Bankruptcy Litigation Committee
ABI Committee News

In This Issue **Volume 8, Number 2 / March 2011**

Using Experts in Bankruptcy Litigation: The Rules Matter

by: Howard P. Magaliff [1]
DiConza Traurig Magaliff LLP; New York

Committee Officers

Upcoming Events

Contribute to the Newsletter

ABI World

Newsletter Archives

I sometimes joke that "bankruptcy litigator" is an oxymoron because bankruptcy and litigation practice often seem fundamentally at odds. Bankruptcy is, first and foremost, an equitable process, designed to be flexible and pragmatic in practice, which works best when it is consensual. By contrast, litigation is rules-driven: The process is made rigid by the Federal Rules of Civil Procedure (FRCP) and Federal Rules of Evidence (FRE), deviation from which can have severe consequences. It is the opposite of consensual; it is combative.

Bankruptcy practitioners often commence litigation with the goal of achieving a settlement. Even so, there are times when lawyers are willing to gloss over important rules of trial practice, but this can be dangerous. A bankruptcy court may be flexible and allow leeway but an appellate court will not necessarily take the same view. While you may prevail at trial, failure to follow the rules of procedure and evidence can cause you to lose on appeal.

The approach to litigating in bankruptcy court should be the same as litigating in any other federal court. Litigation is governed by Part VII of the Bankruptcy Rules [2] and the FRE. [3] The Part VII rules generally incorporate the FRCP, and can be broadly

classified into three groups: (1) pleadings, parties and process; [4] (2) discovery; [5] and (3) trial. [6] In my experience, it is in the area of evidence, rather than procedure, that bankruptcy lawyers tend to falter. This article focuses on the use of experts in bankruptcy litigation, and precluding or limiting expert testimony.

Expert Disclosures [7]

The starting point in litigation, if you contemplate using a testifying expert, is to tell your adversary, which is critical. Fed. R. Civ. P. 26(a)(2) requires a party to disclose to the other parties the identity of any witness that may be used at trial to present evidence under FRE 702 (testimony by experts), 703 (bases of opinion testimony by experts) or 705 (disclosure of facts or data underlying expert opinions). The 1993 amendments to the FRCP introduced the mandatory expert report of Fed. R. Civ. P. 26(a)(2)(B). The report is required of every expert who is "retained or specially employed to provide expert testimony…or whose duties as an employee of the party regularly involve giving expert testimony" under Rule 26(a)(2)(B), and must include: (1) a complete statement of *all opinions* to be expressed and the *basis and reasons* therefor; (2) the data or other information [8] *considered* by the witness in forming the opinions; (3) any exhibits to be used as a *summary of or support* for the opinions; (4) the qualifications of the witness, including a list of all publications authored by the witness within the preceding 10 years; (5) the compensation to be paid for the study and testimony; and (6) a listing of any other cases in which the witness has testified as an expert at trial or by deposition within the preceding four years. It is incumbent on you to disclose this information without waiting for another party to ask. [9]

Absent a stipulation or court order, a party is required to make its expert disclosures at least 90 days prior to the start of trial under Fed. R. Civ. P. 26(a)(2)(C)(i). If the expert is being offered solely to rebut evidence offered by another party, these disclosures must be made within 30 days after the other party's disclosure.

What Happens if You Do Not Make Timely Disclosures?

Fed. R. Civ. P. 37(c)(1) provides that "[i]f a party fails to provide information or identify a witness as required by Rule 26(a) or (e), the party *is not allowed* to use that information or witness…at a trial, unless the failure was substantially justified or is harmless." If the court does not find harmless error or substantial justification, the expert's testimony will be precluded. This is not some hypothetical remedy that is not applied in practice. Judges frequently exclude opinions and exhibits that are not disclosed in a timely fashion under Fed. R. Civ. P. 26(a)(2)(B). [10] Experts have even been stricken for failing to provide the mandatory case list identifying prior testimony they have given over the past four years. [11]

As with many rules, there are exceptions. Rule 37 states that if the court finds that a sanction is warranted, "[i]n addition to *or instead* of this sanction (*i.e.,* mandatory preclusion), the court, on motion and after giving an opportunity to be heard" may impose *other appropriate sanctions*. [12] In other words, the consequence of failing to timely disclose a trial expert is discretionary with the judge. A late disclosure can be excused if it was substantially justified or harmless, thereby avoiding mandatory preclusion of the expert's testimony at trial, but even in the absence of harmless error or substantial justification, the judge can impose a lesser sanction.

