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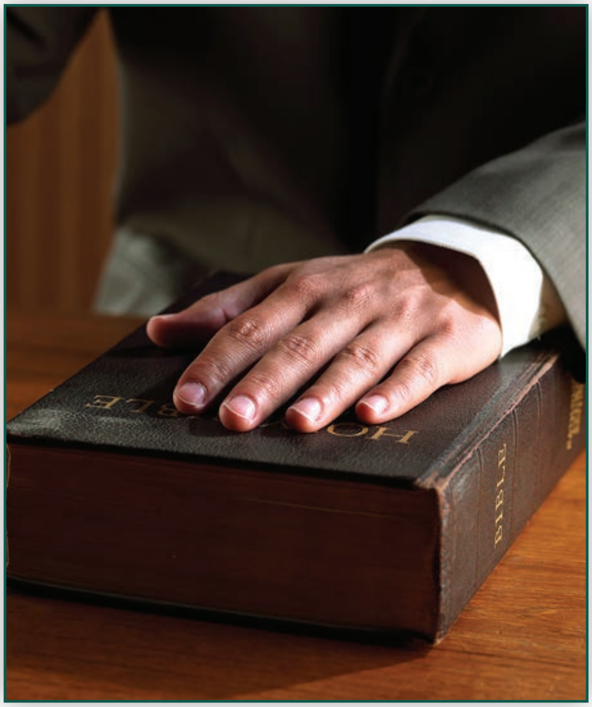
# Can a court allow an expert to *partially* testify on damages?

The U.S. Court of Appeals for the Second Circuit recently revived a massive securities fraud class action that had been dismissed by a district court in July 2014. The appellate court vacated and remanded the case based on the lower court's exclusion of the testimony from the plaintiff's damages expert. While the appellate court agreed that *some* of the testimony could be barred, here's why it found exclusion of the expert's *entire* testimony to be improper.



## Without expert testimony, plaintiffs have no case

Several investors sued Pfizer under Rule 10(b) of the Securities Exchange Act of 1934. The case involved allegations of fraudulent misrepresentations and omissions related to the safety of two anti-inflammatory drugs, Celebrex® and Bextra. The plaintiffs alleged that, when the market eventually learned about the cardiovascular risks associated with the drugs, the value of Pfizer's shares fell, damaging shareholders in the process.

After extensive discovery and almost a decade of litigation, the district court granted a motion to exclude the plaintiff's expert on loss causation and damages. It provided two reasons.

First, in an earlier summary judgment, the court had determined that Pfizer wasn't liable for certain misrepresentations made by the two companies that originally manufactured Celebrex and Bextra, from which Pfizer later obtained the rights to manufacture, promote and sell the drugs. The expert didn't "disaggregate," or isolate, the effects of Pfizer's alleged misrepresentations and omissions from the effects of the other companies' allegedly fraudulent statements. Therefore, the court concluded that his analysis would be unhelpful to the jury in determining the losses Pfizer caused.

Second, the district court ruled that the expert's testimony should be excluded due to an adjustment he made to his study of Pfizer's stock price after the court had found that the losses on two of the trading days couldn't reasonably be attributed to the alleged fraud. The court held that the adjustment rendered his opinion unreliable because he offered no explanation of its analytical basis and failed to show it was based on reliable principles and methods reliably applied.

Without the expert's testimony, the plaintiffs couldn't support key elements of their claims. The court granted Pfizer's motion for summary judgment, and the plaintiffs appealed.

## Federal appeals courts split over inflation-maintenance theory

When it comes to the inflation-maintenance theory under Section 10(b) of the Securities Exchange Act of 1934, the federal appellate courts can't seem to agree. On the same day that the U.S. Court of Appeals for the Eighth Circuit rejected the inflation-maintenance theory in a case against retail giant Best Buy, the Second Circuit released its decision in *Pfizer*, which is based on the inflation-maintenance theory.

