Litigation & Valuation REPORT

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Adventures in e-discovery

New rules, new strategies

The advent of computers has radically altered the business paradigm. Today's companies couldn't function without e-mail and other electronically stored information (ESI). To keep pace with the electronic transformation of business operations, recent e-discovery amendments to the Federal Rules of Civil Procedure (FRCP) are having a profound impact on discovery practices involving ESI.

The new rules impose additional responsibilities on counsel to oversee clients' document management and discovery activities. They also make it even more important to get experts involved early to help ensure that ESI is received in a usable format.

Highlights of the new rules

Key amendment provisions include:

Rule 16. The amended rules emphasize the importance of addressing e-discovery issues early. Thus, Rule 16 now provides that a scheduling order may include "provisions for disclosure or discovery of ESI" and any agreements the parties reach on handling privileged materials or work product that attorneys inadvertently produce.

Parties must confer early in the litigation process to address e-discovery issues.

Rule 26. Parties must confer early in the litigation process to address e-discovery issues. These include how the discoverable information will be preserved, the form the ESI should take and any potential privilege claims.

The rule also requires parties not to wait for a discovery request to disclose ESI they may use to support their claims or defenses. Disclosure means providing a copy of the information or describing its category and location.

But a party doesn't need to produce the ESI — at least not right away — if the information isn't reasonably accessible. For example, obtaining "legacy" data or disaster-recovery backup tapes may impose an undue burden or expense.

In the event of a motion to compel, the respondent must show that the information isn't reasonably accessible. The court may still compel production for good cause, but it has some flexibility to place conditions and limits on the discovery.

Rule 26 also establishes procedures for dealing with inadvertent disclosure of allegedly privileged ESI.

Rule 33. A party may produce ESI in response to interrogatories provided the burden of doing so "is substantially the same for the party serving the interrogatory as for the party served."

Rule 34. This rule allows the requesting party to specify the ESI format it prefers. The rule also establishes procedures for resolving disputes over the form of ESI production. If no format is specified, the respondent can produce ESI in the form in which it's ordinarily maintained or in some other form that's "reasonably usable."

Rule 37. The amendments establish a safe harbor to protect parties against sanctions for failing to provide ESI "lost as a result of the routine, good-faith operation of an electronic information system."

The impact

Practically speaking, the recent rules require attorneys to become intimately familiar with clients' electronic data "architecture" as well as clients' policies and procedures for storing, archiving and destroying ESI.

Rule 37's safe harbor recognizes that ESI may be deleted through routine operation of a company's backup and document retention procedures. But the concept of "good faith" means this protection may be lost if a client allows ESI to be destroyed despite a duty to preserve information for pending or reasonably anticipated litigation.

If litigation is imminent, attorneys should work closely with clients to design and implement a "litigation hold" to preserve ESI that's likely to be discoverable and not available from other reasonably accessible sources. But determining the scope of a client's duty to preserve ESI can be a challenge. For instance, in a controversial ruling in *Columbia Pictures v. Bunnell*, the U.S. District Court for the Central District of California found that information in a server's random access memory (RAM) was ESI and ordered the defendant to start logging certain RAM content and producing the logs, rejecting the defendant's objection that this was tantamount to creating new documents solely for purposes of production.

The expert's role

Forensic experts can help attorneys understand and manage clients' e-discovery obligations. For the best results, it's helpful to involve financial or valuation experts early in the discovery process.

Experts typically need to review and analyze large amounts of data, and they can help draft discovery requests designed to obtain ESI in a usable, cost-effective format. Once the data is received in a particular format (hard copy, for example), it may be too late to request an alternative format, such as an Excel file.

In addition, confer with your experts about their own ESI. Can they overwrite electronic drafts of reports? Are electronic drafts discoverable? Does an expert have a duty to preserve them?

In *University of Pittsburgh v. Townsend*, the U.S. District Court for the Eastern District of Tennessee found that experts had no affirmative duty to preserve or disclose electronic draft reports. But if they received deposition subpoenas that clearly requested drafts, they were obligated to retain and produce them. The parties were not subject to sanctions, however, for draft reports destroyed before the subpoenas.

Be prepared

The recent e-discovery amendments to the FRCP help clarify that identifying ESI early in the case is key in preparing for e-discovery. It's also important to determine the burden and expense of collecting and producing the ESI and to request it in a usable format.

There are still many unanswered questions about the parameters of e-discovery. The answers will come over time as courts grapple with these rapidly evolving legal and technical issues. ❏

Hiring an expert?

Beware the dangers of advocacy

In settling a dispute through litigation, one side or the other may need to hire an expert witness. Unlike an attorney, an expert is not there to be an advocate for the client. All too often, however, experts do act as advocates — either at the urging of counsel or because they want to please the client.

This is a dangerous situation and one that often backfires, especially in today's post-*Daubert* environment. With courts scrutinizing experts' assumptions and methods, anything less than an impartial analysis of the evidence can hurt a client's case.