The Role of Experts

Disclosing your expert is mandatory, while deciding whether to offer the expert as a witness at trial involves strategic considerations. As Fed. R. Civ. P. 26(a)(2)(A) provides, disclosure extends to any witness a party *may* use at trial to present expert evidence. Failing to disclose can lead to preclusion of the expert's testimony, thus cutting off both your strategic option to offer or not offer the witness, who may be the only evidence you have for a decisive element of your case. Assume that you have made your disclosures and finished discovery, and decided that your expert is going to testify at trial. FRE 702 governs expert testimony in federal court, and provides:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.

The Supreme Court has held that Rule 702 imposed a gatekeeping function on the trial court to ensure that an expert's testimony "both rests on a reliable foundation and is relevant to the task at hand." [13] Thus, to be *admissible*, expert testimony must be reliable *and* relevant. [14] An expert opinion under Rule 702 is relevant if it "will assist the trier of fact to understand the evidence or to determine a fact in issue." The party offering the expert bears the burden of establishing admissibility by a preponderance of the evidence. [15] The essential inquiry under Rule 702 is the "validity and thus the evidentiary relevance and reliability of the principles that underlie a proposed submission. The focus, of course, must be solely on principles and methodology, not on the conclusions that they generate." [16] Reliability within the meaning of Rule 702 requires a sufficiently rigorous analytical connection between the methodology employed by the witness and his or her conclusions. [17]

The purpose of this inquiry into reliability is to "make certain that an expert, whether basing testimony upon professional studies or personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field." [18]

What does this mean in practice?

Preference cases involve factual questions such as the debtor's insolvency, and the ordinary course of business, which are particularly well suited to expert analysis and testimony. It is especially important that experts are carefully chosen and vetted thoroughly, and make certain that they are qualified within the meaning of Rule 702 if they are going to be offered as testifying witnesses. This was not done by the defendants in a recent preference case tried in the bankruptcy court [19] where the court rejected the testimony of one of the defendants' experts on ordinary course of business because in one instance, the testimony was not the product of reliable methods, and in the second instance, the testimony was not based on sufficient facts and data.

The plaintiff sued to recover $20 million of preferential transfers. The defendants manufactured tools and dies that they sold to a tier 1 supplier in the automotive industry. [20] A central issue was whether payments that were made to the defendants were within the ordinary course of business in the automotive industry. [21] The defendants offered the testimony and reports of three experts.

During his deposition, the first expert testified that in preparing his report, he spoke with five former colleagues from other automotive supply companies about payment terms in the industry. He testified that he spoke to these colleagues informally to get a sense of whether they agreed with his conclusions, not as an integral part of forming his opinions. He also testified that he did not make the calls to specifically ask their opinions; those discussions were more in the nature of "while I have you on the phone, let me ask you something." Nonetheless, he refused to name the individuals with whom he spoke, thus denying the plaintiff the opportunity to depose them and verify the accuracy of the information the expert considered. He also conceded that he did not even know whether the information the former colleagues provided was accurate, because he had no industry data against which to measure their opinions.

Plaintiff's counsel filed a motion *in limine* to exclude the report and all testimony by the expert at trial. The plaintiff argued that under Rule 702, the facts and data upon which the expert relied in forming his opinion were insufficient and unreliable, in particular due to the manner in which he obtained them. The expert simply asked

former colleagues about their recollection of payment practices in the industry without (1) giving them advance notice of the information he wanted, (2) informing them that he was preparing an expert report, (3) identifying the time period during which the transfers were made as relevant or (4) asking them to get back to him with accurate data once they knew what information he was seeking. As a result, the data that the expert collected consisted of nothing more than his former colleagues' incomplete recollections of payment terms for tooling at various times in the past. It was asserted that any conclusions the expert drew from his former colleagues' statements were not based on sufficient facts and data.

The defendants countered that the information that the expert obtained from industry professionals went to the weight of his testimony, not its admissibility. [22] The defendants also argued that knowledge of industry payment terms would come from experience, and that it was not necessary to review actual data for information the professionals already knew. The fact that the expert did not disclose the names of the people with whom he spoke did not mean that their information was neither accurate nor reliable. The defendants asserted that the expert spoke to these former colleagues to verify his conclusions, not as a source of information to form his opinions.

