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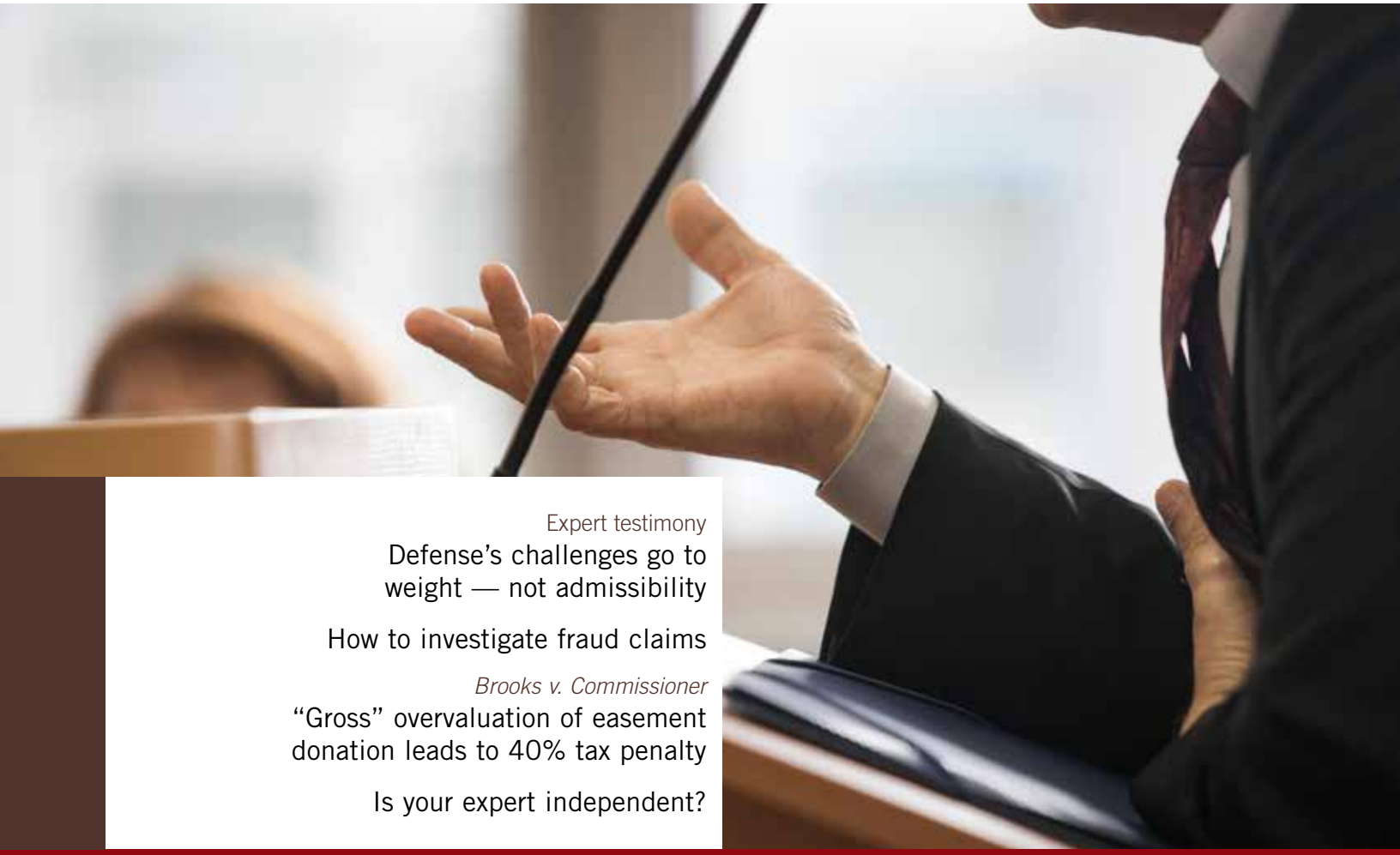

Expert testimony
Defense's challenges go to weight — not admissibility

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"Gross" overvaluation of easement donation leads to 40% tax penalty

Is your expert independent?

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Expert testimony

Defense's challenges go to weight — not admissibility

The resolution of a Federal Rule of Evidence 702 and *Daubert* motion in an ongoing complex litigation shows how a federal judge views the admissibility of expert testimony versus weight. In a recent case, the U.S. District Court for the Northern District of Texas considered several arguments against admissibility, but determined that each amounted to an issue of weight that should be left to the jury.