The expert's role

An expert's job is to educate the judge and jury and help them reach a fair decision. It is not to advocate a particular outcome.

When an expert does act as advocate, this is usually readily apparent to the court. That's because an expert who attempts to support a particular position typically manipulates the methods, underlying assumptions or both to arrive at the desired result.

Much of what experts do involves subjective judgment, particularly in the areas of damage calculations and business valuations. But though experts have some leeway in selecting assumptions and applying methods, there are clear boundaries. When an expert consistently pushes the limits of those boundaries — or even crosses the line — it's painfully obvious to other experts and, increasingly, to the courts.

Consequences of advocacy

Experts who appear to take sides often do more harm than good. In recent years, there have been many cases in which courts disregarded one party's expert and relied completely on the other party's expert. In other cases, courts have thrown out both experts' testimony and instead performed their own analyses.

Estate of Thompson, for example, involved the valuation of stock for estate tax purposes. The estate's expert calculated a value of $1.75 million, while the IRS expert arrived at a value of more than $32 million. The Tax Court rejected the testimony of both experts and, based on its own calculations, valued the stock at around $13.5 million.

The court found many problems with both parties' expert opinions. The estate's experts, for example, applied a 40% minority discount and a 45% marketability discount. Not only were these discounts "extreme and highly favorable for the estate," but also the experts failed to offer any "credible substantive discussion of how the facts of this case support such particular discounts."

Similarly, the IRS expert's analysis contained significant errors. Several recalculations weren't sufficiently explained and appeared designed to inflate the company's value.

If either expert had presented a fair view of the facts, it's possible the client would have obtained a more favorable outcome.

Experts under pressure

Widespread advocacy on the part of experts also puts added pressure on experts who conduct impartial analyses of the facts. To avoid suspicion, these experts must thoroughly explain and document their assumptions and methods.

Consider the case of *Parlour Enterprises, Inc. v. The Kirin Group, Inc.* A California appellate court threw out a jury award of more than $6 million in lost profits damages because it found the testimony of the plaintiff's expert to be too speculative. But the court's criticisms focused more on the expert's failure to explain his methods and assumptions than on the end result.

For example, the expert relied on prelitigation projections prepared by the plaintiff, but he was unable to identify their source or the qualifications of the person who prepared them. He also analyzed market data from another company but failed to offer any evidence that it was comparable to the plaintiff's business.

Make a case

To improve the chances of successful litigation, it's important to be aware of the dangers of expert advocacy and the importance of presenting the facts fairly. Any expert opinion must be based on reasonable assumptions, accepted methodology and reliable empirical data. ❑

Defense experts and the “double or nothing” strategy

Defendants are often reluctant to put a damages expert on the stand. But defendants that don’t offer an alternative damages calculation are taking a big gamble. One litigant recently learned this lesson the hard way in *FMS Inc. v. Volvo Construction Equipment North America Inc.*

Defendant digs itself into a hole

The plaintiff, FMS, sold excavators in Maine under a dealer agreement with Samsung. Volvo acquired Samsung and notified FMS that it was discontinuing the Samsung excavator line and terminating the dealer agreement. But Volvo continued to manufacture excavators based on the Samsung platform and sell them through another Maine dealership.

FMS and several other former Samsung dealers sued Volvo for wrongful termination of their dealer agreements. Initially, the district court granted summary judgment for Volvo, but the appellate court found that Maine franchise law “applied to trump termination provisions in FMS’s dealer agreement” and remanded the case for trial.

Volvo presented an expert who challenged the FMS expert’s assumptions and methods but offered no alternative damages calculation. Volvo also argued that FMS’s damages evidence should be excluded under the *Daubert* standard as speculative and unreliable, but it didn’t raise the issue until after both sides had rested their cases. The jury awarded FMS more than $2 million in lost profits.

Volvo moved for judgment as a matter of law or, alternatively, for a new trial on various grounds. But the focus of Volvo’s argument was that the testimony of FMS’s damages expert was unreliable under the *Daubert* standard and impermissibly speculative.

A losing bet

The district court held that Volvo had waived its *Daubert* challenge because it raised the argument too late. It also rejected Volvo’s argument that the FMS expert’s testimony was unduly speculative. The court explained that the plaintiff’s expert:

“… used accepted methodology, and supported FMS’s owner’s testimony with historical financial information and industry projections. While Volvo may disagree with the choices [the expert] made . . . [his] analysis is not speculative or conjectural such that Volvo could not challenge the basis for his opinions by cross-examination and the presentation of competing theories.”

A calculated risk

Regarding Volvo’s decision not to present an alternative calculation of lost profits, the court quoted *Empire Gas Corp. v. American Bakeries Co.*, saying the “[defendant] may have feared that if it put in its own estimate of damages, the jury would be irresistibly attracted to that figure as a compromise. But if so, [defendant] gambled double or nothing, as it were; and we will not relieve it of the consequences of its risky strategy.”