The court deferred ruling on the motion *in limine* until after the expert's trial testimony. Unfortunately for the defendants, that testimony completely undermined the expert's opinion. Contrary to what he explained at his deposition, he testified at trial that the phone calls were an important part of ensuring that the information included in his report was reliable, and that double-checking his conclusions was part of the procedure and process that his firm utilized and approved when providing expert testimony. He also testified that double-checking his conclusions helped to make his method of preparing expert reports reliable.

The court concluded that resolution of the motion *in limine* was governed by Rule 702, which permits expert testimony if three conditions are met, one of which is that "the testimony is the product of reliable principles and methods." The court found that based on the expert's trial testimony about the importance of the confirming phone calls to his method of preparing the report, his failure to identify the former colleagues at his deposition could not be disregarded. The court rejected the expert's opinion because of his refusal to disclose the identities of the individuals with whom he had spoken to confirm his opinion, which made it impossible to determine the reliability of his methods. It also made it impossible to test the basis for his opinion on cross-examination. The refusal "totally undermined [the expert's] credibility and that of his report and his opinion." The court did not allow the witness to testify as an

expert.

The defendants were unable to establish their ordinary-course-of-business defense, and the plaintiff obtained a judgment in excess of $19 million. [23] Had the defendants been more careful in choosing their witnesses and making certain they could satisfy Rule 702, the outcome might have been different.

Valuation

In *In re Nellson Nutraceutical Inc., et al.*, [24] the bankruptcy court held a trial to consider a chapter 11 debtor's enterprise value. The debtor offered the testimony of a valuation expert, and after the trial's conclusion, the creditors' and secured lenders' committees filed a joint motion *in limine* to exclude the expert's testimony and report. At issue was whether the opinion was admissible under FRE 702 as an expert opinion.

Relevant Third Circuit law provided that Rule 702 encompasses three restrictions on expert testimony: qualification, reliability and fit—that is whether the testimony is sufficiently reliable and relevant to be admissible as expert testimony. The trial court determined that the expert was qualified, and that his opinion was relevant. The issue of whether his testimony would be admissible turned on whether it was reliable.

The expert utilized the discounted cash-flow (DCF) method to determine the debtor's enterprise value. As part of that methodology, the expert was required to calculate the debtor's terminal value at a certain date. The expert testified that he used the debtor's EBITDA minus cap ex to calculate terminal value. He also testified that (1) this method had never been used by any expert before any U.S. court to determine a company's terminal value under a DCF analysis, (2) he never used this methodology in any expert report that he ever submitted to a court and (3) he could not identify any publications, treatises or articles that validated the use of EBITDA minus cap ex to determine terminal value under a DCF analysis.

The motion *in limine* asserted that the expert's method to determine terminal value was not reliable, and that his opinion of enterprise value was therefore inadmissible, with which the court agreed. The court, applying a *Daubert* analysis, [25] concluded that because the expert had simply invented the EBIDTA minus cap ex methodology, it was inherently unreliable. The court excluded the expert's opinion. Further, because the calculation of terminal value constituted the bulk of the expert's ultimate conclusion of enterprise value, the court excluded all of the expert's testimony.

Conclusion

Experts play an increasingly critical role in bankruptcy cases. Bankruptcy lawyers routinely rely on experts in matters including solvency opinions in litigation, valuation in § 363 sales and contested confirmation hearings. If it is necessary to litigate, it behooves both the clients and the practice as a whole for bankruptcy lawyers to know the rules as well as the substantive law. Understanding the rules of evidence and civil procedure, and how to use them to your advantage, will make the "bankruptcy litigator" a worthy advocate, not an oxymoron.

1. The views expressed in this article are solely the author's views.

2. Bankruptcy Rule 7001 states, "[a]n adversary proceeding is governed by the rules of this Part VII." Bankruptcy Rule 9014(c) makes the procedural and discovery rules of Part VII, with certain exceptions concerning mandatory disclosures, applicable in contested matters. In keeping with bankruptcy's flexible approach, Bankruptcy Rule 9014(c) also gives the court the power to direct that any of the Part VII rules shall apply.

