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Unreliable damages expert leads to summary judgment for defendant

In a recent federal case, *Motobilt, Inc. v. Bystronic, Inc.*, the U.S. District Court for the Northern District of Illinois, Eastern Division, excluded the testimony of the plaintiff's damages expert. In the absence of any evidence of damages, it granted summary judgment for the defendant.

Case facts

The plaintiff, a manufacturer of custom automotive parts, purchased equipment from the defendant that was designed to automate the process of metal sheet-cutting. The plaintiff claimed that the equipment failed to function properly. And, for more than a year and a half, the defendant failed to remedy the problem as the limited sales-order warranty required.

The plaintiff sued for breach of warranty and sought to recover losses it had allegedly suffered because of the equipment's failure to function as warranted. Both parties filed *Daubert* motions to exclude the opposing expert's testimony.

The defendant also filed a motion for summary judgment, which the court granted. It found that there were genuine issues of material fact regarding whether the defendant satisfied its warranty obligations. However, even assuming the defendant had breached the warranty, the court ruled that the plaintiff had offered "no admissible evidence to establish its damages."

Evidentiary issues

The plaintiff claimed that its inability to fill orders resulted in "lost revenue, lost profits, lost customers and lost opportunities." But no documents were produced to support that claim. Moreover, in their depositions, the manufacturer's CEO and COO were unable to quantify damages or explain how

they could be calculated. Rather, the plaintiff relied on an expert witness to calculate damages.

The expert measured damages using two valuation models. The first model was based on representations from the plaintiff's officers that the equipment was 60% less productive than it would've been if it functioned as warranted. Therefore, the expert reasoned, the value of the equipment was 60% less than the purchase price.

The second model was based on a blog post on the defendant's website claiming that automation provides 30% greater efficiency. Based on an assumed 30% loss of productivity, the expert opined that the equipment's value was 30% less than the purchase price.

The court concluded that neither model survived scrutiny under *Daubert*. Notably, the plaintiff failed to show that the witness — a certified fraud examiner with no experience valuing industrial equipment — was qualified as an expert.

But even if the expert were qualified, the court explained, his "valuation methodology — which boils down to an unexamined and unexplained one-to-one correlation between a perceived impairment in the equipment's productivity, expressed as

a percentage, and a corresponding percent reduction in the equipment's dollar value — lacks any of the usual indicia of reliability that courts typically consider."

Indeed, the expert didn't use any treatises, manuals, textbooks or other authorities to develop his damages models; had never used the methodology in another case; and wasn't aware of any court that had ever accepted the same methodology. What's more, his approach suffered from a fatal analytical flaw: His models measured the equipment's diminution in value as if its productivity were *permanently* impaired, even though the defendant ultimately repaired the equipment 20 months after the equipment was installed. At that point, it functioned as warranted. In other words, the period of alleged damages was finite, not permanent.

Absent the expert's testimony, the only evidence of damages was an affidavit of the plaintiff's CEO, estimating damages based on his "years of experience." But the court excluded this testimony because the plaintiff disclosed the CEO as only a lay witness, even though his damages opinions were "in the nature of expert testimony."

Vet your experts

This case demonstrates the importance of vetting expert witnesses. Offering experts who are unqualified or who fail to use reliable methods can lead to exclusion of their opinions and testimony. ■

8 questions to help evaluate a valuator's qualifications

When choosing a business valuation expert, you want the best. Here are eight questions to ask a prospective expert to help you gauge whether that person has the skills, knowledge and experience your case requires:

1. Do you belong to any business valuation professional organizations, such as the American Society of Appraisers, the National Association of Certified Valuators and Analysts, or the American Institute of Certified Public Accountants?
2. Are you up to date on membership dues and continuing professional education requirements for any valuation credentials you hold?
3. How many years have you worked as a valuator?
4. What percentage of your time is spent valuing businesses?
5. How many valuations have you performed in your career and over the last year? How many involved damages calculations?
6. Do you have experience valuing companies in the same industry as the subject company?
7. Have you ever testified in court? If so, what's your track record?
8. Do you specialize in a particular valuation niche?

The last item may be particularly important for testifying experts. For example, someone who works primarily for nonmonied spouses in divorce cases might be perceived as a hired gun by the court.

Astute questioning can also be invaluable when dealing with opposing experts. Guided by a valuation expert, you can devise deposition and trial questions about the opposing expert's understanding of basic valuation terms and methods, steps used to value a business, and key assumptions and limiting conditions that may affect the opinion (including scope limitations or potential conflicts of interest).

