

## Daubert Challenges

# How Expert Testimony Works — or Doesn't

**F**or expert financial witnesses, it all comes down to the two “R’s”: reliability and relevance. These are the two “must-haves” for expert testimony as outlined in the 1993 U.S. Supreme Court case that gave Daubert challenges their name: *Daubert vs. Merrell Dow Pharmaceuticals*.

Since then, countless experts have been challenged in court, and many have had their testimony excluded because it didn't meet the Daubert standard. For attorneys and their clients, a successful case often rides on expert valuation testimony, so it's imperative to know how and why a challenge might occur.

### Daubert Basics

Testimony by expert witnesses is addressed by Federal Rules of Evidence No. 702. This rule states that a witness is qualified as an expert by his or her “knowledge, skill, experience, training or education.” The rule says an expert can offer an opinion in a trial if:

- The expert's scientific, technical or other specialized knowledge will help the trier of fact to understand the evidence or determine a fact in issue;
- Testimony is based on sufficient facts or data;
- Testimony is the product of reliable principles and methods; and
- The expert has reliably applied the principles and methods to the facts of the case.



Two court cases created the basis for current-day Daubert challenges of expert witnesses. The first, the aforementioned *Daubert vs. Merrell Dow Pharmaceuticals*, established a “gate-keeping” role for judges in determining the reliability and relevance of expert scientific testimony in federal trials.

The second, *Kumho Tire Co. v. Carmichael*, decided in 1999, affirmed that the Daubert criteria applied to all types of expert testimony, including financial expert testimony. After this case was decided, many state courts adopted the Daubert standard for expert witnesses.

### Just the Facts

For the last 17 years, PwC has done an annual analysis of Daubert cases.

In its most recent report, “Daubert Challenges to Financial Experts: A yearly study of trends and outcomes, 2000-2016,” PwC identified 2,200 challenges.

Of those challenges, the most common occurred in cases involving breach of contract or breach of fiduciary duty. Litigation involving securities, intellectual property and fraud have the highest rates of exclusion for this type of testimony.

Historically, there have been twice as many Daubert challenges to plaintiff-side experts (67 percent) as there have been to defendant-side experts (33 percent). In 2016, things evened out a bit, with 58 percent of chal-

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# Why Fair Market Value Does Not Equal Selling Price

**I**t's not unusual for a valuation analyst to be called upon to "come up with a quick price" for a company, as if a few mathematical calculations would do the trick.

Often this is because a business owner has a number in mind that he or she is aiming to confirm for a sale. Or sometimes, an owner really has no idea what the company might sell for. The owner is hoping that a quick look at the books will yield a dollar amount that can then be shopped around.

What many of these owners say they're after is "fair market value." The reality, though, is that valuations take time and effort. Even then, the valuation analyst's arrival at a fair market value doesn't mean that's what the company will sell for.

## Managing Expectations

The American Institute of Certified Public Accountants (AICPA) defines fair market value as "... the price, expressed in cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

In real life, however, a company will likely sell above or below fair market value depending on a number of factors, including the particular buyer involved. Once that buyer is identified, the price becomes based on "investment value." This is defined by the AICPA as "...the value to a particular investor based on individual investment requirements and expectations."

Investment value differs from one buyer to another based on such variables as perception of risk, required rate of return, estimates of future earnings, financing costs, tax status, and synergies with existing companies.



For sellers interested in aggressively marketing their companies, it's wise to create compelling stories to "sell" the company to potential buyers based on these variables.

## Highlighting Synergies

Most buyers are interested in acquiring other companies to facilitate expansion into new markets, increase market share, obtain new or better technology or processes, or decrease competition. With these motivations in mind, the seller should present his or her company in a way that highlights the opportunities and synergies the newly combined company would provide.

For example, the buyer could illuminate the bottom line benefits of better technology, or demonstrate the results of an expanded footprint. The buyer could also communicate the increased revenues or decreased expenses gained from eliminating duplicate administrative jobs, sales staff or line employees; obtaining a larger customer base; or taking advantage of economies of scale in purchasing.

Showing a potential buyer what he or she could do with the newly com-

bined company is inspiring and creates a more realistic earnings stream on which to base negotiations. The idea is that a buyer with these synergistic opportunities would be more likely to pay above fair market value for the company.

## Affecting Value

Of course, there are always ways to improve the value of a company to any seller. Identifying the key value drivers in the company provides a path toward enhancing efficiency, capacity and profitability, to name just a few outcomes.

These actions include steps that tend to increase the fair market value by reducing risk and increasing cash flow. For example, owners can diversify the customer base, fine-tune supplier contracts and pricing, improve accounts receivable turnover ratios, and streamline inventory.

Being "sales ready" is a good state for a seller to be in. This only improves the daily operations of the company — and increases the likelihood of an optimized sales price.

*Need valuation input or assistance getting a company ready for sale? Our team can help.*

# Daubert Challenges and Expert Testimony

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lenges to plaintiff-side experts and 42 percent to defendant-side experts.

