

NO MONEY, NO PROBLEM – LITIGATING ON A BUDGET

I. NO MONEY TO HIRE AN EXPERT:

- a. Use the witnesses that you do have to your advantage
 - i. Debtor can testify to the value of his own property.
 1. 5th Circuit – Debtor can testify to value of his own property because of the presumption of special knowledge that arises out of owning land.
- b. Debtor can testify to value under 701 as layman **OR** 702 as an expert.
 - i. Under 701 – may merely give his opinion based on his financial familiarity with the property (generally what he paid for it)
 - ii. Under 702- testifying as an expert, the debtor (home-owner) can testify to what others have told him concerning value of his or comparable properties.
- c. In the absence of other evidence, debtor’s testimony as an owner may be conclusive, if the debtor is found to be credible.

II. RULES OF EVIDENCE ARE YOUR BEST FRIEND

- a. Use your witness as best as possible.
- b. Most lawyers will object on the grounds of *Hearsay, Best Evidence Rule, Lacks Foundation*, without knowing how to argue those objections when you are armed with case law.
 - i. Bring case law to court.
 - ii. Preparing for objections in advance is key.
- c. Judicial Notice
 - i. The Court can take Judicial Notice of certain facts for which you do not need an expert witness.
 - ii. *Ex/ In re Gbadebo* (Chapter 11 Case) – Debtor testified to the value of his home. Creditor objected and noted that an appraisal was obtained 3 years earlier and that it was not credible that the value of the property declined so dramatically in such a short amount of time. The Judge held that the Court is regularly confronted by comparable declines in value in the last few years on its relief from stay calendar. This phenomenon is sufficiently well known and beyond dispute that it is a fact that the Court took judicial notice.

III. USE THE OTHER SIDES’ EXPERT

- a. Discredit the expert.
- b. Intensive cross-examination
 - i. Voir Dire – take control of the hearing to discredit the expert.
- c. Background research on your witness
 - i. Review and compare expert’s resume(s)
 - ii. Experience of the expert
 1. Does he ALWAYS testify for the debtor?
 2. Ever been discredited by any court?

IV. SOCIAL MEDIA & THE INTERNET

- a. Google Earth

- i. *In re Helena Christian School, Inc.* - The Debtor's valuation evidence hinged on printouts from Google Earth.
 - ii. Expert witness used printouts from Google Earth to testify that there could be \$60million of gold on the property. Court was unimpressed by satellite photographs obtained from Google Earth and unknown photographer.
- b. www.Zillow.com
 - i. Debtor attempted to introduce valuation evidence based on reports from "zillow.com" and other similar Internet based sources. This evidence was not admissible. It is hearsay. See Fed. R. Evid. 801. And, while Fed. R. Evid. 803(17) excepts from the hearsay rule market compilations generally used and relied upon by the public, no foundation was laid establishing that the values reported by these Internet sites meet this criteria.
 - ii. www.zillow.com is "inherently unreliable because it's a participatory site almost like Wikipedia, where a homeowner with no technical skill beyond the ability to surf the web can log in to Zillow and add or subtract data that will change the value of his property.
- c. Facebook
 - i. Shocking what an expert or Debtor might disclose on their facebook page.
 - ii. Recent photographs of debtor's property.

V. FROM THE CREDITOR'S PERSPECTIVE

- a. Use simple discovery in preparation for a hearing on value.
- b. Send Interrogatories and Request For Admissions to find out what the Debtor relied upon when determining the value of an asset listed in his schedules.
- c. Otherwise, you cannot prepare rebuttal exhibits when the Debtor testifies in court that he relied on comparable properties, damage to property, appraisal district, etc.
- d. Will help with discrediting the Debtor if the Debtor attempts to introduce new facts at the valuation hearing.

