

***DAUBERT WITH EMPHASIS ON
COMMERCIAL LITIGATION, DAMAGES,
AND THE NONSCIENTIFIC EXPERT***

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STATE BAR OF TEXAS
23RD ANNUAL ADVANCED CIVIL TRIAL COURSE
Houston - August 30-September 1, 2000 - Woodlands Resort
San Antonio - September 27-29, 2000 - Doubletree
Dallas - November 1-3, 2000 - Fairmont

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Chapter 24

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DAUBERT WITH EMPHASIS ON
COMMERCIAL LITIGATION, DAMAGES,
AND THE NONSCIENTIFIC EXPERT

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I. SCOPE OF ARTICLE. The first part of this article discusses Daubert's concept of reliability of methodology and relevance of expert witness evidence, with a special emphasis on commercial litigation, damages, and the nonscientific expert.

The second part of the article discusses the procedural mechanisms for raising Daubert objections.

The third part of the article discusses the trial court's little-discussed Rule 705(c) gatekeeping function regarding the facts or data underlying an expert's opinion, and the procedural vehicles used to raise Daubert issues.

The fourth part of this article discusses cases that have applied the Daubert reliability concept to financial experts in litigation.

The fifth part of this article takes stock of the governmental regulatory bodies, and professional associations, overseeing certain financial experts, and discusses some of the standards that apply to various areas.

II. QUALIFICATIONS OF EXPERTS. The following text is taken from Chapter 3-2 of the State Bar of Texas Family Law Section's EXPERT WITNESS MANUAL.

Qualifications of Experts

Under Rule 702, a person may testify as an expert only if (s)he has knowledge, skill, experience, training or education that would assist the trier of fact in deciding an issue in the case.

to prove that the witness is qualified under Rule 702. The decision of whether an expert witness is qualified to testify is within the trial court's discretion, and will be reviewed on appeal only if the ruling is an abuse of discretion, meaning that the trial court acted without reference to any guiding rules or principles.

Whether an expert is qualified to testify under Rule 702 involves two factors: (1) whether the expert has knowledge, skill, etc.; and (2) whether that expertise will assist the trier of fact to decide an issue in the case.

Courts sometimes evaluate the first prong, of adequate knowledge, skill, etc., by asking whether the expert possesses knowledge and skill not possessed by people generally.

The second prong, assisting the trier of fact, requires that the witness's expertise go to the very matter on which the expert is to give an opinion. The test then for qualifications is whether the expert has knowledge, skill, experience, training or education regarding the specific issue before the court which would qualify the expert to give an opinion on the particular subject.

3Broders v. Heise, 924 S.W.2d 148, 151 (Tex. 1996).

4Broders v. Heise, 924 S.W.2d 148, 151 (Tex. 1996).

5Broders v. Heise, 924 S.W.2d 148, 153 (Tex. 1996). See Duckett v. State, 797 S.W.2d 906, 914 (Tex. Crim. App. 1990) ("The use of expert testimony must be limited to situations in which the issues are beyond that of an average juror"); John F. Sutton, Jr., Article VII: Opinions and Expert Testimony, 30 HOUS. L.REV. 797, 818 (1993) [Westlaw cite 30 HOULR 797].

6Broders v. Heise, 924 S.W.2d 148, 153 (Tex. 1996), citing Christopherson v. Allied Signal Corp., 939 F.2d 1106, 1112-1113 (5th Cir.), cert. denied, 503 U.S. 912, 112 S. Ct. 1280, 117 L.Ed.2d 506 (1992).

7Broders v. Heise, 924 S.W.2d 148, 153 (Tex. 1996).

1FED. R. EVID. 702; TEX. R. EVID. 702.

2Broders v. Heise, 924 S.W.2d 148, 149 (Tex. 1996).

Stated differently, the offering party must demonstrate that the witness possesses “special knowledge as to the very matter on which he proposes to give an opinion.”⁸

III. RELIABILITY OF EXPERT'S METHODOLOGY; RELEVANCY.

A. FEDERAL. In the case of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S. Ct. 2786, 125 L.Ed.2d 469 (1993), the U.S. Supreme Court held that FRE 702 overturned earlier case law requiring that expert scientific testimony must be based upon principles which have “general acceptance” in the field to which they belong. See *Frye v. U.S.*, 293 F. 1013 (D.C. Cir. 1923) (establishing the “general acceptance” test for scientific expert testimony). Under Rule 702, the expert's opinion must be based on “scientific knowledge,” which requires that it be derived by the scientific method, meaning the formulation of hypotheses which are verified by experimentation or observation. The Court used the word “reliability” to describe this necessary quality.

In *Kumho Tire Co. v. Carmichael*, 526 U.S.137, 11 S. Ct. 1167, 143 L.Ed.2d 238 (1999) (ruling below: 131 F.3d 1433 (11th Cir. 1997)), the Supreme Court said that the reliability and relevancy principles of *Daubert* apply to all experts, not just scientists, and where objection is made the court must determine whether the evidence has “a reliable basis in the knowledge and experience of [the relevant] discipline.” The trial court has broad discretion in determining how to test the expert’s reliability. *Id.*

B. TEXAS CIVIL PROCEEDINGS. The Texas Supreme Court adopted the *Daubert* analysis for TRE 702, requiring that the expert's underlying scientific technique or principle be reliable and relevant. *E.I. du Pont de Nemours v. Robinson*, 923 S.W.2d 549 (Tex. 1995). The Texas Supreme Court listed factors for the trial court to consider regarding reliability: (1) the extent to which the theory has been or can be tested; (2) the extent to which the technique relies upon the subjective interpretation of the expert; (3) whether the theory has been subjected to peer review and/or publication; (4) the technique's potential rate of error; (5) whether the underlying theory or technique has been generally accepted as valid by the relevant scientific community; and (6) the non-judicial uses which have been made of the theory or technique. *Robinson*, 923 S.W.2d at 557. See *America West Airline Inc. v. Tope*, 935 S.W.2d 908 (Tex. App.--El Paso 1996, no writ) (somewhat unortho-

dox methods of mental health worker in arriving at DSM-III-R diagnosis did not meet the admissibility requirements of *Robinson*). The burden is on the party offering the evidence to establish the reliability underlying such scientific evidence. *Robinson* at 557.

In *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713 (Tex. 1998), the Texas Supreme Court announced that the reliability and relevance (discussed below) requirements of *Robinson* apply to all types of expert testimony, whether or not it is based on science. In *Gammill* a unanimous Supreme Court said:

We conclude that whether an expert's testimony is based on “scientific, technical or other specialized knowledge,” *Daubert* and Rule 702 demand that the district court evaluate the methods, analysis, and principles relied upon in reaching the opinion. The court should ensure that the opinion comports with applicable professional standards outside the courtroom and that it “will have a reliable basis in the knowledge and experience of [the] discipline.” [FN47]

We agree with the Fifth, Sixth, Ninth, and Eleventh Circuits that Rule 702's fundamental requirements of reliability and relevance are applicable to all expert testimony offered under that rule. Nothing in the language of the rule suggests that opinions based on scientific knowledge should be treated any differently than opinions based on technical or other specialized knowledge. It would be an odd rule of evidence that insisted that some expert opinions be reliable but not others. All expert testimony should be shown to be reliable before it is admitted. [FN48]

Gammill, 972 S.W.2d at 725-26.

After noting that the reliability and relevancy criteria listed in *Daubert* may not apply to experts in particular fields, the Texas Supreme Court noted that nonetheless there are reliability criteria of some kind that must be applied.

The Court said:

[E]ven if the specific factors set out in *Daubert* for assessing the reliability and relevance of scientific testimony do not fit other expert testimony, the court is not relieved of its responsibility to evaluate the reliability of the testimony in determining its admissibility.

Gammill, 972 S.W.2d at 724.

C. TEXAS CRIMINAL PROCEEDINGS. The Texas

⁸*Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713, 718 (Tex. 1998). See *United Blood Services v. Longoria*, 938 S.W.2d 29 (Tex. 1997); Linda Addison, *Recent Developments in Qualifications of Expert Witnesses*, 61 TEX. B.J. 41 (Jan. 1998) [Westlaw cite: 61 TXBJ 41].