The Second Circuit didn't decide whether the theory was legally sustainable in *Pfizer*, because it was subsequently settled out of court. But the Second Circuit has since accepted the theory, joining the Seventh and Eleventh Circuits. In a recent securities fraud case, *In re Vivendi, S.A. Securities Litigation*, the Second Circuit reasoned that rejecting the theory would allow defendants to avoid securities fraud liability whenever they perpetuated, through affirmative misstatements, existing stock price inflation, as long as they couldn't be found liable for causing the original inflation.

The *Vivendi* opinion states that it's "far more coherent to conclude that such a misstatement does not simply *maintain* the inflation, but indeed '*prevents* the preexisting inflation in a stock price from dissipating.'" When deciding on how to calculate damages, it's important to consider which theories of liability are accepted in the venue.

## Appeals court allows some expert testimony

The Second Circuit noted that the plaintiffs relied on the inflation-maintenance (or price-maintenance) theory of liability. They claimed that, by fraudulently concealing the same risks that the original manufacturers hid, Pfizer perpetuated the market's misperceptions about the drugs, causing the market to maintain an artificially high stock price.

Because the market would have adjusted the stock value to reflect the cardiovascular risks if Pfizer hadn't continued to conceal the risks, the plaintiffs asserted, Pfizer should be liable for the full amount of the price decline when the market discovered the truth. In other words, Pfizer should be liable for the full value of the price inflation, regardless of its cause.

The appeals court found that, under this theory, the expert's opinion could be helpful to the jury without disaggregating the effects of Pfizer's specific misrepresentations — because the plaintiffs don't need to disaggregate those statements to succeed at trial under their theory. But the court didn't decide whether the inflation-maintenance theory was "legally or factually sustainable." (See "Federal appeals courts split over inflation-maintenance theory" above.)

The Second Circuit did find that the district court's conclusion regarding the expert's adjustment to his study wasn't an abuse of discretion. Nonetheless, it held that the expert's failure to adequately explain the adjustment didn't justify excluding his testimony in its entirety. Rather, the district court should have prevented the expert from testifying about the adjustment and otherwise allowed him to offer his opinion about loss causation and damages.

## Exclusion goes too far

The revival of the class action against Pfizer — and a subsequent out-of-court settlement of the case for $486 million — has received most of the headlines. But the appeals court's ruling has additional significance for litigators and experts. It reiterates that wholesale exclusion of expert testimony generally isn't an appropriate response when only part of the testimony is inadmissible. ■

# To catch a thief

## ACFE report highlights most effective methods of detecting fraud

Every two years, the Association of Certified Fraud Examiners (ACFE) conducts an extensive analysis of occupational fraud. The ACFE's latest findings appear in its *2016 Report to the Nations on Occupational Fraud and Abuse*, which examines 2,410 cases of fraud in 114 countries. Its trends are consistent across borders and time — and the findings can help steer efforts to detect fraud in all types of organizations.

### Create fraud awareness

Three factors — known as the fraud triangle — must be present for fraud to occur: The perpetrator must have a perceived financial need, be able to rationalize his or her behavior and see an opportunity to commit wrongdoing. The third factor can be dramatically reduced if the company makes a would-be fraudster think there's a threat of getting caught. Strong internal controls and fraud awareness training can help keep employees honest.

Unfortunately, there's no foolproof way to prevent thieves. When fraud happens, losses are generally lower if detection happens early on. Not surprisingly, passive detection methods, such as confessions, notification by law enforcement, external audit and accidental discovery, often take longer to uncover fraud, allowing losses to pile up.

For example, frauds detected accidentally tend to last the longest, with a median duration of 24 months and a median loss of $250,000. Schemes revealed by notification from law enforcement cause the highest median loss ($1 million) and had a median duration of 36 months.

### Be proactive, not reactive

The ACFE report finds that the following detection methods are among the most effective at reducing the cost and duration of fraud losses:

| Detection method | Median loss | Median duration |
|---|---|---|
| Surveillance/monitoring | $ 48,000 | 6 months |
| Account reconciliation | $ 85,000 | 12 months |
| Internal audit | $ 100,000 | 12 months |
| Management review | $ 135,000 | 18 months |
| IT controls | $150,000 | 6 months |

What do all of these detection methods have in common? Each requires management to *proactively* look for fraud. Put simply, companies that look for occupational fraud, even when there's no sign of it, can dramatically cut the cost and duration of schemes. In some cases, they can even prevent it from occurring in the first place.