Context of Valuation of Assets of Business

- On-going Concern
- Liquidation

Basic On-going Concern Methodologies

1. Adjusted Book Value
 - a. An acceptable, but not preferred methodology because Book Value does not represent market value
 - b. Method consists of:
 - i. Take the Book Value of net worth
 - ii. -assets not acquired
 - iii. +liabilities not assumed
 - iv. +fair market value of assets acquired
 - v. +any net worth adjustments
 - vi. =Adjusted Book Value
2. Capitalized Adjusted Earnings
 - a. An acceptable, but not preferred methodology.
 - b. Method consists of:
 - i. Adjust Historical Earnings for Anticipated Changes of New Ownership (Owner salary, etc.)
 - ii. Perform a Weighted Average of the Adjusted Earnings (give more weight to recent years, less to older years)
 - iii. Determine an appropriate Discount Rate that reflects suitable risk and illiquidity
 - iv. Value Equals Weighted Average Earnings/Discount Rate
3. Discounted Future Earnings
 - a. An acceptable, but not preferred methodology due to the number of assumptions (# of years, inflation rate, discount rate, etc.) utilized in the valuation process. The methodology has value as a means to check the reasonableness of other valuations.
 - b. Method consists of:
 - i. Adjust Historical Earnings for Anticipated Changes of New Ownership (Owner salary, etc.)
 - ii. Perform a Weighted Average of the Adjusted Earnings (give more weight to recent years, less to older years)
 - iii. Determine an appropriate Discount Rate that reflects suitable risk and illiquidity
 - iv. Increase the Weighted Average Earnings by inflation for each of the future years then apply the present value of the future year using the assumed Discount Rate.
4. Cash Flow Method
 - a. Preferred methodology – The buyer is purchasing future cash flows. What is the value of the future cash flows today? The method identifies the future cash flows available to the business before financing (tax deductible) and capital requirements (tax deductible).
 - b. Method consists of:

- i. Determine an appropriate Discount Rate that reflects suitable risk and illiquidity
 - ii. Estimate cash flows from operations (EBITDA – Earnings before Interest, Depreciation, and Amortization) for future years (typically 5-10 years),
 - iii. Apply a present value to each of the future years cash flows utilizing the Discount Rate.
 - iv. Calculate the present value of each future years earnings using the Discount Rate.
 - v. Value equals the sum of the present values of future years earnings.
5. Gross Revenue Multiplier
- a. A notorious unreliable indicator of valuation but utilized for start-up businesses that have no history of earnings. The key assumption is the business will grow to be profitable, or provide profitable synergies, in the future. Example – Facebook paying \$19 Billion for Whatsapp.
 - b. In established businesses and markets, the method is sometimes used to purchase new competitors and limit competition (maintain industry pricing levels).

Liquidation Valuations are self-explanatory. Typically valued on a distressed sale basis occurring within a 30-90 day period.

Noteworthy cases:

- *In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Tex. 2005)
- *In re Nellson Nutraceutical, Inc.*, 2007 WL 201134, Case No. 06-10072 (Bankr. D. Del. Jan. 18, 2007)

Commercial Real Property Valuation

I. Examples of Bankruptcy Code Sections that Implicate Valuation Issues

- a. Adequate protection – 11 U.S.C. § 361
- b. Relief from Stay – 11 U.S.C. § 362
- c. Sale of Assets – 11 U.S.C. § 363
- d. Determination of Secured Status – 11 U.S.C. § 506
- e. Plan Confirmation and Cramdown – 11 U.S.C. § 1129(b)(2)(A)

II. Qualifications of Experts

- a. FRE 702
 - i. "A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if: (a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue; (b) the testimony is based on sufficient facts or data; (c) the testimony is the product of reliable principles and methods; and (d) the expert has reliably applied the principles and methods to the facts of the case."
- b. *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993)

III. Credibility

- a. Court determines credibility of the experts.
- b. "A bankruptcy court is not bound by the expert reports or opinions of appraisers and may form its own opinion of value of the subject property. The court may accept an entire appraisal or give weight to only a portion of the report. When competing appraisals are submitted, the court must consider portions of each report in order to arrive at a realistic market value. When two competent appraisals presented by qualified appraisers provide widely divergent value, heightened scrutiny is appropriate." *Int'l Bank of Commerce v. Davis (In re Diamond Beach)*, Bankruptcy No. 12-10175, Adv. No. 12-01006, 2014 WL 896784 at *13 (Bankr.S.D.Tex. Mar. 6, 2014).