Court of Criminal Appeals, which established a reliability requirement even before the U.S. Supreme Court decided *Daubert* (see *Kelly v. State*, 824 S.W.2d 568 (Tex. Crim. App. 1992)), has extended reliability requirements to *all* scientific testimony, not just novel science. See *Hartman v. State*, 946 S.W.2d 60 (Tex. Crim. App. 1997) (applying *Kelly*-reliability standards to DWI intoxilyzer). In the case of *Nenno v. State*, 970 S.W.2d 549 (Tex. Crim. App. 1998), the Court extended the *Kelly*-reliability standards to mental health experts, but indicated that the *Daubert* list of factors did not apply. Instead, the Court of Criminal Appeals suggested the following factors be applied to fields of study outside of the hard sciences (such as social science or fields relying on experience and training as opposed to the scientific method): (1) whether the field of expertise is a legitimate one; (2) whether the subject matter of the expert's testimony is within the scope of that field; (3) whether the expert's testimony properly relies upon and/or utilizes the principles involved in the field. *Nenno*, 970 S.W.2d at 561.

D. RELEVANCE. *Daubert* and *Robinson* contain a relevancy requirement, to be applied to expert evidence. As explained in *Gammill v. Jack Williams*, 972 S.W.2d 713, 720 (Tex.1998):

The requirement that the proposed testimony be relevant incorporates traditional relevancy analysis under Rules 401 and 402 of the Texas Rules of Civil Evidence. To be relevant, the proposed testimony must be "sufficiently tied to the facts of the case that it will aid the jury in resolving a factual dispute." Evidence that has no relationship to any of the issues in the case is irrelevant and does not satisfy Rule 702's requirement that the testimony be of assistance to the jury. It is thus inadmissible under Rule 702 as well as under Rules 401 and 402.

Some courts and commentators call this connection the "fit" between the evidence and the issues involved in the case.

E. RECAP. Due to increasing complexity and specialization, a person who is degreed or licensed in a particular field is not necessarily qualified to give expert testimony regarding all areas of that field. Federal courts in Texas, and Texas courts in both civil and criminal cases, must determine the appropriate criteria of reliability and relevancy for all experts who testify, and as a preliminary matter must determine that those criteria are met before the expert is permitted to testify.

The reliability and relevancy requirement for expert testimony has become one of the most controversial evidentiary issues, nationwide. Virtually every week some court in the USA makes a ruling on *Daubert* or *Robinson*-like issues. One important area is expert

testimony from treating physicians, based upon differential diagnosis and not large-scale research. The Fifth Circuit Court of Appeals issued an en banc opinion saying that the *Daubert* reliability factors precluded a clinical physician from testifying to the cause of a patient's condition. See *Moore v. Ashland Chemical Co., Inc.*, 151 F.2d 269 (5th Cir. 1998) (en banc). That issue is discussed in Section VIII below.

IV. MAKING AND PRESERVING ERROR ON A DAUBERT CHALLENGE. It is a fundamental rule of evidence law that a party wishing to exclude evidence offered by another party must make a timely objection. Otherwise the evidence is admitted and no right to complain on appeal has been preserved. See TRE 103; TRAP 33. How, then, can a *Daubert*, *Robinson*-type of objection be raised, and error preserved?

A. PRELIMINARY QUESTIONS OF ADMISSIBILITY UNDER TRE 104. FRE 104 and TRE 104 provide that the court shall determine preliminary questions concerning the qualification of a person to be a witness, or the admissibility of evidence. In making its determination, the trial court is not bound by the rules of evidence other than with respect to privileges. FRE 104(a), TRE 104(a). Such a preliminary proceeding must be conducted out of the hearing of the jury, "when the interests of justice so require." FRE 104(c), TRE 104(c).

Although trial courts often conduct pre-trial *Daubert* hearings without reference to the specific procedural rule they are relying upon, the procedure for pretrial determination of the admissibility of evidence is Rule of Evidence 104. The *Daubert* case itself says this. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 592 ("[T]he trial judge must determine at the outset, pursuant to Rule 104(a), whether the expert is proposing to testify to (1) scientific knowledge that (2) will assist the trier of fact to understand or determine a fact in issue.") The Third Circuit has specifically suggested that a Rule 104 hearing be the vehicle to determine a *Daubert* objection. *U.S. v. Downing*, 753 F.2d 1224, 1241 (3rd Cir. 1985). And the Third Circuit points out that the obligation of the trial court to offer the parties an adequate opportunity to be heard may require a hearing at which the proper showing can be made, if possible. See *Padillas v. Stork-Gamco, Inc.*, 186 F.3d 412 417-18 (3rd Cir. 1999) (reversing a summary judgment granted because the plaintiff's expert did not meet *Daubert* criteria, saying that the trial court should have conducted a FRE 104 hearing, with an opportunity for the plaintiff to develop a record).

The U.S. Supreme Court has ruled that preliminary determinations of admissibility are made by the trial court on a preponderance of the evidence standard, as opposed to a prima facie showing, or in a criminal case, proof beyond a reasonable doubt. See *Bourjaily v. U.S.*, 483 U.S. 171, 175 (1987).

The Texas Court of Criminal Appeals held, in *Kelly v. State*, 824 S.W.2d 568, 573 (Tex. Crim. App. 1992), that the preliminary showing of reliability of expert testimony must be made by clear and convincing evidence, in a criminal case.

In some instances, the trial court may take judicial notice of matters going to the reliability of an expert's technique. This occurs when any fact is "capable of accurate and ready determination by resort to sources whose accuracy cannot reasonably be questioned." *Emerson v. State*, 880 S.W.2d 759, 764 (Tex. Crim. App. 1994). If the court takes judicial notice or some component of the reliability requirement, the proponent of the evidence is relieved of the burden to prove the judicially noticed fact. *Id.* at 764.

B. MOTION IN LIMINE. In a Texas court, a motion in limine alone is not an adequate vehicle to pursue a *Daubert* challenge. Texas appellate cases have made it clear that a ruling on a motion in limine cannot itself be reversible error. In *Hartford Accident & Indemnity Co. v. McCardell*, 369 S.W.2d 331, 335 (Tex. 1963), the Supreme Court said:

If a motion in limine is overruled, a judgment will not be reversed unless the questions or evidence were in fact asked or offered. If they were in fact asked or offered, an objection made at that time is necessary to preserve the right to complain on appeal

Id. at 335. Nor can the granting of a motion in limine be claimed as error on appeal. *Keene Corp. v. Kirk*, 870 S.W.2d 573, 581 (Tex. App.--Dallas 1993, no writ) (after motion in limine was sustained as to certain evidence, counsel conducted the balance of his examination of the witness without ever eliciting the excluded evidence; error was therefore waived); *Waldon v. City of Longview*, 855 S.W.2d 875, 880 (Tex. App.--Tyler 1993, no writ) (fact that motion in limine was sustained, and proponent offered exhibit on informal bill of exceptions, did not preserve error, since it was incumbent upon the proponent to tender the evidence offered in the bill and secure a ruling on its admission).

If a motion in limine is granted and the evidence is nonetheless offered, or comment of counsel made, in violation of the order in limine, an objection to the offending evidence or argument is prerequisite to raising a complaint on appeal at the violation of the order. If the objection is sustained, then the aggrieved party should move that the jury be instructed to disregard the improper evidence or argument. If the instruction is denied, complaint can be premised on the denial. If the instruction is granted, it will cure harm, except for incurable argument, such as an appeal to racial prejudice. In criminal cases, the aggrieved party who timely objects

and receives a curative instruction, but who is still not satisfied, must push further and secure an adverse ruling on a motion for a mistrial, in order to preserve appellate complaint. Immediately pushing for a mistrial should not be necessary in a civil proceeding, for the following reason. If the harm is curable, then by necessity a curative instruction will cure the harm. If the harm is incurable, then an instruction will not cure the harm, and the only relief is a new trial. However, a new trial is not necessary if the aggrieved party wins. Judicial economy suggests that the aggrieved party should be able to raise incurable error after the results of the trial are known, rather than having civil litigants moving for mistrial in a case that they otherwise might have won. TRCP 324(b)(5) specifically permits incurable jury argument to be raised by motion for new trial, even if it was not objected to at the time the argument was made. See generally *In re W.G.W.*, 812 S.W.2d 409, 416 (Tex. App.--Houston [1st Dist.] 1991, no writ) (insinuation that cervical cancer was caused by immoral conduct was incurable error). Counsel's violation of a motion in limine exposes the lawyer to a contempt citation.

