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Demystifying Damages:
Five Flagrant Fouls of Financial Experts

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Speakers

Joseph Galanti, CFA, CFE

Principal, Forensics Advisory Services

Joseph.Galanti@us.gt.com

Michelle Gettinger, JD, CPA

Senior Manager, Forensic Advisory Services

Michelle.Gettinger@us.gt.com

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Learning objectives

1. Identify common errors of financial experts in their damages models
2. Identify the subtle nuances of damages claims that often render them improper
3. Cite legal and industry standards applicable to damages experts
4. Equip disputing parties and their counsel with core tools to better represent their interests and accelerate resolution of disputes

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Agenda

1 Overview

2 Discussion of Five Flagrant Fouls of Financial Experts

3 Recapitulation

4 Questions

OVERVIEW

Overview

Five Flagrant Fouls of Financial Experts

1. "**The Hockey Stick**" – Little or no historical profits then exponential growth in lost profits during the damages period.
2. "**One Is Not Like the Others**" – Subject company growth differs substantially from primary competitors, overall industry, and macro economy.
3. "**Discount Rate Delusions**" – Discount rate used to value future lost profits in today's dollars calculated incorrectly.
4. "**Causation. Causation. Causation.**" – Just as "Location. Location. Location." is key in real estate, causation is key in damages claims. Alleged damages must have a reasonable nexus to the alleged wrongful action.
5. "***Daubert* Divergence**" – Expert fails to satisfy *Daubert* requirements, which then requires judge to exercise gatekeeper role.

Bonus Free Throw:

"**Neutral Advocates**" – Instead of impartial neutrals, some experts demonstrate bias and appear to advocate for their clients.

Discussion of Five Flagrant Fouls of Financial Experts

Flagrant Foul #1 – "The Hockey Stick"

Characteristics:

- Steady track record of little or no historical profits
- Inconsistent/excessive growth in profits projected during the damages period
- Unsupported/unreasonable bridge between historical and projected performance
- Sometimes based on *ipse dixit* ("he himself said it": it is because I said so)

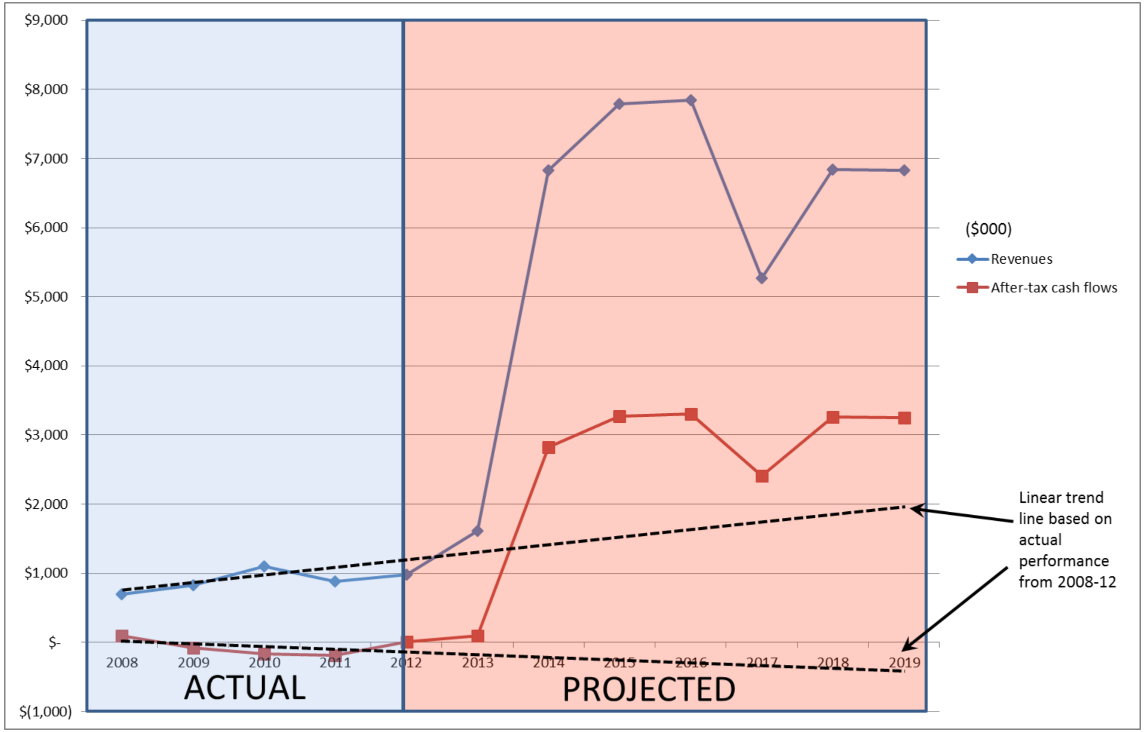
Flagrant Foul #1 – "The Hockey Stick"