Laurilliard v. McNamee Lochner, P.C.

How legal agreements may come back to haunt minority shareholders

The New York Supreme Court for Albany County recently dismissed a complaint filed by two terminated law firm shareholders. As a result, they were forced to part with their shares for $100 each. Here's why the court held that the plaintiffs couldn't pursue an action for breach of fiduciary duty.

Agreements restrict shareholder rights

The plaintiffs were long-time shareholder-employees of a law firm with 11 shareholders. All the firm's shareholders were bound by an employment contract that provided shareholder-employees could be terminated at "the option of either Employer or Employee after not less than ninety days' written notice."

In addition, they'd signed a shareholders' agreement that included a mandatory redemption provision. It required owners to surrender their shares for $100, if their employment was terminated.

Plaintiffs squeezed out

In early 2020, the shareholders met to discuss merging with another law firm. The plaintiffs didn't support the merger, but the other nine shareholders agreed to explore the opportunity.

About a month later, several of the firm's partners — including one of the plaintiffs — received offers to become partners in the other firm. The plaintiffs unsuccessfully attempted to persuade the other shareholders to stay with the firm, and the plaintiff who received a partnership offer turned it down. Then the majority shareholders took various actions to "squeeze out" the plaintiffs. They included:

- Ceasing pension plan contributions,
- Terminating most of the firm's support staff, including the plaintiffs' administrative assistants,
- Reducing the plaintiffs' salaries, and
- Circulating a press release stating that some of the firm's attorneys would be joining the other firm.

Ultimately, the managing partners ordered the plaintiffs to vacate their offices and surrender their shares for $100 each, in accordance with the shareholders' agreement.

Plaintiffs file suit

The plaintiffs sued the firm and its majority shareholders. They alleged, among other things, breach of the employment and shareholders' agreements and breach of fiduciary duty. The plaintiffs argued that the defendants breached their fiduciary duties by driving them out of the firm to avoid sharing in the distribution of the firm's assets, including $600,000 in federal Paycheck Protection Program funds.

However, the court dismissed the complaint. It ruled that the plaintiffs

weren't entitled to relief for breach of the employment or shareholders' agreements because the plaintiffs gave the firm the unconditional right to terminate them under the employment contract. Moreover, the firm's only obligation under the shareholders' agreement was to pay $100 for each plaintiff's shares, which it attempted to do.

At-will employment trumps fiduciary duty

The defendants clearly owed fiduciary duties to the plaintiffs as minority shareholders. However, there was no breach of those duties in this case.

The court stated, "[C]ontrolling shareholders… may not enrich themselves personally by altering the terms and conditions of minority shareholders' employment to force a buy-out at a low price." However, it ruled that isn't the case when minority shareholders are "at-will employees," and their shares are subject to "mandatory repurchase by the corporation upon the termination of employment."

The court said, even if the plaintiffs' allegations were true, the parties were bound by the terms of the agreements they negotiated. Undoing the agreements based on "unfairness" would "destroy their very purpose, which is to provide a certain formula by which to value stock in the future."

Lesson learned

Consider the *Laurilliard* decision when drafting, reviewing and signing employment and shareholders' agreements. By discussing matters with their attorneys, business owners can ensure that these arrangements reflect the parties' intent — and won't come back to haunt them. ■

Unrealistic expectations

Court rejects M&A fraud damages based on speculative synergies

In *NetApp, Inc. v. Cinelli*, the Delaware Chancery Court found that the seller in a business acquisition was clearly liable for breach of contract and fraud. While the fact of the plaintiff's damages wasn't in doubt, the amount of those damages was murkier.

Inflated revenue

The case involved a data management company that acquired a cloud-based software company for $35 million. After the deal closed, the buyer discovered that the seller had improperly recorded internal software use as revenue in its financial statements, substantially inflating its revenue.

The buyer sued the seller for breach of contract and fraud. After trial, the court entered judgment in favor of the plaintiff, finding that the defendant had breached multiple representations in the merger agreement. For example, the seller falsely claimed that its financial statements complied with Generally Accepted Accounting Principles and reflected bona fide transactions.

Divergent damages theories

The remedy for breach of contract or fraud under Delaware law is based on the parties' reasonable expectations. The court explained that damages are measured "by the amount of money that would put the plaintiff in the position it would have held if the defendant's representations were true."