The most recent report includes some interesting findings about what gets financial expert witnesses in trouble in court.

**Reliability:** Lack of reliability was the main reason for financial expert testimony exclusion. In their role as gatekeepers, judges have to carefully evaluate testimony.

Sometimes judges will find that an expert's opinion is admissible, but will assign it more or less weight based on its reliability. Over the years, it appears that judges often allow testimony, leaving the issues of weight and validity to be handled via cross-examination.

**Data:** Questionable data is the most frequent reason for testimony to be deemed unreliable. Among experts' most common mistakes: Not collecting sufficient data, using data selectively, and failing to evaluate the accuracy of data provided by third parties.

**Qualifications:** While an expert may indeed be an expert in one type of calculation or industry, this background may or may not qualify him or her as "expert" in the testimony required.

For example, despite one expert's advanced business degree, he was not a licensed financial professional and was not particularly qualified to offer an opinion on damages calculations in a breach of contract case.

**Legal conclusions:** In order for their testimony to be deemed relevant, valuation experts cannot offer opinions or make conclusions about legal issues, nor should they be asked to. They must stick to what they know and avoid testifying about issues outside their valuation purview.

Of all of the cases included in the report, a little over 10 percent involved testimony excluded purely for its lack of relevance.

**Some in, some out:** A Daubert exclusion doesn't always mean that the witness's entire testimony will be excluded. Interestingly, 38 percent of expert financial testimony in 2016 was only "partially excluded," with some testimony deemed admissible, and some not.

Also, in recent years, judges have often given financial experts a chance to revise their testimony to address issues in a challenge.

## What to Do

Lawyers often challenge the opposing valuation expert in court — that's to be expected. But there are a few tactics legal teams and their clients can use to avoid a Daubert challenge. For example:

**Ask for references.** The outcome of your case may depend on expert testimony. Therefore, be sure you're working with an experienced, credentialed valuation analyst who can defend his or her valuation opinion. Check the expert's references and

ask for details to learn about what went well (or not so well) during prior cases.

**Get the expert involved early.** A valuation analyst can be helpful early in the litigation process, especially in the discovery phase when he or she can assist with document and information requests. Also, the expert and the legal team need sufficient time to not only complete the valuation, but also review all of the data and the report in the context of the expected testimony.

**Be forthcoming.** To be credible, valuation analysts must be neutral. They must base their opinions on all of the relevant facts and data. Providing an expert with information that supports only one side of the case is destined to backfire and will not reflect well on your team.

**Understand the facts.** If you don't grasp the data, approach or analysis behind the valuation testimony, it can be hard to convince a judge of its reliability and relevance. Good valuation analysts are happy to explain their process and valuation methodology and can defend their conclusions. Be sure the legal team is well versed in the valuation report to avoid stumbles or surprises.

## What If Testimony Is Challenged?

Of course, if the valuation expert's testimony is challenged, he or she is the first person to turn to for a defense. The expert knows the valuation report and opinion better than anyone else and will be the best resource for a rebuttal.

Lessons learned? Hiring a qualified expert, working closely with him or her on the case, sticking to relevant data and opinions, and being prepared for testimony are the keys to successfully avoiding a Daubert challenge.

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# Valuation Report



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## Treasury Withdraws Section 2704 Regulations

**The dramatic saga of IRC Section 2704** seems to have come to an end. The U.S. Department of the Treasury officially withdrew its controversial Section 2704 regulations affecting valuation discounts for family-owned and operated businesses.

As a reminder, Section 2704 is one of several sections of IRC Chapter 14. Passed by Congress in 1990, the idea was to limit valuation discounts for gift and estate tax purposes in cases of family-to-family transfers of interests in family-owned or closely held businesses.

In the summer of 2015, the IRS took further action. In order to prevent families from engaging in rule-bending practices to preserve their wealth, the IRS proposed a

number of additional regulations to curtail valuation discounts for family businesses.

Since then, a number of valuation-related organizations — including the American Society of Appraisers, the National Association of Valuation Analysts, and the American Institute of Certified Public Accountants — have banded together to fight the regulations. For the past two years, these organizations and their members have been vociferous in their opposition to the controversial regulations, speaking out against the negative effects they would have on estate, gift and tax planning.

In October, the Treasury withdrew the proposed regulations for good, citing them as “burdensome” under

President Trump’s Executive Order 13789, intended to identify and reduce regulatory burdens. At the same time, the Treasury also announced that it was initiating a comprehensive review of all regulations. It has already identified more than 200 regulations that the department believes should be repealed.

“This is only the beginning of our efforts to reduce the burden of tax regulations,” said Treasury Secretary Steven T. Mnuchin in the announcement of the withdrawal of the proposed regulations. “Our tax code has been broken for too long, and this retrospective review, along with our efforts on tax reform, will ensure that we have a tax system that fosters economic growth.”



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