IV. Highest and Best Use

- a. 11 U.S.C. § 506(a)(1) – "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."
- b. Fair Market Value

V. Approaches to Determining Market Value

- a. Comparable Sales Method
 - i. Appraiser analyzes sales of reasonably similar properties and then adjusts the purchase price for those properties to account for differences between the subject property and the comparable properties.
 - ii. The appraiser's selection of comparable properties is important.
- b. Cost Method
 - i. Determines value of property by estimating the current cost to construct a replacement for, or reproduction of, the existing structure, including an entrepreneurial incentive, deducting depreciation from the total cost and adding the estimated land value.
- c. Income Method
 - i. Net income is determined by estimating future income, deducting for expenses and applying a capitalization rate to determine the present value of future income.
- d. Subdivision Development Method
 - i. Values an undeveloped tract of land by calculating what a developer could expect to realize from sale of individual lots, taking into account the cost of development and discounting future revenues to present value.

VI. Examples from Case Law

- a. *Int'l Bank of Commerce v. Davis (In re Diamond Beach)*, Bankruptcy No. 12-10175, Adv. No. 12-01006, 2014 WL 896784 (Bankr.S.D.Tex. Mar. 6, 2014)
- b. *In re SCC Kyle Partners, Ltd.*, No. 12-11078-HCM, 2013 WL 2903453 (Bankr. W.D.Tex. June 14, 2013)

Fifth Circuit Law on Expert Witnesses

Prepared By: Arsalan Muhammad, Haynes and Boone, LLP
and Evelyn Breithaupt, Thompson & Knight LLP

I. FEDERAL RULES OF EVIDENCE

a. Background Regarding Admissibility (FED. R. BANKR. P. 9017 makes the Federal Rules of Evidence applicable)

- i. FED. R. EVID. 401 states that evidence is relevant if (a) it has any tendency to make a fact more or less probable than it would be without the evidence; and (b) the fact is of consequence in determining the action.
- ii. FED. R. EVID. 402 states that relevant evidence is admissible unless any of the following provides otherwise, (i) the United States Constitution; (ii) a federal statute; (iii) these rules; or (iv) other rules prescribed by the Supreme Court. Irrelevant evidence is not admissible.

b. Qualifications of an Expert

- i. FED. R. EVID. 702 states that a witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:
 1. the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;
 2. the testimony is based on sufficient facts or data;
 3. the testimony is the product of reliable principles and methods; and
 4. the expert has reliably applied the principles and methods to the facts of the case.

II. DAUBERT

a. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993)

- i. Two minor children who suffered from birth defects, and their parents, sued a company which marketed a drug used by the children's mothers. The defendant moved for summary judgment after its experts demonstrated that there were no published studies showing a link between the drug and the birth defect. The district court granted the summary judgment based on the standard that expert testimony should be generally accepted in the particular field. The Ninth Circuit affirmed citing the "general acceptance" standard established in *Frye v. United States*, 293 F. 1013, 1014 (D.C. Cir. 1923). *Frye* stated that "while courts will go a long way in admitting expert testimony deduced from a well-recognized scientific principle or discovery, the thing from which the deduction is made must be sufficiently established to have gained general acceptance in the particular field in which it belongs."
- ii. The Supreme Court stated that in the 70 years since *Frye*, the "general acceptance" standard had become the dominant standard for determining admissibility of scientific evidence. The plaintiffs contended that the Federal Rules of Evidence overruled *Frye*. The Supreme Court cited FED. R. EVID. 401 and 402's liberal standard of admissibility. The Supreme Court ruled that FED. R. EVID. 702 superseded the *Frye* standard and

vacated the Ninth Circuit's ruling and remanded for a decision consistent with the new standard.