Challenged testimony

The defendants founded VeroBlue Farms to revolutionize the farm-raised fishing industry, but plans went awry. The company filed for bankruptcy and sued its founders, alleging mismanagement and misrepresentation. (Three of its founders have recently been indicted on felony counts related to deception.)

The defendants filed a motion to exclude the testimony of the company's damages expert. They argued it was unreliable and irrelevant under Rule 702 and *Daubert*. The expert concluded that the total damages to the company, caused by the defendants, was about $102 million. She reached that figure by combining the results of two damages theories.

The company's expert also submitted a supplemental report opining that the company was always insolvent. As a result, she concluded that every dollar it obtained or spent constituted waste.

Damages theory

The same expert argued that the defendants' devaluation and waste of the company's assets caused damages of at least $93 million, equal to the total debt and equity investment in the company. The defendants contended that this opinion: 1) was irrelevant because these weren't damages the company had standing to recover, and 2) relied on the wrong measure of damages.

The magistrate judge found that the expert's opinion couldn't be excluded as irrelevant simply because the defendants believed she was opining on damages that the company couldn't recover as a matter of law. As to the measure of damages, the judge found the argument may be a better summary judgment argument or fodder for cross-examination at a trial. It didn't convince the judge that the opinion couldn't assist the trier of fact.

The judge found that the defendants' reliability arguments went to the weight of the opinion, not its admissibility. Their doubts about the bases and sources for the opinion didn't render the opinion so unsupported as to be inadmissible.

Daubert challenges focus on 4 key factors

The *Daubert* test focuses on the reliability and relevance of an expert's analyses. It applies the following four-prong test:

1. Testing. Has the methodology been tested?

2. Peer review. Have other practitioners reviewed the method to reveal its potential flaws? Has the methodology been published in professional journals?

3. Error rate. What is the methodology's known rate of error? Has the expert's profession established standards to control the method's use? If so, has the expert complied with these standards?

4. Acceptability. Does the scientific community generally accept the method?

The U.S. Supreme Court also expects courts to consider the "replicability" of the expert's method. For instance, a novel technique might pass muster if another expert can replicate the expert's analyses — and if the expert can persuade the court that the method is appropriate for the case.

Note: Amendments to Federal Rule of Evidence 702 — which were pending approval by the U.S. Supreme Court at the time of publication — would require that the proponent of expert testimony must meet all the substantive standards for admissibility by a *preponderance of the evidence*. In addition, under amended Rule 702, an expert opinion must be based on "sufficient facts or data" before it can be admitted. If approved, the changes would go into effect as of December 2023.

Extra damages assessment

The expert also found that the defendants' misappropriations caused damages of at least $9 million. Specifically, she theorized that "every penny" paid to or spent by the defendants in their role as the company's directors constituted misappropriations and were recoverable as out-of-pocket damages.

> Doubts about the bases and sources for the opinion didn't render the opinion so unsupported as to be inadmissible.

The defendants asserted that the expert double-counted when she added the total amount invested in and loaned to the company (in other words, debt plus equity) to the amount allegedly misappropriated. However, the judge found that this wasn't a challenge to the reliability of the method but to the expert's consistency across damages models — so it was a matter for cross-examination.

The judge made a similar point regarding the defendants' arguments that the opinion was unreliable based on the timing and receipt of payments. These challenges, too, were related to the opinion's bases and sources and didn't render the opinion fatally unsupported.

Discredited insolvency method

The defendants also made several challenges to the expert's supplemental report regarding the company's insolvency. Most importantly, they claimed that she relied on a "discredited balance sheet method." The defendants said that the fundamental flaw in her methodology was her failure to value the company's assets and liabilities during the relevant period.

The judge found the defendants' assertions again addressed the bases and sources of the opinion. While some other experts may question the appropriateness of valuing a company based on its balance sheets, that goes to the weight of the opinion, rather than its admissibility.

Key takeaway

The magistrate judge made clear that the party putting forth the expert doesn't need to prove to the judge by a preponderance of the evidence that the testimony is *correct*. The proponent must show only that the testimony is sufficiently *reliable and relevant*. The rejection of expert testimony is the exception, not the rule. Generally, questions relating to the bases and sources of an expert's opinion affect the weight to be assigned that opinion, rather than its admissibility. ■

How to investigate fraud claims

When it comes to uncovering the truth about fraud suspicions, the job is best left to experienced forensic accountants. They're trained to follow the footprints criminals may leave behind and help build a defensible case. Here are some best practices that forensic accountants use to conduct interviews and gather evidence.