Cases like *FMS* illustrate the dangers of a “double or nothing” strategy. While the strategy may be important in some cases, it’s important to talk with clients about the dangers of not presenting an alternative damages calculation. ❑

Preferred stock presents uncommon valuation challenges

Small and midsize companies increasingly use preferred stock, once associated primarily with large companies. Unlike common stock, preferred stock can be designed with practically limitless combinations of rights and privileges, making valuation a challenge. Typically, preferred stockholders trade limited upside potential for cash dividend preferences and protection against some of the risks associated with common stock.

A valuation of preferred stock may be required in several contexts, including preferred stock sales, mergers and acquisitions, gift and estate tax returns, bankruptcy reorganizations, and recapitalizations. Here's a brief overview of preferred stock and how its characteristics affect value.

Preferential treatment

Preferred stock is a hybrid investment that possesses both equity and debt characteristics. The right to dividend payments is what gives preferred stock its debt-like quality.

Its most important feature — and the source of its name — is that preferred stockholders are preferred over common stockholders when dividends are paid and, in some cases, in the event the company is liquidated.

How does it work? The dividend requirement entitles a preferred stockholder to receive dividends at a promised rate, which may be fixed or variable, before any dividends can be paid to common stockholders.

In addition, dividends may be cumulative or noncumulative. If the dividends are cumulative, a company that fails to pay the dividends in a particular period must make up missed payments to preferred shareholders before it can declare and pay dividends to common or other junior stockholders. If dividends are noncumulative, the company is under no obligation to make up dividend payments from prior years. Investors consider preferred shares that pay cumulative dividends less risky — and thus more valuable — than those with noncumulative dividends.

Valuation methodology

IRS Revenue Ruling 83-120 provides some guidance on valuing preferred stock for gift and estate tax purposes. According to the ruling, the most important factors to consider in valuing preferred stock are yield, dividend coverage and the protection offered by its liquidation preference.

Whether a stock's yield supports a valuation at par or issuance value depends in part on the adequacy of its dividend rate compared with rates paid by comparable high-grade publicly traded preferred stocks. The basic formula for valuing preferred stock is:

$$\text{Value} = \frac{\text{Dividend}}{\text{Required yield}}$$

Suppose that an issue of preferred stock has a par value of \$100 and a fixed dividend rate of 6%, or \$6 per share. If the market-derived required yield is 8%, the stock's value is calculated as follows:

$$\text{Value} = \frac{\$6.00}{.08} = \$75 \text{ per share}$$

The formula is simple, but determining the required yield can be complex. The valuator conducts an analysis similar to that used in valuing common stock with a market-based approach. He or she identifies publicly traded preferred stock with similar features, making adjustments to account for differences between the subject company and the comparables.

Unless preferred stock can be converted into common stock (see "Convertible vs. nonconvertible" in "Special

Special features of preferred stock

Many special characteristics of preferred stock have an impact on value, including:

Dividend rate. The higher the dividend rate is, the higher the value becomes. In addition, preferred stock with an adjustable dividend rate may be more valuable than preferred stock with a fixed rate.

Participating vs. nonparticipating. Nonparticipating preferred shareholders are entitled to no more than the promised dividend rate. Participating preferred shareholders share in additional earnings above the contractual rate. The extent of this participation varies depending on the stock's terms.

Liquidation preference. Most, but not all, preferred stock confers a liquidation preference on the holder. For example, if a company liquidates, preferred stockholders might be entitled to receive $100 per share before payments are made to junior shareholders.

Cumulative vs. noncumulative. The right to cumulative dividends reduces the risk of nonpayment in a particular period, increasing the value of the stock.

Redeemable vs. nonredeemable. Although not typical for closely held companies, some preferred stock is redeemable by the corporation. The impact on value depends on the redemption terms. A higher call price tends to increase the stock's value, as does a longer waiting period before the company is permitted to redeem the stock.

Put option. A put option gives a preferred shareholder the option to require the company to buy back his or her shares at a fixed price. This increases the value of the stock, assuming the company has the financial ability to meet its obligation.

Voting vs. nonvoting. Voting rights generally increase the value of preferred stock, though quantifying the value of voting rights can be difficult.

Convertible vs. nonconvertible. Often, preferred stock can be converted into a specified number of shares of common stock or some other security. Conversion rights generally increase the value of preferred stock, and they also complicate the valuation process.

One of the biggest challenges in valuing closely held preferred stock is dealing with these characteristics.

features of preferred stock" above), its value is equal to the present value of the future income stream (from dividends and, in some cases, liquidation payments) discounted using the required yield.

Thus, it's important for the valuator to adjust the required yield to reflect the risk that dividend or liquidation payments won't be made. The higher the risk that the subject company's earnings will not be sufficient to cover these payments, the higher the required yield, resulting in a lower value.

Do your homework

As this article shows, preferred stock's value is highly influenced by its specific terms, which can vary dramatically from company to company. To ensure accurate valuations, review preferred stock agreements carefully and discuss their terms with your valuation experts. ❑

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