- iii. "Faced with the proffer of expert scientific testimony, then, the 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. This entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue."
- iv. *Daubert* provided five (5) factors to be considered, which are not a definitive checklist or a test:
 1. "[W]hether a theory or technique is scientific knowledge that will assist the trier of fact will be whether it can be (and has been) tested."
 2. "[W]hether the theory or technique has been subjected to peer review and publication."
 3. "[I]n the case of a particular scientific technique, the court ordinarily should consider the known or potential rate of error...."
 4. "[T]he existence and maintenance of standards controlling the technique's operation...."
 5. "Widespread acceptance can be an important factor in ruling particular evidence admissible..."

b. Standard of Review

- i. *General Electric Co. v. Joiner*, 522 U.S. 136 (1997) held that a decision regarding admissibility of expert testimony should be reviewed under the abuse of discretion standard.

Selected Cases

VALUATION AND APPRAISAL

In re Mirant Corp., 334 B.R. 800 (Bankr. N.D. Tex. 2005) (Lynn, J.).

- In a complex valuation case, expert reports that admittedly contained material mathematical errors were not reliable, even though the individual experts were qualified.
- An expert influenced by his or her retainer's needs does not necessarily act improperly, but the court should be cautious to avoid undue optimism.
- Court found that the Discounted Cash Flow (DCF) Method and the Comparable Method were more likely than the Transactions Method and the Capacity Method to ensure that the valuation would be based on the worth of the debtor's future ability to produce income.
- Court determined that one expert report was more reliable than the others and relied on that report as a base for recalculating value, rather than melding the values provided by multiple experts.

Anderson v. Mega Lift Sys., L.L.C. (In re Mega Sys., L.L.C.), Adv. No. 04-6085, 2006 WL 6571680 (Bankr. E.D. Tex. Sept. 14, 2006) (Parker, J.).

- Court admitted informal appraisal report despite *Daubert* challenge where the “primary complaints of the Trustee [went] to the exercise of [the expert’s] professional judgment and his utilization, or lack thereof, of any particular methodology available in the business valuation field, or his reliance upon factual assumptions with which the Trustee obviously disagrees.” Court stated that potential errors in judgment calls went to the “credibility or weight to be given to [the] testimony, not to its admissibility.”

Anderson v. Mega Lift Sys., L.L.C. (In re Mega Sys., L.L.C.), Adv. No. 04-6085, 2006 WL 6571681 (Bankr. E.D. Tex. Sept. 14, 2006) (Parker, J.).

- Expert was not qualified to render an expert opinion on the value of a patent where he had no specialized knowledge, skill, training or education in the value of patents, and had only once valued a patent.
- Proposed expert was not a fact witness as to value even though he may have given a valuation opinion prior to the sale of a business. Court would not permit him “to testify as to the value he assigned to the patent at that time, nor the process by which he made such a determination, because he never possessed the specialized knowledge or experience which would allow him to legitimately make that determination.”

In re Gen. Electrodynamics Corp., 368 B.R. 543 (Bankr. N.D. Tex. 2007) (Lynn, J.)

- Despite lack of objection to expert’s status, court’s confidence in valuation expert’s projections was negatively affected by his potential failure to have investigated new technologies that would arguably allow the debtor to remain competitive, his possible failure to have spoken to industry experts to analyze the feasibility of making payments on a claim, and the expert’s possible lack of the training necessary to conduct such analysis.

DAMAGES

Blackwell v. Wells Fargo Bank, N.A. (In re I.G. Servs., Ltd.), Adv. No. 04-5041, 2005 WL 6523867 (Bankr. W.D. Tex. May 11, 2005) (Clark, J.).

- Court denied motion to exclude CPA’s expert report on damages. Defendants sought to exclude report because it failed to establish cause-in-fact between breach of duty and the damages; Court noted that this is “a job for the trier of fact.” Expert report easily met standard of reliability where it relied in part on earlier expert opinion and did not improperly ignore factual causation.
- Court also overruled arguments that report wrongly ignored various factors, because expert adequately explained why these factors did not bear on his opinion.
- Finally, expert adequately explained why he chose certain starting dates for calculating damages.