Case example:

- Software developer suffered alleged damages due to an accidental fire caused by defendant
- Annual revenues of approximately **$1M** were stable for the previous 5 years, yet plaintiff projected them to jump to **$5-8M** per year during most of the 7-year loss period claimed
- Average annual after-tax cash flows of **-$63K** were stable for the previous 5 years and the highest was **$102K**, yet plaintiff projected them to jump to **$2-3M** per year during most of the 7-year loss period claimed
- Historical average annual after-tax margin was **-7%** and projected margin was **46%**
- Historical average annual earnings growth was **-38%** and projected growth was **428%**
- Historical industry earnings growth for the previous 5 years was **6-11%**
- Spike in projected revenues and after-tax cash flows was not supported by budgets, business plans, or other contemporaneous information, and it was inconsistent with historical performance, as well as research on industry and competitor performance
- Plaintiff's expert did not take ownership of the projections or perform any analysis to assess their propriety, instead relying solely on plaintiff and acting as a human calculator

Flagrant Foul #1 – "The Hockey Stick"

Demonstrative:



Flagrant Foul #2 – "One Is Not Like the Others"

Characteristics:

- Subject company performance is inconsistent with guideline company/industry performance
- Typically occurs with plaintiff claims, which may contain overly-optimistic projections
- Often accompanies "The Hockey Stick"
- Also applies to valuation disputes

Flagrant Foul #2 – "One Is Not Like the Others"

Case example:

- Plaintiff medical device manufacturer suffered alleged damages in breach of contract case relating to unpaid sales commissions
- Sales data demonstrated significant growth, but not expected to continue
- Rather than develop sales projections based on historical growth rates, expert used industry growth rate
- Industry growth rate was obtained from independent research report and was significantly lower than historical growth, but more accurately reflected anticipated sales
- No flagrant foul committed

Flagrant Foul #2 – "One Is Not Like the Others"

Demonstrative:

Table 1 - Actual and Projected Sales

	Year	Annual Sales		Growth %
Actual	2010	$	79,346	n/a
	2011	$	214,049	170%
	2012	$	415,583	94%
	2013	$	1,050,659	153%
Projected	*2014*	*$*	*1,219,815*	*16.1%*
	2015	*$*	*1,416,205*	*16.1%*
	2016	*$*	*1,644,214*	*16.1%*
	2017	*$*	*1,908,933*	*16.1%*
	2018	*$*	*2,216,271*	*16.1%*
	2019	*$*	*1,929,818*	*16.1%*

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Flagrant Foul #3 – "Discount Rate Delusions"

Characteristics:

- Purpose of discount rate is to measure future cash flows in current dollars
- Discount rate should account for both the time value of money and the riskiness of future cash flows
- Most experts use a firm's weighted average cost of capital (WACC) as the discount rate to apply to future firm cash flows
- This foul is typically committed when the discount rate **fails to properly account for future cash flow risk** (e.g., too low for plaintiff or too high for defendant)
- Often overlooked risk components are **industry risk, size risk, and company-specific risk**

Flagrant Foul #3 – "Discount Rate Delusions"

Case example:

- Software developer suffered alleged damages due to an accidental fire caused by defendant
- Plaintiff used an arbitrary **4%** discount rate for future damages in interrogatories and plaintiff's expert used a rate of **15.9%** based on build-up method
- **Incorrectly estimated size risk and ignored industry and company-specific risk**
- Size risk was about double (**12% v. 6%**) given capitalization of plaintiff, the industry was slightly more risky than the market (**0.4% v. 0%**), and company-specific risk estimated at **3.5% v. 0%**
- Company-specific risk included key employee, concentration of customers (1-2/yr. for past 5 yrs.), fraud risk, and history of losses

Flagrant Foul #3 – "Discount Rate Delusions"

Demonstrative:

	Plaintiff	**Defendant**	
Risk-free rate	2.98%	2.90%	20-yr. U.S. Treasury bond
Equity risk premium	6.96%	6.70%	Additional risk of equities
Size risk premium	5.99%	11.65%	Additional small-co. risk
Industry risk premium	0.00%	0.40%	Additional industry risk
Company-specific risk premium	0.00%	3.50%	Additional co.-specific risk
Cost of equity	15.93%	25.15%	

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Flagrant Foul #4 – "Causation. Causation. Causation."

Characteristics:

- Cause of damages not specifically linked to alleged wrongful acts
- Damages include losses attributable to causes other than the alleged wrongful acts (e.g., increased competition, industry decline, loss of customers, price increases, management changes, operational problems, macroeconomic decline, etc.)
- Projected profits not adjusted to remove impact of things that would have happened anyway

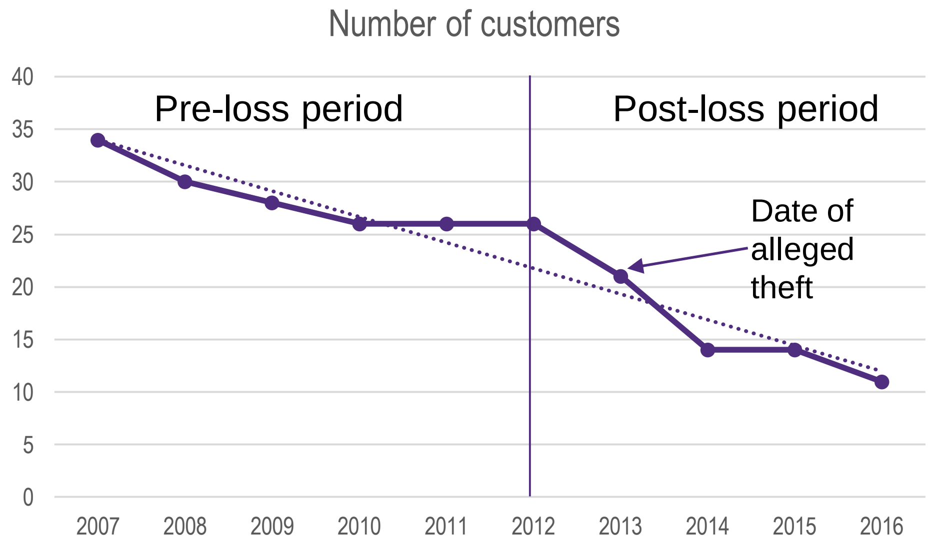
Flagrant Foul #4 – "Causation. Causation. Causation."

Case study:

- A statistics firm that analyzed utility outages and sold benchmarking reports to utility companies alleged some of its customers stole its trade secrets
- Its customers were also members of a utility company association that collected annual dues and provided industry support, training, and research
- The utility company association developed benchmarking reports using government-mandated regulatory data and provided them at no cost to members
- The statistics firm filed suit against certain customers seeking lost profits associated with the alleged theft of trade secrets
- The statistics firm reported it was losing customers prior to the alleged theft and its expert included corresponding lost profits in its damages calculations

Flagrant Foul #4 – "Causation. Causation. Causation."