Thus, if a motion in limine is used to bring a *Daubert* challenge, and the challenge is upheld, the proposing party will have to approach the court during trial and indicate a desire to offer the evidence, and if that request is denied, then an offer of proof or bill of exception must be made outside the presence of the jury. (It is possible, but not guaranteed, that any proof offered at the motion in limine hearing could suffice as an offer of proof for appellate purposes. But if all that is offered at the hearing on motion in limine is attorney argument, that is inadequate.) If the motion in limine based on *Daubert* is overruled, the opposing party will have to assert an objection when the evidence is offered during trial.

In federal court, a motion in limine alone does not preserve error for admitting evidence. *Marceaux v. Conoco, Inc.*, 124 F.3d 730, 734 (5th Cir. 1997) (general rule in Fifth Circuit is that an overruled motion in limine does not preserve error on appeal—an objection at trial is required).

Some courts recognize an exception to this rule when "the issue (1) is fairly presented to the district court, (2) is the type of issue that can be finally decided in a pretrial hearing, and (3) is ruled upon without equivocation by the trial judge." *U.S. v. Nichols*, 169 F.3d 1255 (10th Cir. 1999); *United States v. Mejia-Alarcon*, 995 F.2d 982, 986 (10th Cir. 1993).

As to excluding evidence pursuant to a motion in limine, the Fifth Circuit has said:

Generally speaking, "this circuit will not even consider the propriety of the decision to exclude the evidence at issue, if no offer of proof was made at trial." *Stockstill v. Shell Oil Co.*, 3 F.3d 868, 872 (5th Cir. 1993); *United States*

v. 873 Winkle, 587 F.2d 705, 710 (5th Cir.), cert. denied, 444 U.S. 827, 100 S.Ct. 51, 62 L.Ed.2d 34 (1979). While a formal proffer is not essential, the proponent of the evidence "must show in some fashion the substance of the proposed testimony." Id.

Seatrac Inc. v. Sonbeck International, Inc., ___ F.3d ___ (5th Cir. Jan. 27, 2000) [No. 98-20815]. Thus, when a motion in limine is granted, the aggrieved party must make an offer of proof at trial in order to complain on appeal.

C. RULING OUTSIDE PRESENCE OF JURY. TRE 103(b) provides that "[w]hen the court hears objections to offered evidence out of the presence of the jury and rules that such evidence be admitted, such objections shall be deemed to apply to such evidence when it is admitted before the jury without the necessity of repeating those objections." *Accord*, FRE 103(b). If the objection is made in connection with presenting a motion in limine, does Rule 103(b) obviate the need to object in the presence of the jury?

This question was considered in *Rawlings v. State*, 874 S.W.2d 740, 742-43 (Tex. App.--Fort Worth 1994, no pet.), in connection with old Rule 52(b), now Rule 103(b). In determining whether counsel's objection was a motion in limine or an objection outside the presence of a jury, the appellate court disregarded the label used by counsel and the trial judge, and looked instead to the substance of the objection or motion. The court made the following observations:

[A] motion in limine characteristically includes: (1) an objection to a general category of evidence; and (2) a request for an instruction that the proponent of that evidence approach the bench for a hearing on its admissibility before offering it. Conspicuously absent from a motion in limine is a request for a ruling on the actual admissibility of specific evidence.

In contrast, Rule 52(b) seems to require both specific objections and a ruling on the admissibility of contested evidence. In fact, we question whether Rule 52(b) comes into play until specific evidence is actually offered for admission. Rule 52(b) only provides that complaints about the admission of evidence are preserved when the court hears objections to offered evidence and rules that such evidence shall be admitted.

The court concluded that in that case the request was a motion in limine that did not preserve error.

See K-Mart No. 4195 v. Judge, 515 S.W.2d 148, 152 (Tex. Civ. App.--Beaumont 1974, writ dismissed) (even if trial objection was seen as incorporating objections set

out in motion in limine, still the objection was a general objection). Restating the objection made outside the presence of the jury was held not to be necessary in *Klekar v. Southern Pacific Transp. Co.*, 874 S.W.2d 818, 824-25 (Tex. App.--Houston [1st Dist.] 1994, no writ).

D. OBJECTION DURING TRIAL. It is proper and sufficient to make a *Daubert* objection during trial. However, a court could adopt a local rule or scheduling order in a particular case requiring that *Daubert* objections be raised before trial or they are precluded. In *Scherl v. State*, 7 SW3d 650 (Tex. App.--Texarkana 1999, pet. ref'd), the Texas appellate court ruled that TRE 702 is not a sufficiently precise objection to preserve appellate complaint. The court's language is worth reading:

Scherl objected to the intoxilyzer evidence when it was offered at trial on the basis that it was inadmissible under Rule 702, *Daubert*, *Kelly*, and *Hartman*. However, to preserve error an objection to the admission of evidence must state the specific grounds for the objection, if the specific grounds are not apparent from the context. Tex.R. Evid. 103(a); Tex.R. App. P. 33.1; *Bird v. State*, 692 S.W.2d 65, 70 (Tex.Crim.App.1985). An objection to an improper predicate that fails to inform the trial court exactly how the predicate is deficient will not preserve error. *Bird*, 692 S.W.2d at 70; *Mutz v. State*, 862 S.W.2d 24, 30 (Tex.App.-Beaumont 1993, pet. ref'd). Rule 702, *Daubert*, *Kelly*, and *Hartman* cover numerous requirements and guidelines for the admission of expert testimony. An objection based on Rule 702 and these cases alone is effectively a general objection to an improper predicate and is by no means specific. [FN3] Scherl's objection, without more specificity, did not adequately inform the trial court of any complaint upon which it might rule. Therefore, we conclude that no specific complaint about the reliability of the evidence was preserved for appellate review.

[FN 3] Based on the objection made, how was the trial judge to know if Scherl was objecting because: (1) the judge failed to conduct a hearing outside the presence of the jury, or (2) the witness was not "qualified as an expert by knowledge, skill, experience, training, or education," or (3) the witness's testimony would not "assist the trier of fact to understand the evidence or to determine a fact in issue" and therefore was not relevant, or (4) the witness's testimony was not reliable because (a) the underlying scientific theory is not valid, or (b) the technique applying the theory is not valid, or (c) the technique was not properly applied on the occasion in ques-

tion? See Texas Rule of Evidence 702, Daubert, Kelly, and Hartman.

Litigators are cautioned to consider how detailed they should be in asserting a *Daubert* or *Robinson* objection.

A party objecting based on *Daubert* should also object based on Rule of Evidence 403, arguing that probative value is outweighed by charges or prejudice or confusion. This is an independent basis to exclude the evidence.

E. "NO EVIDENCE" CHALLENGE. A party in a Texas civil proceeding can attack the sufficiency of the evidence on appeal, on the ground that the expert testimony admitted into evidence did not meet the necessary standards of reliability and relevance. *Merrill Dow Pharmaceuticals v. Havner*, 953 S.W.2d 706, 711 (Tex. 1997), cert. denied, 523 U.S. 1119, 118 S.Ct. 1799, 140 L.Ed.2d 939 (1998). However, this complaint cannot be raised for the first time after trial. In the case of *Maritime Overseas Corp. v. Ellis*, 971 S.W.2d 402, 406-07 (Tex.), cert. denied, ___ U.S. ___, 119 S.Ct. 541, 142 L.Ed.2d 450 (1998), the Texas Supreme Court said:

Under *Havner*, a party may complain on appeal that scientific evidence is unreliable and thus, no evidence to support a judgment. See *Havner*, 953 S.W.2d 706. *Havner* recognizes that a no evidence complaint may be sustained when the record shows one of the following: (a) a complete absence of a vital fact; (b) the reviewing court is barred by rules of law or evidence from giving weight to the only evidence offered to prove a vital fact; (c) the evidence offered to prove a vital fact is no more than a mere scintilla; or (d) the evidence establishes conclusively the opposite of the vital fact. See *Havner*, 953 S.W.2d at 711 (citing Robert W. Calvert, "No Evidence" and "Insufficient Evidence" Points of Error, 38 TEX. L.REV. 361, 362-63 (1960)). Here, like in *Havner*, *Maritime* contends that because *Ellis*'s scientific evidence "is not reliable, it is not evidence," and the court of appeals and this Court are "barred by rules of law or of evidence from giving weight" to *Ellis*'s experts' testimony. See *Havner*, 953 S.W.2d at 711, 713.