Dijo, Inc. v. Hilton Hotels Corp., 351 F.3d 679 (5th Cir. 2003).

- Although lay opinion on lost profits is sometimes permitted when the witness is or was an officer or employee, a financial consultant who was neither qualified as an

expert nor an officer or employee and who was not sufficiently acquainted with the company's affairs could not testify on lost profits.

- Because the plaintiff never attempted to qualify the financial consultant as an expert, information regarding her years of general experience did not help to show that she could testify on lost profits.

In re Texans CUSO Ins. Grp., LLC, 426 B.R. 194 (Bankr. N.D. Tex. Mar. 2, 2010) (Houser, J.).

- CPA's testimony as damages expert was admissible as based on his general experience although he lacked specific experience in the insurance field.
- CPA's lack of knowledge about the content and methodology of a best practices study went to the weight, rather than the admissibility, of the expert's testimony.

QUALIFICATION

Blackwell v. Wells Fargo Bank, N.A. (In re I.G. Services, LTD), Adv. No. 04-5041, 2004 WL 5866104 (Bankr. W.D. Tex. Dec. 14, 2004) (Clark, J.).

- In breach of fiduciary duty case, money-laundering investigator could testify as to whether bank complied with applicable industry standards in handling bank accounts even though he was not a banker. Court stated, "Moynihan need not be a banker to be an expert on banking practices."

INDUSTRY TERMINOLOGY

Cutting Underwater Technologies USA, Inc. v. ENI U.S. Operating Co., 671 F.3d 512 (5th Cir. 2012).

- An expert witness may testify that a particular set of facts falls within a technical definition without testifying as to an ultimate conclusion of law. "It would be a different situation had [the expert witness] stated in his affidavit that, for instance, the term 'abandoning a well' has a particular technical meaning and that the work performed by TBS does not fall within the scope of that technical meaning."

Kona Tech. Corp. v. Southern Pac. Transp. Co., 225 F.3d 595 (5th Cir. 2000).

- In a contract dispute, Fifth Circuit affirmed district court's reliance on an expert's testimony regarding specialized industry terms. Court stated that "a trial court's reliance on individuals experienced in a particular field for the purposes of obtaining explanation of the technical meaning of terms used in the industry is 'prudent.'" Because individual was qualified to testify on industry practice, court upheld reliance on the testimony.

EXPERT REPORTS

NGP Capital Resources Co. v. ATP Oil & Gas Corp. (In re ATP Oil and Gas Corp.), Adv. No. 12-3443, 2013 WL 6798767 (Bankr. S.D. Tex. Dec. 19, 2013) (Isgur, J.).

- Expert reports were incompetent summary judgment evidence because they were not sworn nor submitted under penalty of perjury.

- An accountant who was a Certified Public Accountant and Certified Valuation Analyst and who had provided expert opinions regarding oil and gas accounting in royalty transactions and an economist with a Ph.D. who specialized in the economics of valuation with a particular emphasis on the energy sector were qualified as an experts on the economic substance of oil and gas royalty transactions.
- In a dispute regarding the substance versus the form of transactions, experts could testify as to the “economic substance” of the transactions, and analysis based on the GAAP treatment of the transactions was sufficiently reliable.
- An expert may testify as to whether a set of facts falls within a particular technical definition without testifying as to an ultimate conclusion of law.

O’Malley v. U.S. Fidelity & Guar. Co., 776 F.2d 494 (5th Cir. 1985).

- An expert report is inadmissible unless it qualifies as data relied upon by an expert witness under Rule 705 or fits within a hearsay exception.

Perez v. City of Austin, 2008 WL 1990670 (W.D. Tex. May 5, 2008).

- An expert report is generally not an admissible document at trial, as it is hearsay.