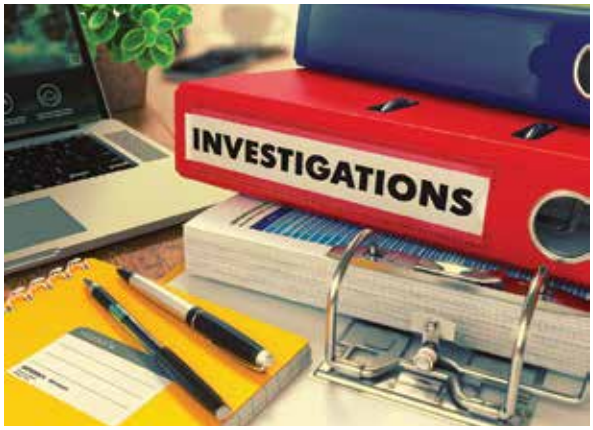
Applying a methodical approach

Although business owners may want immediate results, forensic accountants don't rush into the interview process. They take time planning what to accomplish, anticipating obstacles and resistance, and organizing the interview from the opening comments to the closing strategy. Before they start the interview process, forensic accountants will:

- Gather evidence,
- Decide who to interview,
- Organize the structure of the meeting and its location, and
- Determine the content and types of questions to ask.

In addition, these experts are aware of the legal pitfalls surrounding fraud interviews and can avoid putting companies at risk for charges of discrimination or harassment. They take care to comply with federal and state laws.

Outside professionals are also removed from the emotional aspects of the investigation. And unlike company insiders, forensic accountants have no stake in the outcome, so they can diffuse anger and anxiety from suspects, witnesses and victims during the investigative process.



Interviewing suspects and witnesses

When deciding the types of interview questions to ask, forensic accountants have different interview styles, depending on their personalities and backgrounds. The specific information experts ask for depends, in part, on the circumstances and individuals involved.

An interview usually starts with introductions and rapport-building. Experts typically explain the purpose of the interview and ask questions to which the answers are already known so they can observe the subject's demeanor and degree of candor.

Then interviewers transition to more specific questions. They encourage the interviewee to do most of the talking — and may even use silence

as a tool, as people being interviewed frequently try to fill conversation gaps. An employee may disclose information unintentionally, provide clues or suggest an unplanned, but fertile, line of questioning. Before ending the interview, experts confirm the information elicited. They also ask open-ended questions about other individuals to interview and areas to explore.

Even after extensive preparation, interviews rarely go as planned. Forensic accountants are trained to deal with unforeseen possibilities. By listening actively during the meeting, the interviewer is ready to pursue unexpected lines of questioning that can help advance or broaden the investigation. This is especially true at the beginning of a complex investigation involving numerous suspects. Trained interviewers also look for nonverbal behaviors or body language that can indicate deception.

Gathering evidence

Another key task fraud experts perform during an investigation is collecting evidence from the company's internal documents. Examples include personnel files, internal communications, financial records, security camera recordings, and physical and IT system access records. Locating this data may require the forensic accountant to perform computer examinations. Experts also consider external sources of evidence, such as public records, customer and vendor information, media reports, and private detective reports.

Forensic accounting specialists have been trained on how to review and categorize internal and external evidence, conduct computer-assisted data analysis, and test various hypotheses. When experts are finished conducting interviews and gathering evidence, they generally report any findings. Attorneys usually determine the appropriate format for the report and how distribution will be affected by the need to protect legal privileges and avoid defamation.

Avoid do-it-yourself investigations

When business owners and managers suspect fraud, the use of an outside forensic expert, along with an understanding of the investigative process, can facilitate matters and minimize potential losses. A trained professional can help gather evidence that will withstand courtroom scrutiny. ■

Brooks v. Commissioner

"Gross" overvaluation of easement donation leads to 40% tax penalty

It's generally not a good sign when the U.S. Tax Court describes your expert's value conclusion as "incredible as a practical matter." Recently, taxpayers who claimed charitable contribution deductions for donating a conservation easement learned that lesson the hard way. Not only did the court reject the value provided by the taxpayers' expert, but it also assessed a 40% penalty for a "gross valuation misstatement."