* * *

To preserve a complaint that scientific evidence is unreliable and thus, no evidence, a party must object to the evidence before trial or when the evidence is offered. See *Robinson*, 923 S.W.2d at 557; see also *Havner*, 953 S.W.2d at 713 ("If the expert's scientific testimony is not reliable, it is not evidence."). Without requiring a timely objection to the reliability of the scientific evidence, the offering party is not given an opportunity to cure any defect that may exist, and will be subject to trial and appeal by ambush. See *Marbled Murrelet v. Babbitt*, 83 F.3d 1060, 1066-67 (9th Cir. 1996), cert. denied, ___ U.S. ___, 117

S.Ct. 942, 136 L.Ed.2d 831 (1997); *Sumitomo Bank v. Product Promotions, Inc.*, 717 F.2d 215, 218 (5th Cir.1983). Reviewing courts may not exclude expert scientific evidence after trial to render a judgment against the offering party because that party relied on the fact that the evidence was admitted. *Babbitt*, 83 F.3d at 1067. To hold otherwise is simply "unfair." *Babbitt*, 83 F.3d at 1067. As the *Babbitt* court explained:

[P]ermitting [a party] to challenge on appeal the reliability of [the opposing party's] scientific evidence under *Daubert*, in the guise of an insufficiency-of-the-evidence argument, would give [appellant] an unfair advantage. [Appellant] would be 'free to gamble on a favorable judgment before the trial court, knowing that [it could] seek reversal on appeal [despite its] failure to [object at trial].'

Babbitt, 83 F.3d at 1067 (citations omitted). Thus, to prevent trial or appeal by ambush, we hold that the complaining party must object to the reliability of scientific evidence before trial or when the evidence is offered.

Ellis, 971 S.W.2d at 409-10.

Accord, *General Motors Corp. v. Sanchez*, 997 S.W.2d 584, 590 (Tex. 1999); *Melendez v. Exxon Corp.*, 998 S.W.2d 266, 282 (Tex. App.—Houston [14th Dist.] 1999, no pet.); *Harris v. Belue*, 974 S.W.2d 386, 393 (Tex. App.—Tyler 1998, pet. denied) (party, who did not object to admission of expert testimony on *Daubert* grounds until after plaintiff rested and in connection with motion for instructed verdict, waived *Daubert* attack).

* * * * *

IMPORTANT DEVELOPMENT

On February 22, 2000, the U.S. Supreme Court decided *Weisgram v. Marley Co.*, No. 99-161 (Feb. 22, 2000). In that case the Court unanimously held that, where a federal district court admitted expert testimony over objection, and the federal court of appeals determined that the evidence was not admissible under *Daubert*, the appellate court can, if it finds the remaining evidence insufficient to support a favorable verdict, reverse and render judgment for the opposing party, or the appellate court can reverse and remand for a new trial, or the appellate court can send the case back to the trial court to determine

whether to enter judgment for the opposing party or to order a new trial.

dire examination into the qualifications of an expert.

V. FACTS OR DATA UNDERLYING EXPERT OPINION. TRE 705 reads as follows. Pay particular attention to TRE 705(c), new to Texas civil litigation, establishing a gatekeeper function for the trial judge concerning the facts or data supporting an expert’s opinion.

It can be seen that new TRE 705(b) offers a right to *voir dire* the expert about the underlying facts or data outside the presence of the jury. TRE 705(c) permits the trial court to reject expert testimony if the court determines that the expert doesn't have a sufficient basis for his opinion. And TRE 705(d) establishes a balancing test for underlying facts or data that are inadmissible except to support the expert's opinion: the court should exclude the inadmissible underlying information if the danger of misuse outweighs the value as explanation or support for the expert opinion.

RULE 705. DISCLOSURE OF FACTS OR DATA UNDERLYING EXPERT OPINION

VI. CASES APPLYING *DAUBERT* TO FINANCIAL EXPERTS.

- (a) **Disclosure of Facts or Data.** The expert may testify in terms of opinion or inference and give the expert’s reasons therefor without prior disclosure of the underlying facts or data, unless the court requires otherwise. The expert may in any event disclose on direct examination, or be required to disclose on cross-examination, the underlying facts or data.
- (b) ***Voir dire.*** Prior to the expert giving the expert’s opinion or disclosing the underlying facts or data, a party against whom the opinion is offered upon request in a criminal case shall, or in a civil case may, be permitted to conduct a *voir dire* examination directed to the underlying facts or data upon which the opinion is based. This examination shall be conducted out of the hearing of the jury.
- (c) **Admissibility of opinion.** If the court determines that the *underlying facts or data do not provide a sufficient basis for the expert’s opinion under Rule 702 or 703*, the opinion is inadmissible. [Emphasis added]
- (d) **Balancing test; limiting instructions.** When the underlying facts or data would be inadmissible in evidence, the court shall exclude the underlying facts or data if the danger that they will be used for a purpose other than as explanation or support for the expert’s opinion outweighs their value as explanation or support or are unfairly prejudicial. If otherwise inadmissible facts or data are disclosed before the jury, a limiting instruction by the court shall be given upon request.

A. ECONOMISTS. The *Daubert* reliability concept has been applied to economists.

In *Concord Boat Corp. v. Brunswick Corp.*, 207 F.3d 1039 (8th Cir. 2000), the court of appeals applied the *Daubert* reliability standard to the testimony of an economist in an anti-trust case, and ruled the testimony inadmissible because not all relevant circumstances were incorporated into the expert’s economic model, and the model failed to account for market events that did not relate to any anticompetitive conduct.

In *In re Valley-Vulcan Mold Co.*, ___ F.3d ___ (6th Cir. 1999) [No. 98-8070], the Court of Appeals applied *Kuhmo* and affirmed the admission of the opinion of a financial expert on the solvency of a company in connection with an effort to recover fraudulent conveyances. The witness, who was national director of a valuation services group, had degrees from prestigious universities, and had experience in determining the solvency of companies.

In *Liu v. Korean Air Lines Co., Ltd.*, 1993 WL 478343 (S.D.N.Y. 1993), the trial court applied *Daubert* standards and partially admitted and partially rejected a professional economist’s testimony. The court permitted testimony on: the future growth of Taiwan’s economy and its effect on employment in the shipping industry; the concept of the lost value of household services (but not the value of them, since the expert’s value was based in US and not Taiwanese figures); the decedent’s statistical work life expectancy; the projected spread of growth of decedent’s income over 10 years. The court rejected testimony on: the likelihood of the decedent being promoted on any particular dates; the assumption of an 8% annual increase in the decedent’s earnings; lost fringe benefits (because the expert did not support with evidence his assumption that fringe benefits equalled 19.95% of salary).

Notes and Comments

Comment to 1998 change: Paragraphs (b), (c), and (d) are based on the former Criminal Rule and are made applicable to civil cases. This rule does not preclude a party in any case from conducting a *voir*

Other cases applying the *Daubert* reliability concept to economists are discussed in Androque & Ratliff, *Kicking*

the Tires After Kuhmo: the Bottom Line on Admitting Financial Expert Testimony, 37 HOUS. L. REV. 431, 454-464 (2000).

B. ACCOUNTANTS. The *Daubert* reliability concept has been applied to accountants. In *G.T. Laboratories, Inc. v. The Cooper Companies, Inc.*, No. 92-C-6647 (W.D. Ill. Sept. 24, 1998) [1998 WL 704302], an accountant's testimony was excluded because it was based on non-standard methodology and the expert did not show that the methodology had been tested or subjected to peer review or had had an error rate determined. In *S.E.C. v. Lipson*, 46 F. Supp.2d 758 (N.D. Ill. 1999), a CPA's opinion that a company's internal financial reports were not reliable was excluded because the expert's opinions were not based on the methods and principles of accountancy. These cases and others are discussed in Androgué & Ratliff, *Kicking the Tires After Kuhmo: the Bottom Line on Admitting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 454-464 (2000).