### Ask for help

Consistent with past studies, the latest ACFE report finds that tips are the most common method of detecting occupational fraud by a significant margin. While receiving tips may seem like a passive method, organizations can take a proactive

approach by providing a reporting hotline for employees, vendors, customers and others. In organizations without hotlines, some of the less effective detection methods are more than twice as common — making these organizations more vulnerable to longer and more costly schemes.

Unfortunately, many organizations overlook some of the most effective antifraud controls. For example, proactive data monitoring and analysis — used by only 36.7% of the victim organizations in the study — is correlated with frauds that are 54% less costly and 50% shorter in length. Other less common (but proactive) controls, including surprise audits and formal fraud risk assessments, show similar associations with reductions in cost and/or duration.

### Design a customized plan of attack

The ACFE report consistently shows that there's no one-size-fits-all approach to prevent and detect fraud. Fortunately, a credentialed forensic accountant can help clients customize proactive strategies to minimize fraud risks, based on what's most appropriate for their circumstances. ■

# 4 types of financial statement adjustments

Information presented on a company's financial statements may not always be meaningful from a valuation perspective — even if it follows U.S. Generally Accepted Accounting Principles (GAAP). Often, valuation experts make adjustments to get a clearer picture of a company's financial position, market risk and ability to generate cash flow in the future.

Here are four types of adjustments that may be appropriate when valuing a business interest, depending on the facts and circumstances of the assignment.

### 1. Nonstandard accounting practices

A valuation expert may estimate value by using pricing multiples derived from comparable private and public transactions (under the market approach) and discount rates derived from returns on public company stocks (under the income approach). Thus, if the subject company deviates from how other companies in its industry typically report transactions, the valuator may need to make adjustments.

Certain financial reporting practices may require adjustment, if the subject company's methods differ from industry norms. Examples include differences in inventory, depreciation or revenue recognition methods.

For example, if a company uses the last-in, first-out method (LIFO) to report inventory but other companies in its industry typically use the first-in, first-out (FIFO) inventory method, an adjustment may be needed to normalize the subject company's earnings. That's because companies that use LIFO tend to report lower inventory values and higher cost of sales, assuming an inflationary market and increasing inventory levels, than companies that use FIFO.

## 2. Extraordinary or nonrecurring items

Sometimes future performance deviates from historic performance. A valuation expert might need to strip nonrecurring or extraordinary items from the financial statements to normalize the economic benefits stream. Examples include start-up fees, remodeling costs, pending litigation, discontinued business lines, capital losses and gains (or losses) on sales of fixed assets.

> Discretionary adjustments typically are *not* taken when valuing a business interest that lacks control over day-to-day decisions.

Valuators also adjust for nonoperating assets and liabilities, such as marketable securities, real estate and shareholder loans. These items typically have different risk profiles and, therefore, may need to be valued separately from the business's operating assets, possibly using higher or lower discount rates.

## 3. Hidden assets and liabilities

Under GAAP, some assets and liabilities may not be reported on the balance sheet, even though they may affect the value of the business interest. Valuation experts consider the existence of unreported assets and liabilities — and they may adjust the balance sheet accordingly, especially when using the cost approach to value a business.

Examples include internally generated intangible assets (such as goodwill and customer lists) and contingent liabilities (such as pending litigation, tax investigations and warranties). Some tangible assets also might require adjustments. For example, accounts receivable may require an adjustment to net realizable value, or inventory may need to be reduced from missing or damaged items.