Demonstrative:



Net loss	4	2	2	0	0	5	7	0	3

<u>Average annual net customer loss</u>:

2007-12: **2 customers**

2012-16: **4 customers**

Flagrant Foul #5 – "*Daubert* Divergence"

Characteristics:

- Expert fails to satisfy *Daubert* standards, which then requires judge to exercise gatekeeper role
- Typically, if expert violates *Daubert* standards, then professional standards and Federal Rules of Evidence also violated
- Several reasons courts have provided for excluding testimony include:
  - Opinions not based on sufficient facts or data
  - Underlying assumptions used to form opinions were unreliable
  - Methodology used was unreliable, novel, or inappropriate based on the facts
  - Insufficient explanation provided on how opinions were reached
- Many judges seem to avoid disqualifying/excluding experts unless they commit egregious errors that would likely mislead fact-finders
- Parties continue to challenge each other's financial experts at a steady pace

Flagrant Foul #5 – "*Daubert* Divergence"

Case example:

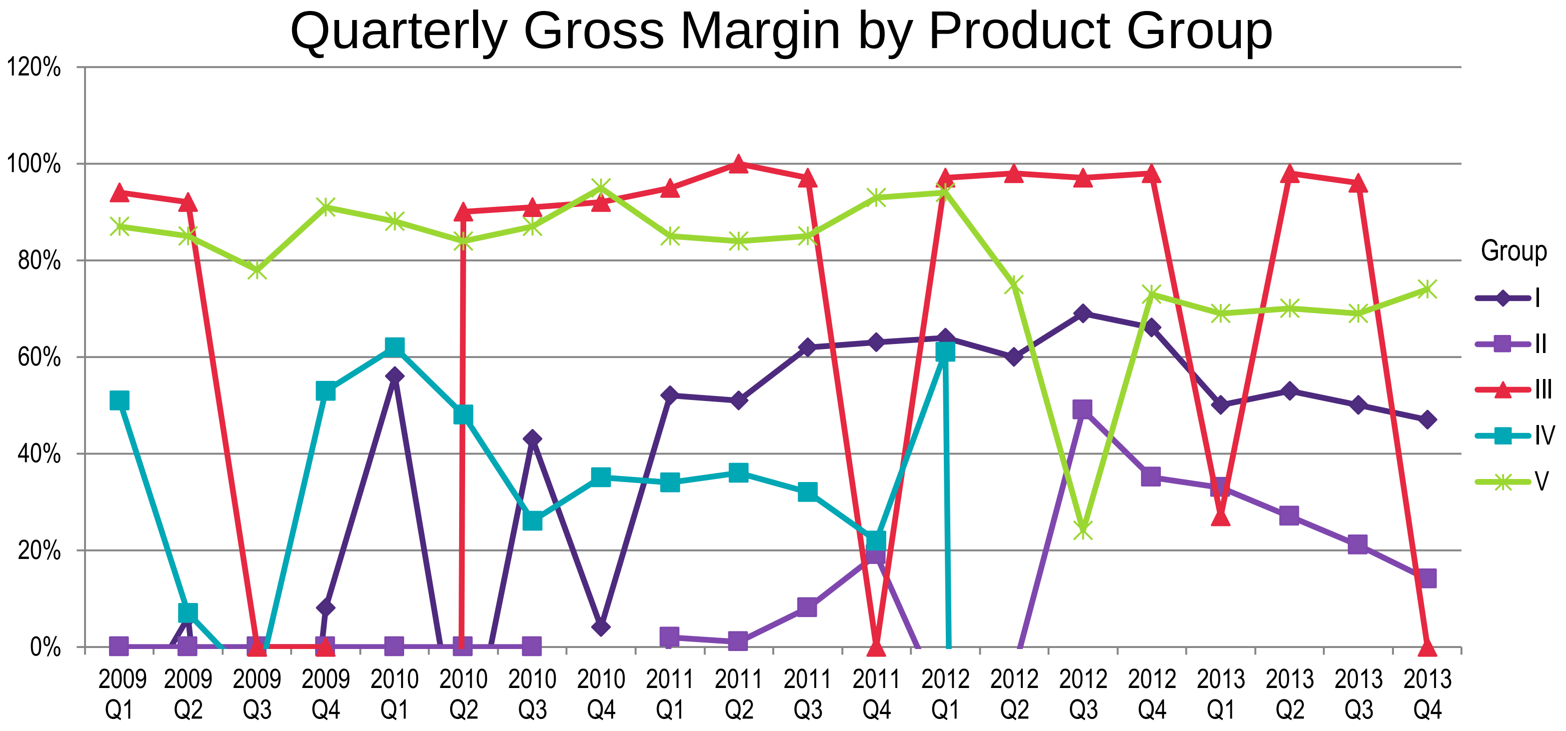
- Plaintiff medical device manufacturer suffered alleged damages in breach of contract case relating to unpaid sales commissions
- The formula for calculating gross margin on products to determine sales commissions was very clear:

$$\frac{\text{Net Sales} - (\text{Cost of Direct RM} + \text{Cost of Direct Labor to Manufacture Same})}{\text{Net Sales}}$$

- Plaintiff's expert incorrectly included overhead and other indirect costs to reduce the gross margin so that commissions would be zero or de minimis
- Plaintiff's expert even labeled some of these unallowable costs as such in his report (e.g., "Indirect Labor")
- Plaintiff's expert reformed the contract and would have misled the jury

Flagrant Foul #5 – "*Daubert* Divergence"

Demonstrative 1:



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Flagrant Foul #5 – "*Daubert* Divergence"

Demonstrative 2:

Daubert:

- Expert's theory and methodology is generally accepted in the expert's community;
- Expert's theory and methodology can be and have been tested;
- Expert's theory and methodology have been subjected to peer review and publication;
- There is a known or potential error rate and that rate is acceptable; and
- There are standards controlling expert's theory and methodology.

FRE 702:

- The expert's scientific, technical, or other specialized knowledge **will help the trier of fact** to understand the evidence or to determine a fact in issue;
- The testimony is **based on sufficient facts or data**;
- The 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.

AICPA Consulting Standards (subset):

- Professional Competence (have proper training and experience)
- Due Professional Care (exercise due professional care when performing work)
- Sufficient Relevant Data (obtain to afford reasonable basis for conclusions)
- Client Interest (accomplish objectives while maintaining integrity and objectivity)

Bonus Free Throw – "Neutral Advocates"

Characteristics:

- Expert makes unreasonable assumptions that appear to advocate client's position
- Expert forms legal conclusions in lieu of assumptions (e.g., concludes fraud)
- Expert uses biased tone
- Expert makes unsupported conclusions
- Expert develops speculative projections
- Expert adds irrelevant, judgmental commentary (e.g., opposing party is unethical, knew or should have known something, intended something, etc.)

Bonus Free Throw – "Neutral Advocates"

Case example:

- Construction management firm and construction company (plaintiffs) were engaged by a school district (defendant) to manage and execute capital improvement projects
- Plaintiffs alleged monies for capital improvements were being divested to attorney fees which impeded plaintiffs' progress on the capital improvement projects
- Defendant terminated its agreement with plaintiffs for cause and plaintiffs sued for unpaid invoices
- Defendant counter-sued for fraud, breach of fiduciary duty, and breach of contract
- In his expert report, defendant's financial expert concluded that plaintiffs committed fraud

Recapitulation

Recapitulation

Five Flagrant Fouls of Financial Experts

1. "**The Hockey Stick**" – Call a foul if there is an unsupported disconnect between past performance and projected future performance
2. "**One Is Not Like the Others**" – Call a foul if there is an unsupported disconnect between projected subject company performance and that of primary competitors, overall industry, and macro economy
3. "**Discount Rate Delusions**" – Call a foul if the discount rate does not appropriately reflect the riskiness of future damages claimed
4. "**Causation. Causation. Causation.**" – Call a foul if the damages lack a reasonable nexus to the alleged wrongful acts and other causes of loss are not ruled out or removed
5. "***Daubert* Divergence**" – Call a foul if the expert fails to satisfy *Daubert* requirements or professional standards

Bonus Free Throw:

"**Neutral Advocates**" – Call a foul if the expert demonstrates bias and appears to advocate

Any final questions?

Q&A

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Principal, Forensics Advisory Services

Joseph.Galanti@us.gt.com

Michelle Gettinger, JD, CPA

Senior Manager, Forensic Advisory Services

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