In *TUF Racing Products v. American Suzuki Motor*, ___ F. 3d ___ (3rd Cir. July 24, 2000) [No. 99-3497], the court of appeals upheld the admission of a CPA's opinion on lost profits under *Daubert* standards. It was permissible for the CPA to testify to the discounted present value of lost future earnings based upon information provided by the plaintiff and assumptions given by counsel.

C. OTHER FINANCIAL EXPERTS. In *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513 (Del. 1999), the Delaware Supreme Court held that *Daubert* and *Kumho Tire* apply to valuation experts testifying in appraisal proceedings regarding corporate stock. The court upheld the lower court's decision to reject an expert's capital market approach to valuation, and both sides' experts' discounted cash flow approach to valuation. How *Daubert* standards might be applied to valuation experts is further discussed in Androgué & Ratliff, *Kicking the Tires After Kuhmo: the Bottom Line on Admitting Financial Expert Testimony*, 37 HOUS. L. REV. 431, 454-464 (2000).

In *Callahan v. A.E.V. Inc.*, 182 F.3d 237 (3rd Cir. 1999), the court of appeals indicated that *Daubert* applied to lost profit testimony in an antitrust case and ruled that the testimony of two financial experts was admissible.

United States v. Whitehead, 176 F.3d 1030 (8th Cir. 1999), the appellate court upheld the admissibility of an FBI agent's opinions explaining the criminality of a check kiting scheme. *Accord, United States v. Yoon*, 128 F.3d 515, 527-28 (7th Cir. 1997) (also involving a check-kiting scheme).

VII. ACCOUNTANTS. To apply the mandate of *Kumho Tire* and *Gammill* to accountant witnesses, it is necessary to know something about the licensing and professional standards in the accounting field.

A. LICENSING.⁹ Certified Public Accountants (CPAs) are licensed professionals in the broad field of accounting. After passing a uniform national CPA examination, CPAs are licensed and governed by state (and related U.S. jurisdictions such as the District of Columbia, etc.) Boards of Accountancy that set forth their own education, experience and other requirements. These State Boards are given broad powers to adopt regulations, promulgate rules of conduct for the proper administration of the law, and ensure that the public is served by qualified professional accountants. They are generally made up of practicing CPAs plus attorneys, economists, state officials and public members among others. The State Boards of Accountancy are generally guided by their respective governments, the American Institute of Certified Public Accountants (AICPA), and to a lesser extent the Securities and Exchange Commission (SEC).¹⁰

The Texas State Board of Public Accountancy has been given the legal authority to govern the practice of public accountancy in Texas. The Board has adopted many of the AICPA professional standards as their own professional conduct rules. The Texas State Board of Accountancy requires that a CPA have a Bachelor's Degree and complete not fewer than 150 semester hours (of which 30 semester hours are accounting courses), and pass a test administered by the Texas State Board of Accountancy.

Most states provide for periodic peer review of CPAs' accounting and auditing practices. The AICPA has promulgated "Standards for Performing and Reporting on Peer Reviews." These standards have been adopted in various states.

It is permissible for a person to render bookkeeping services in Texas without being licensed. But these persons cannot provide audit or "attest" services. Only licensed CPA's can do that.

B. THE AICPA. The American Institute of Certified Public Accountants (AICPA) describes itself as the premier national professional association for CPAs in the United States. The AICPA has more than 330,000 members.

To qualify for admission to membership in the American Institute, a CPA must:

⁹The author received assistance in preparing this section from Patrice L. Ferguson, of Ferguson, Camp & Poll, Houston, Texas. Ms. Ferguson is both an attorney and a CPA, and has a forensic and accounting practice in Houston.

¹⁰Authorized Edition of The AICPA's Uniform CPA Exam – 1991; Information for CPA candidates section, page xiii.

- possess a valid and unrevoked CPA certificate issued by the legally constituted authorities of the states, the District of Columbia, territories, or territorial possessions of the United States;

- have passed an examination in accounting and other related subjects satisfactory to the AICPA Board of Directors, which the board has resolved is the Uniform CPA Examination;

- practice in a firm enrolled in Institute-approved practice monitoring programs as long as one is engaged in public accounting as a proprietor, partner, or shareholder, or as an employee who has been licensed as a CPA for more than two years;

- agree to abide by the AICPA Bylaws and the Code of Professional Conduct.

In order to retain membership in the AICPA, a member in public practice for each three-year reporting period must complete 120 hours of continuing professional education with a minimum of 20 hours each year. A member not engaged in public practice must, during the each three year reporting period complete 90 hours of continuing professional education with a minimum of 15 hours in each year.

C. STANDARDS GOVERNING ACCOUNTANTS.

CPAs doing audits, financial statements, or income reporting ordinarily use Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). CPAs who are performing consulting or valuation services don't have "generally accepted" guidelines.

1. Audits. CPAs conducting audits conform to GAAS, generally accepted auditing standards, developed by the AICPA.

2. Financial Statements. Most businesses prepare financial reports to reflect the financial condition of the business. When the financial reports are prepared by the owners or managers of the company, there is no independent assurance of accuracy. When the financial reports are prepared by a certified public accountant, the rules imposed by the accounting profession regarding the accuracy of the financial reports can give a degree of assurance of accuracy, depending upon the extent of the involvement of the CPA.

From highest to lowest, the degree of assurance of a CPA-prepared financial report ranges from (1) audited (highest), to (2) reviewed, to (3) compiled (lowest). Financial reports prepared without input from a CPA are called "internally-generated" reports.

a. Audited. The objective of the ordinary audit of financial statements by the independent auditor is the

expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with GAAP. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected.

b. Reviewed. The objective of the review is to perform inquiry and analytical procedures that provide the accountant with a reasonable basis to express limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with GAAP or, if applicable, an OCBOA (Other Comprehensive Basis of Accounting, e.g. cash basis or tax basis). A review differs from the audit in that a review does not provide the basis for the expression of an opinion because a review does not require the obtaining of an understanding of the internal control structure or assessing control risk, tests of accounting records and responses to inquiries by obtaining corroborating evidential matter through inspection, observation or confirmation, and certain other procedures ordinarily performed during an audit.¹¹

c. Compiled. The objective of the compilation is to present in the form of financial statements information that is the representation of management without undertaking to express any assurance on the statements. A compilation differs from the review in that a review should provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the financial statements. No expression of assurance is contemplated in a compilation.¹²

d. Internally Generated. The objective of the internally generated financial statement is to provide information to the client's management for use in its internal operations. The accountant may not report on financial statements that include one or more periods of client-prepared financial statements that have not been audited, reviewed, or compiled by the accountant.

3. Income Reporting

Tax accounting is different from ordinary accounting. The sources of authority for tax reporting principles is the Internal Revenue Code, Revenue Rulings, and court rulings. Tax laws are promulgated for purposes of

¹¹Ibid., AR§100.04.

¹²Ibid., AR§100.04.

federal revenue and not to make an accurate measure of the income and resources of a business.

D. LITIGATION SERVICES, OR FORENSIC WORK.

Litigation services are rendered by a CPA using accounting and consulting skills to assist a client in a matter that involves pending or potential litigation or dispute resolution proceedings with a trier of fact. These services may include fact-finding (including assistance in the discovery and analysis of data), damage calculations, document management, expert testimony, and other professional services required by the client or counsel.¹³

1. General Standards. The AICPA classifies litigation services as one of six types of consulting services and is therefore subject to the general standards of the AICPA Code of Professional Conduct. The general standards cover professional competence, due professional care, planning and supervision, and sufficient relevant data. The general standards are concerned with the quality of the performance of any professional service.

2. Consulting Standards. In addition to the general standards, specific consulting standards apply to the consulting process and are established by the Statement on Standards for Consulting Services (SSCS) under Rule 202 of the AICPA Code of Professional Conduct. The consulting standards apply specifically to the consulting process to guide practitioners in their relationships with consulting clients. These standards concern serving the client's interest, entering into an understanding with the client, and communicating with the client

The Texas Board of Public Accountancy has determined that the SSCS set the professional standards for practice in the consulting area and thus Texas CPAs are bound under the Board's Rules to these AICPA standards.