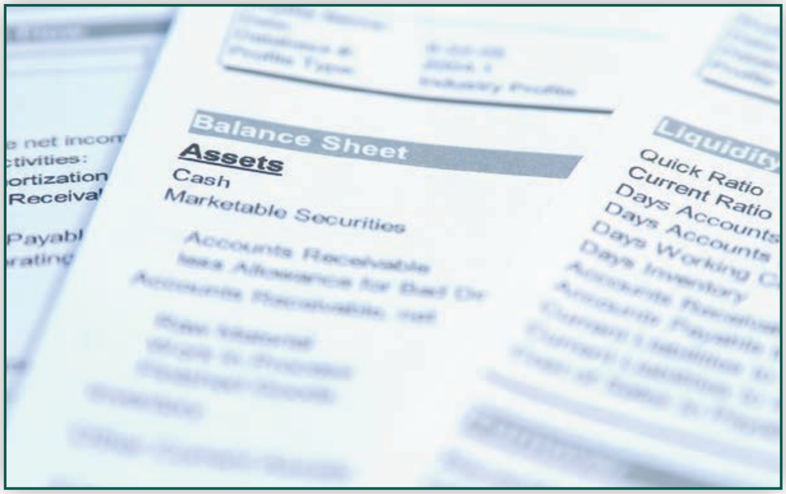
## 4. Discretionary spending

Controlling owners make key decisions about discretionary spending items, such as hiring employees, choosing vendors and paying dividends. When valuing a controlling interest, a valuation professional may need to adjust financial statements for discretionary spending to more accurately reflect the economic benefits to a prospective buyer. Adjustments are especially common for small private businesses that engage in related party transactions at above- or below-market rates or pay the owners' personal expenses with the business checking account.

Discretionary adjustments typically are *not* taken when valuing a business interest that lacks control over day-to-day decisions, however. When valuators refrain from adjusting the financial statements for discretionary spending, the value based on unadjusted economic benefits contains an implicit discount for lack of control. In other words, this methodology may generate a minority basis of value, eliminating the need to apply a separate explicit discount for lack of control.

## Small adjustments, big effects

Valuation experts consider various adjustments during the appraisal process. But they're not all appropriate for every business interest. Deciding what's appropriate is critical, because adjustments can have a substantial effect on value. A credentialed, experienced valuator can help make the right adjustments for your situation. ■



*ESOP litigation*

# Qualified experts preempt breach of fiduciary duty claims

Transactions involving employee stock ownership plans (ESOPs) are complicated and can pose significant risk to those involved. A district court's ruling in a recent ESOP case shows how the use of a qualified valuation expert can help protect trustees from liability under the Employee Retirement Income Security Act (ERISA).

## Buyback leads to bankruptcy

In December 2003, Antioch Company purchased all outstanding shares of its stock that were held outside of its ESOP. The transactions were part of an arrangement designed to leave the company 100% ESOP-owned. The company's board of directors retained GreatBanc Trust as the ESOP's independent trustee for the transaction. In turn, the trustee hired a team of credentialed valuation advisors to consult on the deal.

Antioch Company later reorganized through a Chapter 11 bankruptcy, and the new capital structure didn't include an ESOP. Contending that the ESOP's shares became worthless after the buyback transaction, some employees sued three former members of the company's board or internal ESOP Advisory Committee, alleging several ERISA violations.

## Expert supports business judgment

The plaintiffs' claims required them to demonstrate — among other things — that the trustee had breached an ERISA-based fiduciary duty of prudence to the ESOP. But the court found that GreatBanc had conducted a thorough review of the transaction and worked diligently to protect the ESOP's interests.

Among other things, the trustee engaged top financial and legal advisors, including its valuation experts. While this doesn't provide a complete defense, the court ruled that it provides evidence that the trustee acted prudently. The trustee met at least three times with members of the valuation firm to discuss their interim, preliminary and final analyses.

The plaintiffs argued that GreatBanc had breached its fiduciary duty by accepting the valuator's fairness opinion and underlying financial analysis. "The plaintiffs seem to suggest that the alleged deficiencies in the … analysis were so apparent … that GreatBanc breached its fiduciary duties in accepting them, but this argument is not supported by the trial record … Nothing about [the] analysis of the transaction should have put GreatBanc on notice that it would be imprudent to rely upon its financial expert's fairness opinion."

## Claims are dismissed

The court ultimately dismissed all of the ERISA claims against the defendants, with the valuation expert's contributions to the process weighing against each of them. The takeaway from this case is simple: To safeguard against breach of fiduciary duty claims, perform due diligence by hiring a qualified valuation expert *before* pursuing any ESOP transactions. ■

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