3. *See* Bankruptcy Rule 9017 and *infra.*

4. Rule 4 (service of process; note that Bankruptcy Rule 7004 authorizes nationwide service by mail of the summons and complaint, and all process other than a subpoena); Rule 5 (service and filing of pleadings); Rule 8 (general rules of pleading); Rule 9 (pleading special matters); Rule 12 (presenting defenses); Rules 13, 14 and 15 (counterclaims and cross-claims, third-party practice, and amended and supplemental pleadings); Rule 16 (pretrial procedure and planning conference); Rule 18 (joinder of claims and remedies); Rules 19 and 20 (mandatory and permissive joinder of parties); Rule 22(a) (interpleader); Rule 41 (dismissal of adversary proceedings); and Rule 56 (summary judgment).

5. Rule 26 (general provisions governing discovery); Rule 30 (oral depositions); Rule 31 (written depositions); Rule 32 (use of depositions in adversary proceedings); Rule 33 (interrogatories); Rule 34 (production of documents; entry upon land for inspection); Rule 35 (physical and mental examinations); Rule 36 (requests for admissions); Rule 37 (failure to make discovery; sanctions); and Rule 45 (subpoena).

6. Bankruptcy Rule 9017 provides that the FRE and FRCP 43, 44 and 44.1 apply in cases under the Bankruptcy Code. Rule 43 covers the taking of testimony; Rule 44 dictates how to prove an official domestic or foreign record; and Rule 44.1 is the

procedure for determining foreign law.

7. Bankruptcy Rule 9014(c) provides that Fed. R. Civ. P. 26(a)(2) (disclosures regarding expert testimony) shall not apply in a contested matter governed by Rule 9014, unless the court directs otherwise.

8. The phrase “data or other information” was replaced by “facts or data” in the December 2010 amendments to the FRCP.

9. Rule 26(a)(2)(C) was added in the December 2010 amendments to the FRCP and provides if an expert witness is not required to provide a written report, the disclosures must state the subject matter on which the witness is expected to present evidence under FRE 702, 703 or 705 and a summary of the facts and opinions to which the witness is expected to testify.

10. *See generally,* Joseph, *Sanctions: The Federal Law of Litigation Abuse* §§ 48-49 (3d ed. 2000; Supp. 2007).

11. *See Ortiz-Lopez v. Sociedade Espanola*, 248 F.3d 29 (1st Cir. 2001).

12. Rule 37(c)(1)(C). *See Roberts v. Galen of Virginia Inc.*, 325 F.3d 776, 784 (6th Cir. 2003) (“Rule 37(c)(1) does not compel the district judge to exclude testimony in its entirety.”)

13. *Daubert v. Merrell Dow Pharm.*, 509 U.S. 579, 597 (1993); *see also Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 141 (1999).

14. *See* FRE 402 (“Evidence which is not relevant is not admissible.”).

15. *Bourjaily v. United States*, 483 U.S. 171, 175-76 (1987).

16. *Daubert*, 509 U.S. at 594-95.

17. *Gen. Elec. Co. v. Joiner*, 522 U.S. 136, 146 (1997) (finding that district court did not need to admit opinions that are connected to facts merely by *ipse dixit* of expert).

18. *Kumho*, 526 U.S. at 152.

19. *Collins & Aikman Corp., et al. v. H.S. Die Engineering Inc., et al.*, Adv. Pro. No. 07-05571 (SWR) (*In re Collins & Aikman Corp., et al.*, Case. No. 05-55927, Bankr. E.D. Mich.).

20. A tier 1 supplier produces component parts for the original equipment manufacturer, which is the industry term for the company that actually makes the

cars.

21. The adversary proceeding was brought under the pre-2005 amendment to § 547, so that the ordinary-course-of-business defense in § 547(c) required the defendant to prove both the subjective course of dealing with the plaintiff and the objective industry practice.

22. *See McLean v. 988011 Ontario Ltd.*, 224 F.3d 797, 801 (6th Cir. 2000).

23. New-value defenses of approximately $1 million were allowed as an offset.

24. 356 B.R. 364 (Bankr. D.Del. 2006).

25. In *Daubert*, the Supreme Court identified factors which a court may consider in assessing reliability of an expert's testimony, including (1) whether a theory or technique can be, and has been, tested, (2) whether the theory or technique has been subjected to peer review and publication, (3) a technique's known or potential rate of error and the existence and maintenance of standards controlling the techniques operation and (4) whether a particular technique or theory has gained general acceptance in the relevant scientific community. 509 U.S. at 593-94.