3. No Forensic Standards, Per Se. The CPA organizations do not promulgate standards for much of the forensic work accountants do. CPAs testifying as to lost profits, business valuation, or the character of marital property as separate or community, are operating without controlling standards issued by the accounting profession.

VIII. APPRAISERS AND EVALUATORS.

This section of the paper considers licensing and professional organizations relating to appraisers, and standards of valuation practice.

A. LICENSING.

A real estate appraiser can be, but is not required to be, licensed or certified by the Texas Appraiser Licensing and Certification Board. [See the Texas Appraiser Licensing and Certification Act (Tex. Rev. Civ. Stat. Ann. art. 6573a.2)]. The Financial Institution Reform and Recovery Act (FIRREA) requires an appraiser to be certified by the state if the transaction is subject to federal jurisdiction. But it is only when the appraisal is connected with a "federally related transaction" that the appraiser is required to be certified by the Board. *Smith v. Levine*, 911 S.W.2d 427, 433 (Tex. App.--San Antonio 1995, writ denied).

Only certified or licensed appraisers can do "certified appraisals" or "licensed appraisals." These kinds of appraisals must conform to USPAP. [TEX. ADMIN. CODE ANN. § 155.1]

As far as appraising other types of assets, like personal property or business interests, no particular licensing is required.

B. WHO ISSUES STANDARDS FOR APPRAISING THE VALUE OF ASSETS?

1. The Appraisal Foundation. The Appraisal Foundation was formed in 1987 consisting of nine major professional U.S. appraisal organizations, all exclusively involved in real estate valuation except the ASA, which is multi-disciplinary. The Foundation is governed by a 32-member Board of Trustees, including appointees of member appraisal organizations, certain government bodies, other sponsor organizations and trustees-at-large. Funding is provided by member and sponsor organizations and the federal government under Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). The chairman of the Board of Trustees appoints a nominating subcommittee, which appoints the Appraisal Standards Board and the Appraiser Qualifications Board.

2. Appraisal Standards Board. The Appraisal Standards Board (ASB) is a subdivision of the Appraisal Foundation. The Appraisal Foundation was established pursuant to congressional authority to be a source of appraisal standards and appraiser qualifications. The Appraisal Foundation promulgates appraisal standards through the Appraisal Standards Board (ASB) and qualifications through the Appraiser Qualifications Board (AQB). The Appraisal Standards Board has issued valuation standards, called USPAP. See <<http://www.appraisalfoundation.org>>.

3. Appraiser Qualifications Board The Appraiser Qualifications Board (AQB) is a subdivision of the Appraisal Foundation. The AQB has set minimum qualifications for real estate appraisers and is studying

¹³ Application of AICPA Professional Standards in the Performance of Litigation Services, AICPA Consulting Services Special Report 93-1, 1993

qualifications for personal property and business appraisers.

C. WHAT IS USPAP?

USPAP is the Uniform Standards of Professional Appraisal Practice, issued by the Appraisal Standards Board. USPAP has been adopted by various federal and state agencies. Much of USPAP applies to valuing real estate. However, Standards 9 & 10 apply to business appraisals. See: <<http://www.appraisalfoundation.org/uspap2000/toc.htm>>.

The ASB says this about USPAP:

The Uniform Standards of Professional Appraisal Practice [were] adopted by the Appraisal Standards Board of the Foundation on January 30, 1989 and [are] recognized throughout the United States as the generally accepted standards of professional appraisal practice.

<<https://www.appraisalfoundation.org/overview.htm>>.

Although USPAP is widely-recognized, and some state laws require that appraisals be done in conformity with USPAP, USPAP is not universally acknowledged. For example, the American Institute of Certified Public Accountants and the IRS have not adopted USPAP.

3. USPAP Not a Standard of Admissibility of Opinions on Value. There are no Texas cases considering USPAP as a standard for admissibility of expert valuation evidence. Courts of other states have held that USPAP is not a rule of evidence.

Connecticut has adopted executive department regulations requiring that real property appraisals be performed according to USPAP.¹⁴ One Connecticut judge rejected a claim that an appraisal report was inadmissible for violating USPAP, saying that the purpose of the Connecticut legislative scheme and related regulations was to provide for the licensing and certification of appraisers, and “not to impose threshold standards for the admissibility, or content of, an appraisal”¹⁵ Several Minnesota courts have arrived at the same opinion, rejecting challenges to admissibility based upon a violation of USPAP, saying for example that “USPAP standards are not Rules of Evidence. Rules of

Evidence govern the admissibility of evidence at trial.”¹⁶ The Mississippi Supreme Court rejected an attack on an appraisal by an expert who owned nearby land, saying that the USPAP preamble and Rule 2-3 “do not render incompetent an appraiser with interests in nearby land or in the subject property being appraised. The emphasis of USPAP is on disclosure or any material interest which the appraiser may have.”¹⁷

It thus appears that failure to comply with USPAP is at best just one factor to consider on admissibility. A variation from USPAP in how much disclosure is contained in a written report is not very important from a reliability standpoint. However, a variation from the valuation methodology in USPAP is important to the question of whether the evaluator’s methodology is reliable.

IX. BUSINESS VALUATION.¹⁸

The IRS, in Rev. Rul. 59-60, said that business valuation “is not an exact science.” The business valuation field has general principles that are widely-acknowledged, but business valuation involves many subjective decisions that are not subject to precise measurement. Additionally, there is no “peer reviewed” publishing industry in business valuation, in contrast to scientific fields.

A. BUSINESS EVALUATORS: LICENSING AND PROFESSIONAL ORGANIZATIONS. Business evaluators are not licensed or accredited by the State. Most business evaluators belong to one or more of four associations that offer education and accreditation in business appraisal. These are the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Institute of Business

¹⁶*Ferch Acquisitions, Inc. v. County of Benton*, C5-94-513 and CX-95-274 (Minn. Tax Ct. Sept. 21, 1995) [1995 Minn. Tax LEXIS 62]. See *Huisken Meat Center, Inc. v. County of Murray*, C4-95-87 *3 (Minn. Tax Ct. June 3, 1996) [1996 Minn. Tax LEXIS 34] (failing to adhere to USPAP goes to the credibility, not the admissibility of evidence“); *Small Building Redevelopment Corp. v. County of Hennepin*, TC-19147 (Minn. Tax Ct. April 12, 1995) (“failing to adhere to USPAP goes to the credibility, not the admissibility, of the evidence”) [1995 Minn. Tax LEXIS 19].

¹⁷*Broadhead v. Bonita Lakes Mall, Ltd.*, 702 So.2d 92, 98 (Miss. 1997).

¹⁸The author received assistance in preparing this section from Patrice L. Ferguson, of Ferguson, Camp & Poll, Houston, Texas. Ms. Ferguson is both an attorney and a CPA, and has a forensic and accounting practice in Houston.

¹⁴Conn. Comm. of Consumer Protection Reg. 20-504

¹⁵*Connecticut Housing Finance Authority v. Moniz*, CV-950553406S (Conn. Super. Ct. Hartford Nov. 10, 1997) (unreported) [1997 Conn. Super. LEXIS 3027].

Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA).

1. AICPA. The American Institute of Certified Public Accountants (AICPA) is the national professional organization for all CPAs. Membership is voluntary. In 1997 the AICPA instituted a professional designation for CPAs who have met experience, education and testing requirements for business valuation. That designation is ABV—Accredited in Business Valuation. See: <<http://www.aicpa.org/members/div/mcs/abv.htm>>.

2. American Society of Appraisers. The American Society of Appraisers (ASA) was formed in 1936 and is an appraisal certifying organization representing all major disciplines of appraisal specialists, including those who specialize in business valuation. In order to ensure that professional appraisers adhere to high technical and ethical standards in performing valuation projects, ASA has prepared a comprehensive set of *Principles of Appraisal Practice and Code of Ethics* for its members. These principles are appropriate for business valuation specialists as well as appraisers for other valuation disciplines within the ASA membership. Among topics addressed by the principles are the following major issues:

- Objectivity
- Obligations to the client
- Obligations to other appraisers
- Guidance on the application of various methods and practices
- Unethical and unprofessional practices.
- Guidance on the appraisal report.