Disallowed deductions

In 2006, the taxpayers' limited liability company (LLC) purchased 85.314 acres of property in Georgia for $1.35 million. The land was subdivided into two parcels of about 44 and 41 acres. The LLC granted and recorded a conservation easement over the smaller parcel to a qualified organization in 2007. The LLC valued the conservation easement parcel at $5.1 million.

For the 2007 tax year, the taxpayers deducted $748,702 for their interest in the LLC's charitable contribution deduction. They carried forward the remaining deduction of approximately $4.4 million to future tax years. The IRS disallowed carryforward deductions for 2010, 2011 and 2012. It also assessed 40% accuracy-related penalties resulting from gross valuation misstatements. The taxpayers appealed.

Divergent valuations

At trial, both valuation experts agreed that the "highest and best use" for the property was as a residential subdivision and development. At the time the donation was made, the property could be subdivided into no more than 10 parcels. But that restriction could change if the property became part of an adjacent planned unit development (PUD).

> The Tax Court listed several problems with the analysis set forth by the taxpayers' expert.

The IRS expert determined the value of the property to be $1.41 million before the easement was granted and $940,000 post-easement. He attributed the difference of $470,000 to the fair market value of the easement. Conversely, the taxpayer's expert concluded that the property was worth $7.66 million before the easement and $4.03 million post-easement. The difference ($3.63 million) was attributed to the fair market value of the easement.

Flawed analysis

The Tax Court accepted the IRS expert's valuation, listing several problems with the analysis set forth by the taxpayers' expert. For example, he "misidentified" the property's access to the local interstate highway. He also mischaracterized the zoning of the encumbered parcel but opined that it didn't affect his conclusions because it was reasonably probable that the property could be rezoned for denser development through incorporation into the PUD. The expert assumed the encumbered parcel's zoning would be changed based on a letter from the president of the LLC that owned the PUD.

However, the court noted that this individual had no influence over the county's zoning regulations. And no document showed the owners of other adjacent properties agreed to the parcel's re-zoning or annexation to the PUD.

In addition, the expert failed to include the sale of the property to the taxpayer's LLC as the sale of a comparable property when testing his conclusions for reasonableness. His fair market value *for the easement* was nearly six times the per-acre amount the taxpayers paid *for the entire property* only about a year earlier.

Too good to be true

The results in this case illustrate the high cost of going to court with valuations that aren't based on empirical data and are, therefore, out of touch with economic reality. Hiring qualified valuators can spare your clients similar outcomes. ■

Is your expert independent?

Even the *appearance* of bias can be detrimental to an expert witness's credibility. In today's legal environment, it's common to discredit experts based on their relationship with counsel, the client or the judge. Here are three common red flags that indicate an expert may lack independence — and what you can do to prevent disqualification.

1. Undisclosed conflicts of interest. Ask the expert to contact all members of his or her firm to confirm that no member has potentially problematic relationships with any party involved in the case. These relationships may include:

- Financial, such as partners in other businesses,
- Family, either directly or by law, and
- Any close personal relationships.

It's also essential to identify and evaluate previous services provided to any party involved in the case. Naturally, the larger the firm, the more difficult the task of proving independence will be. And in smaller markets, independence may not be possible. But procedures should be in place to identify potential issues. Even if the expert has determined he or she has no conflict of interest, the expert should disclose to you all relationships, past and present, with all parties that might appear to affect independence.

2. Questionable billing practices. Avoid billing relationships that aren't the expert's standard practice. These may include premium billing rates or fixed-fee retainers regardless of actual time spent. In addition, experts should never be paid fees that are contingent on the outcome of the case. These billing arrangements may cause experts to be perceived as hired guns by judges and juries.

3. Partisan specialists. Experts who typically represent only one side of an issue may lack independence. For instance, an expert who works only for plaintiffs, or only for spouses employed outside the home, could present the appearance of a lack of independence.

If a potential expert witness has great credentials but isn't independent, you don't necessarily have to throw in the towel. Instead, consider using the expert as a *consultant* and finding another expert witness. As a consultant, the professional is free to act as an *advocate* for you and your client and to work actively toward a winning solution for your side. Plus, a consultant's services to an attorney may be protected by privilege and work product.

Can your expert witness pass the independence test? Ultimately, you must decide whether an independence issue would impair your ability to use the expert in court. A little protection up front can help you avoid serious repercussions down the road. ■

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