The seller argued that damages should be measured by the difference between the company's

"as-represented" value (the $35 million purchase price) and its "actual" value if revenue had been reported accurately. The seller's expert determined that the company's actual value was $30.4 million, based on a combination of several income- and market-based methods. The difference between these amounts was $4.6 million of estimated damages.

The court found no evidentiary basis for making a responsible estimate of lost synergistic cash flows.

In contrast, the buyer argued that damages "should address the future cash flows it planned to generate from the acquisition, irrespective of the purchase price." The buyer's expert first calculated the plaintiff's expectations using the acquired company's projected cash flow plus "synergistic cash flow." The buyer's anticipated synergies included increasing sales of the acquired software using its larger sales force and leveraging complementary products.

The expert estimated that the present value of the plaintiff's expected cash flows was $86.2 million. Then he adjusted the projections for the present value of cash flows attributable to improper internal billings ($48.5 million). The difference between these amounts was $37.7 million of estimated damages.

Speculative synergies

The seller's damages estimate was ultimately accepted. The court acknowledged that potential synergistic value between two previously separate businesses is "often a driving factor in business combinations." However, the uncertainties of integrating two businesses "may result in an overvaluation of synergies, which can take longer to capture than anticipated — if they are captured at all."

The court found no evidentiary basis for making a responsible estimate of lost synergistic cash flows. Although mathematical certainty isn't required, the buyer's anticipated synergistic cash flows were "aspirational" and assessing whether the buyer reasonably expected to realize those synergies would be a "theoretical exercise."

The court also noted that the buyer's revenue team didn't review the company's valuation model, and that its expert simply adopted the buyer's assumptions without testing its calculations or assessing their reasonableness. Moreover, the buyer discontinued sales of the acquired software four months after closing, even though the product performed as expected. So, awarding damages above the purchase price would amount to a "windfall."

Let's be real

Plaintiffs hoping to recover damages based on expected synergies should have market-based evidence to back up their claims. Courts tend to be skeptical of these damages, so it's important to demonstrate that a plaintiff's expectations are realistic. ■

Are draft reports discoverable in federal court?

Rule 26 of the Federal Rules of Civil Procedure (FRCP) governs the disclosure of expert witness testimony during the discovery stage of litigation. It underwent a major revision in 2010, which generally protects communications between attorneys and expert witnesses — including draft reports — from discovery. However, many exceptions and gray areas still exist, so it's prudent to remain cautious when exchanging documents and discussing matters with expert witnesses.

Scope of the rule

The current version of Rule 26 defines discoverable items as including, "the facts or data considered by the witness in forming the expert opinions." It protects most communications between counsel and testifying experts, "regardless of the form of the communication." Draft reports are included in the protections, because they're considered a work-in-process rather than a final work product — and they may differ from final reports.

However, the rule currently permits discovery of communications that:

- Are related to the expert's compensation,
- Identify facts or data provided by the attorney that the expert considered, and
- Identify assumptions provided by the attorney that the expert relied on.

It also doesn't provide protection for communications in which the attorney provides certain data or assumptions to use in forming an opinion. But communications in which the attorney and expert discuss 1) the potential *relevance* of facts or data that the attorney provided and 2) general *hypotheticals* using the assumptions are protected under the revised rule.

Differing interpretations

Over the years, federal courts have come to slightly differing opinions on the extent of Rule 26 protections over expert materials. For example, the U.S. Court of Appeals for the Ninth Circuit adopted a narrow view of these protections in *Republic of Ecuador v. MacKay*. The opinion states, "There is no indication that the [FRCP Advisory Committee] intended to expand Rule 26(b)(3)'s protection for trial preparation materials to encompass *all* materials furnished to or provided by testifying experts." (Emphasis added.)

Remember: The protection of draft reports applies in only federal courts, and protected drafts must be prepared "in anticipation of litigation or for trial." It also applies to discovery, though not to admissibility, during trial. States may have adopted rules that differ significantly from FRCP 26. For example, draft reports remain discoverable under California state law.

Tread lightly

Although Rule 26 generally protects draft reports from discovery, it has various exceptions that may come into play when collaborating with testifying experts. Always operate under the assumption that work product and drafts could be discoverable. Experienced experts are aware of Rule 26 and will encourage counsel to allow them to come up with independent assumptions when preparing their opinions. ■

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