Beyond the preceding general standards, the Business Valuation Committee of the ASA has adopted standards that relate specifically to business valuation engagements. These standards currently include eight Business Valuations Standards, Definitions, a Statement of Business Valuation Standards, and one Advisory Opinion.

The ASA follows mainstream business valuation methods for appraising businesses. See <<http://www.appraisers.org>>.

3. Institute of Business Appraisers. The Institute of Business Appraisers (IBA) consists of persons who engage in the valuation of mid-sized to smaller businesses. Members include CPAs, business brokers, attorneys, economists, college professors and estate appraisers. Formed in 1978, the IBA has over 3,000 members, half of whom are CPAs. The IBA awards

Professional Certifications, including: CBA, Certified Business Appraiser; AIBA, Accredited by IBA; BVAL, Business Valuation Accredited for Litigation.

4. National Association of Certified Valuation Analysts. The NACVA is an organization of some 4,500 CPAs and other valuation professionals who engage in business valuation, litigation support and other types of valuation services. The NACVA was formed in 1991. The NACVA offers three designations: Certified Valuation Analyst (CVA); Accredited Valuation Analyst (AVA); and Government Valuation Analyst (GVA). Approximately 3,500 members have obtained one of these designations. A CVA must be a licensed CPA and a member of the local CPA society or of the AICPA. An AVA must have a business degree and experience in business valuation. A GVA must be currently employed by a government agency and performing valuation work. See <<http://www.nacva.com>>.

5. The International Business Brokers Association The International Business Brokers Association (IBBA) has established authoritative principles for conducting business brokerage activities. The IBBA Standards provide a minimum standard of methodology for business brokers when dealing with customers, clients, and other business brokers. In addition to six standards a glossary is included in the standards for terms that are unique to the business brokerage industry.

B. SOURCES OF AUTHORITY ON BUSINESS VALUATION. Sources of authority for business valuation include the IRS, the Appraisal Standards Board, the AICPA's Business Valuation Committee and the other business valuation organizations mentioned above. The non-governmental organizations publish materials, conduct educational classes, conduct testing, and award special designations for business evaluation. There are some privately published books and journals that many consider authoritative. For example, Shannon Pratt's books on business valuation are highly respected. And there are court decisions involving valuation issues—mostly estate tax litigation. However, case law usually is fact-specific and not very helpful in articulating business valuation standards.

C. IRS STANDARDS ON BUSINESS VALUATION. For purposes of business valuation methods, the main authoritative statements by the Internal Revenue Service are revenue rulings. However, private letter rulings (PLRs) which, although not public, do present the IRS' position on substantive tax issues. There are some PLRs that relate to business valuation, and many business evaluators consider PLRs. Remember, these are IRS positions.

The most important source of authority on valuing closely-held businesses, from the IRS or from any other source, is Rev. Rul. 59-60 (1959-1 C.B. 237), which provides guidance regarding the valuation of stock of

closely held corporations for estate and gift tax purposes. In RR 59-60, the IRS reviewed in general the approach, methods, and factors to be considered in valuing shares of closely held corporate stock for estate and gift tax purposes. RR 59-60 was modified by Rev. Rul. 65-193. The provisions of Rev. Rul. 59-60, as modified, were extended to the valuation of corporate securities for income and other tax purposes by Rev. Rul. 68-609, 1968-2 C.B. 327. Rev. Rul 93-12 deals with attributions. There are others, as well.

The IRS has issued other Rev. Rulings on valuing business interests that are considered authoritative. For example, Rev. Rul. 77-287 deals with the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal securities laws. RR 77-287 is
o n - l i n e a t :
<http://www.minval.com/irsrevrule77287_mineral.htm>.

D. GENERALLY ACCEPTED BUSINESS VALUATION METHODS. For publicly-traded stock, market reports reflect what price shares are selling for—this is the value you use, subject to some adjustment.

The starting point for valuing a privately-held business is the historical, existing financial records, including books of account, financial statements, and tax returns. Financial reports and tax returns are designed for purposes other than establishing value, so the rules for preparing these documents are different from the generally-accepted methods for valuing business interests. Additionally, there may be questions about the accuracy of a business's books of account, financial statements, and tax returns.

Some businesses are valued based on Fair Market Value of assets and liabilities. Others are valued based on capitalized income. Others are based on cash flow.

E. VALUING LESS THAN A 100% OWNERSHIP INTEREST. An appraiser valuing a partial interest in a business may make adjustments to the ownership interest being valued. Adjustments would include (1) marketability discount; (2) blockage discount; (3) control premium; (4) minority discount.

F. OTHER FACTORS IN VALUING BUSINESSES. The appraiser may have to consider tax attributes of the corporation (such as capital gains tax on shares, LIFO reserve on inventory, retained earnings in a corporation, etc.), buy-sell agreements, and restricted stock, meaning stock that cannot be sold at the present time due to federal securities laws. In a Texas divorce, the business appraiser may have to deal with the issue of personal goodwill, which under *Nail v. Nail* is not part of the value of the business for purposes of divorce.

X. LOST PROFITS.

The admissibility of testimony on lost profits must be considered against the backdrop of what is required in order to show lost profits.

In *Smith Barney, Inc v. Settle*, No. 13-97-554-CV (Tex. App.--Corpus Christi May 21, 2000, pet. denied) [2000 WL 1146516], the Corpus Christi Court of Appeals recently summarized the requirements of proving lost profits in Texas:

[R]ecovery of lost profits does not require that the loss be susceptible to exact calculation. *Szczepanik v. First Southern Trust Co.*, 883 S.W.2d 648, 649 (Tex. 1994); *Texas Instruments v. Teletron Energy Management, Inc.*, 877 S.W.2d 276, 279 (Tex. 1994). However, the injured party must do more than show that they suffered some lost profits. The amount of the loss must be shown by competent evidence with reasonable certainty. *Id.* What constitutes reasonably certain evidence of lost profits is a fact intensive determination. At a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits may be ascertained. Recovery of lost profits must be predicated on one complete calculation. *Szczepanik*, 883 S.W.2d at 649; *Holt Atherton Ind., Inc. v. Heine*, 835 S.W.2d 80, 84 (Tex.1992).

An award of damages for lost profits may be based on estimates. *Little Darling Corp. v. Ald, Inc.*, 566 S.W.2d 347, 349 (Tex. Civ. App.--Dallas 1978, no writ).

In *Foust v. Estate of Walters*, 21 S.W.3d 495 (Tex. App.--San Antonio April 12, 2000, pet. requested), the appellate court upheld the admissibility of a farmer's projections of future crop yields based on a government agency's records of past crop yields. The court also upheld against a *Daubert* attack the testimony of a witness who had a Ph.D. in agricultural accounting and had been on the Texas A&M faculty for 30 years.

In *Scruggs Management Services, Inc. v. Panasonic Communications & Systems Co.*, No. 05-99-00518-CV (Tex. App.--Dallas Aug. 7, 2000) (not for publication) [2000 WL 1093230], the appellate court upheld the exclusion of the testimony of an actuary and a CPA that problems with a voice mail system caused lost profits to the plaintiff.

In *TUF Racing Products v. American Suzuki Motor*, ___ F. 3d ___ (3rd Cir. July 24, 2000) [No. 99-3497], the court of appeals upheld the admission of a CPA's opinion on lost profits under *Daubert* standards. It was permissible for the CPA to testify to the discounted present value of lost future earnings based upon information provided by the plaintiff and assumptions given by counsel. The court rejected the argument that

only a person with a degree in economics, statistics, or mathematics could give such testimony.

XI. HEDONIC DAMAGES.

"Hedonic damages" are the monetary value of pleasure of life of person who has been injured. In *Smith v. Ingersoll-Rand Co.*, ___ F.3d ___ (10th Cir. 2000) (No. 98-2340), the Tenth Circuit Court of Appeals has described the admissibility of hedonic damages in this way. The expert in the case-in-point was Stan Smith.

