. 1996).

<sup>14</sup> 2 F.3d at 186.

<sup>15</sup> It was unclear whether the trial court was weighing the expert's report or was excluding it. The Circuit Court treated the trial court's ruling as excluding the expert's testimony as unreliable.

<sup>16</sup> That executive had concluded that each zone should generate a profit of \$24,602 per month, compared to Target Market's expert's estimate of \$24,266.

<sup>17</sup> *Lithuanian Commerce Corporation* was a pre-*Kumho* decision.

<sup>18</sup> Aluminum phosphide is a fumigant used to control insects in raw agricultural products.

<sup>19</sup> The trial court considered the plaintiffs' expert to be a "hired gun" in comparison to the defense expert, who had substantially greater professional qualifications and achievements and spends less of his professional life testifying. 893 F. Supp. at 1500 n.5.

<sup>20</sup> The expert had applied a "lag period," allegedly to allow phosphide prices the opportunity to correct themselves following the disclosure of the anti-competitive conduct when the investigative subpoenas were issued, and defendants' presumed cessation of anti-competitive activities at that time. The reason for selecting a "lag period" were unclear, as were the reasons for selecting the fifteen month period chosen by the plaintiffs' expert as opposed to a shorter time. It appeared to the court that the expert chose the "lag period" to avoid a period when phosphide prices were decreasing, in favor of a period of stable prices.

<sup>21</sup> The full details of the *Aluminum Phosphide* court's analysis are beyond the scope of this article. Interested readers are referred to the opinion for its scholarly analysis of the appropriate statistical methods to be used when making a price comparison analysis in an anti-trust claim.

<sup>22</sup> 893 F. Supp. at 1507.

<sup>23</sup> A recent search for *Daubert* in the opinions and briefs maintained on Stanford University Law School's securities law database (Hsecurities.stanford.edu) revealed only one mention to *Daubert* in a brief, which was not addressing damages issues.

<sup>24</sup> A "proportional decay" analysis accounts for the number of shares traded during the class period or retained throughout the period. Because this model assumes that every share has an equal probability of being traded within the period, it probably over-states the amount of shares traded during a class period. A more realistic model is the "accelerated trading model," which assumes that shares which trade once during the class period are more likely to be traded again. See J.M. McCarrick and K.A. Reardon, "When The Merits Don't Matter: The Influence of Insurance on Settlements In Securities Class Actions," published in three parts by Andrews Publications in its *Corporate Directors and Officers Liability LR*, Vol. 14, Issue 4, Dec. 28, 1998 (Part 1); Vol. 14, Issue 20, Aug. 23, 1999 (Part 2); and Vol. 14, Issue 21, Sept. 13, 1999 (Part 3). The *Executive Telecard* court did not need to decide whether the expert's use of a "proportional decay" analysis was appropriate.

<sup>25</sup> *Affiliated Ute Citizens of the State of Utah v. U.S.*, 406 U.S. 128, 92 S. Ct. 1456, 31 L. Ed. 2nd 741 (1972); see also *Robins v. Kogzer*, 116 F. 3rd 1441 (11th Cir. 1997).

<sup>26</sup> 15 U.S.C. § 77k(e).

<sup>27</sup> 979 F. Supp. at 1025, citing *McMahan & Co. v. Warehouse Entertainment Inc.*, 65 F. 3rd 1044 (2nd Cir. 1995); *Green v. Occidental Petroleum Corp.*, 541 F. 2d 1335 (9th Cir. 1976).

<sup>28</sup> Although the court held that the valuation of damages in a securities class action case was not "hard science" which required applying the *Daubert* factors, it elected to use that decision as guidance (979 F. Supp. at 1024). Under *Kumho*, we submit the court would have been compelled to employ such an analysis.

<sup>29</sup> On this issue, the court analogized to *In re Oracle Securities Litigation*, 829 F. Supp. 1176 (N.D. Cal. 1993), in which the court expressed similar doubts about the damage expert's methodologies.

<sup>30</sup> The *Executive Telecard* court noted that another district court had accepted this expert's damages testimony in a securities fraud case, *Winkler v. NRD Mining Limited*, No. 82-CV-3318 (E.D.N.Y., June 29, 1995). However, the *Executive Telecard* court did not believe that the "events study" methodology purportedly performed in *Winkler* was sufficient, in that it did not appear to take into account factors specific to the company, but instead factored out general trends in the prices of mining stocks during the class period.

<sup>31</sup> The court found this weakness somewhat less applicable to the second damages calculation.

<sup>32</sup> 1994 U.S. Dist. LEXIS 15255 (S.D.N.Y. Oct. 21, 1994)

<sup>33</sup> See note 23, *supra*.

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