The concept of hedonic damages is premised on what we take to be the rather noncontroversial assumption that the value of an individual's life exceeds the sum of that individual's economic productivity. In other words, one's life is worth more than what one is compensated for one's work.[fn2] The assumption that life is worth more than the sum of economic productivity leads to the equally noncontroversial conclusion that compensatory awards based solely on lost earnings will under-compensate tort victims.[fn3] The theory of hedonic damages becomes highly controversial when one attempts to monetize that portion of the value of life which is not captured by measures of economic productivity.

Attempts to quantify the value of human life have met considerable criticism in the literature of economics as well as in the federal court system. Troubled by the disparity of results reached in published value-of-life studies and skeptical of their underlying methodology, the federal courts which have considered expert testimony on hedonic damages in the wake of *Daubert* have unanimously held quantifications of such damages inadmissible. See, e.g., *Saia v. Sears Roebuck & Co.*, 47 F. Supp.2d 141,148-49 (D.Mass. 1999) (finding Stan Smith's hedonic damages testimony inadmissible because his calculations are untestable and the theory does not meet the requirement of general acceptability); *Mercado v. Chicago*, No. 96-C-2787, 1997 WL 537343 (N.D.Ill. 1997) (excluding Stan Smith's hedonic damages testimony due to the lack of unanimity among economists as to which life valuation studies ought to be considered) (citing *Mercado v. Ahmed*, 756 F. Supp. 1097 (N.D.Ill. 1991)); *Brereton v. United States*, 973 F. Supp. 752, 758 (E.D. Mich. 1997) (finding Stan Smith's calculations of hedonic damages unreliable under *Daubert*); *Kurncz v. Honda North America*, 166 F.R.D. 386 (W.D. Mich. 1996) (finding Stan Smith's hedonic damages testimony inadmissible under *Daubert* for the

reasons articulated in *Ayers v. Robinson*, 887 F. Supp. 1049 (N.D.Ill. 1995)); *McGuire v. City of Santa Fe*, 954 F. Supp. 230, 232-33 (D.N.M. 1996) (finding, under *Daubert*, hedonic damage testimony is neither testable nor generally accepted); *Ayers v. Robinson*, 887 F. Supp. 1049 (N.D.Ill. 1995) (finding variation of results and assumptions underlying value of life studies made hedonic damages calculations unreliable under *Daubert*); *Hein v. Merck & Co.*, 868 F. Supp. 230 (M. D. Tenn. 1994) (rejecting hedonic damages testimony as insufficiently reliable or valid to meet the requirements of *Daubert*); and *Sullivan v. United States Gypsum Co.*, 862 F. Supp. 317 (D.Kan.1994) (finding Stan Smith's calculation of hedonic damages to lack sufficient validity to be admissible under *Daubert*).

See Thomas J. Airone, *Hedonic Damages and the Admissibility of Expert Testimony in Connecticut After Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 15 QUINNIPIAC L. REV. 235, 261 (1995).

XII. NON-SCIENTIFIC EXPERTS.

Daubert or *Robinson* reliability has been applied to areas outside of physical science.

A. ENGINEERS. In *Kuhmo Tire* and in *Gamill*, reliability standards were applied to engineers. See *Stanczyk v. Black & Decker*, 836 F. Supp. 565 (N.D. Ill. 1993) (court excluded testimony of engineering expert as to safety design of saw, because the expert had never tested his theory, and it had never been submitted to peer review and was not generally accepted).

B. ACCIDENT RECONSTRUCTION. In *Robinson v. Missouri Pac. R.R. Co.*, 16 F.3d 1083, 1088-89 (10th Cir. 1994), the Tenth Circuit held that a video re-creation of an accident by an expert witness and his testimony is subject to *Daubert's* gate-keeping function. The Fifth Circuit concurred in this view in *U.S. v. Norris*, ___ F.3d ___ (5th Cir. 6-26-2000) [No. 99-30689], where it held that the trial court's application of the traditional "substantial similarity" requirement for re-creations amounted to a *Daubert* analysis.

C. MEDICAL TESTIMONY. In *Moore v. Ashland Chemical, Inc.*, 126 F.3d 679 (5th Cir. 1997), the Fifth Circuit Court of Appeals held that *Daubert* reliability standards apply to clinical medical opinions regarding causality. *Accord.*, *Tanner v. Westbrook*, 174 F.3d 542 (5th Cir. 1997).

D. PSYCHOLOGY. In *Wessmann v. Gittens*, 160 F.3d 790 (1st Cir. 1998), the U.S. Court of Appeals for the First Circuit said:

When scientists (including social scientists) testify in court, they must bring the same intellectual rigor to the task that is required of them in other professional settings. See *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993); *Braun v. Lorillard, Inc.*, 84 F.3d 230, 234 (7th Cir. 1996); see also *People Who Care*, 111 F.3d at 537 (declaring, in reviewing admissibility of social science evidence purporting to quantify causes of achievement gap, that "the methods used by the expert to derive his opinion [must] satisfy the standards for scientific methodology that his profession would require of his out-of-court research")

In *Skidmore v. Precision Printing and Pkg., Inc.*, 188 F.3d 606 (5th Cir. 1999), the Fifth Circuit applied the *Daubert* reliability concept to a psychologist who testified to a diagnosis that the plaintiff suffered from post-traumatic stress disorder and depression brought on by the defendant's conduct, and held no abuse in admitting the testimony.

In *Nichols v. American National Insurance Co.*, 154 F.3d 875 (8th Cir. 1998), the Eight Circuit Court of Appeals affirmed the trial court's rejection of the opinion of an M.D. and two Ph.D. psychologists that several children had been subjected to child abuse. The professionals supported their conclusions by Child Behavior Checklists (CBCs) completed by the children's parents; (2) conducting clinical interviews with the children that involved role playing with anatomically correct dolls; and (3) interviews with the children's parents and assessment of their credibility. The District Court found:

(1) that the CBCs relied upon in part by the appellants' experts had not been validated for use with mentally retarded children; (2) that in any event a CBC is insufficient, on its own, to establish that a child has been abused; (3) that Dr. Sullivan's clinical interview protocol, which [the children's] experts submitted and which they claimed was accepted by the relevant scientific community, did not provide specific guidance for conducting clinical interviews; and (4) that in interviewing the [children], [the children's] experts departed significantly from the clinical protocol that they submitted to the court.

The Eight Circuit Court of Appeals also noted that there was no support for the low rate of error claimed by the experts. And the Court noted that the experts' methodology led to the choice of a mode of therapy for these children, and not a diagnosis of child abuse.

E. OTHER TYPES OF EXPERTS. A wide variety of other non-scientific experts have been held to the *Daubert* reliability concept, but not so much the *Daubert* factors. In *United States v. Ramsey*, 165 F.3d 980 (D.C. Cir. 1999), the court upheld the admission of opinion testimony of a DEA agent regarding drug trade. In *U.S. v. Tocco*, 200 F.3d 401 (6th Cir. 2000), the court upheld the admission of a law enforcement officer's testimony regarding the nature of organized crime. In *U.S. v. Hankey*, 203 F.3d 1160 (9th Cir. 2000), the court affirmed the admission of a police officer's explanations of gang behavior. In justifying its decision, the court made the following comments about how to evaluate the reliability of non-scientific expert testimony:

Given the type of expert testimony proffered by the government, it is difficult to imagine that the court could have been more diligent in assessing relevance and reliability. The *Daubert* factors (peer review, publication, potential error rate, etc.) simply are not applicable to this kind of testimony, whose reliability depends heavily on the knowledge and experience of the expert, rather than the methodology or theory behind it. See *Kumho Tire*, 119 S.Ct. at 1175 ("Engineering testimony rests upon scientific foundations, the reliability of which will be at issue in some cases. . . . In other cases, the relevant reliability concerns may focus upon personal knowledge or experience.") (internal citations omitted); *United States v. Plunk*, 153 F.3d 1011, 1017 (9th Cir. 1998) (upholding admission of expert testimony from law enforcement officer regarding jargon of narcotics trade, on basis of expert's training, experience, and personal knowledge). [fn7] The district court probed the extent of this knowledge and experience during the motion in limine-FRE 104 hearing, and therefore did not abuse its discretion in determining how best to conduct an assessment of the expert testimony.