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How to Prepare for and Successfully Try a Securities Class Action in the Post-Reform Era

***847** CHALLENGES TO EXPERT TESTIMONY IN THE AFTERMATH OF DAUBERT AND KUMHO

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***849 Introduction**

Two United States Supreme Court decisions - Daubert v. Merrell Dow Pharmaceuticals, 509 U.S. 579 (1993) and Kumho Tire Co. v. Carmichael, 526 U.S. 137 (1999) - have provoked considerable motion practice on the issue of admissibility of expert testimony in securities fraud class actions. In particular, the defense bar has launched challenges to plaintiffs' damages expert witnesses claiming such testimony is unreliable under Federal Rule of Evidence ("FRE") 702 and under the principles articulated in Daubert.

This article (i) addresses the standard for admissibility of expert testimony under the Federal Rules of Evidence, (ii) discusses the Supreme Court's application of the federal rules in the Daubert and Kumho decisions and (iii) notes the recent court rulings on motions to exclude expert testimony in securities fraud class actions.

***850 I. THE STANDARD FOR ADMISSIBLITY OF EXPERT TESTIMONY UNDER THE FEDERAL** RULES OF EVIDENCE

The admissibility of expert testimony is governed by FRE 702 [FN2] which provides:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by

knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

A judge assessing a proffer of expert testimony should also be attentive to other applicable Federal Rules of Evidence. Daubert, 509 U.S. at 595. For instance, FRE 703 provides that expert opinions based on otherwise inadmissible hearsay are to be admitted only if the facts or data are "of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject." Daubert, 509 U.S. at 595 (quoting FRE 703). FRE 706 allows the court, at its own discretion, to "appoint expert witnesses of its own selection." Also, FRE 403 permits the exclusion of relevant evidence "if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury...." Finally, the court must seek to avoid "unjustifiable expense and delay" as part of the search for "truth" and the "just[] determin[ation]" of proceedings. FRE 102.

The Supreme Court in Daubert stressed that when a trial judge is faced with a proffer of expert scientific testimony, the "judge must determine at the outset, pursuant to ***851** [FRE] 104(a), [FN3] 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." Daubert, 509 U.S. at 592.

II. APPLICATION OF FEDERAL RULE OF EVIDENCE 702 BY THE UNITED STATES SUPREME COURT

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

In Daubert, the Supreme Court addressed the standard for admitting expert scientific testimony in a federal trial. Daubert, 509 U.S. at 582. Petitioners, two minor children, were both born with serious birth defects. Id. They and their parents sued respondent alleging that the birth defects were caused by the mothers' use of Bendectin, an anti-nausea prescription drug marketed by respondent. Id. Respondent moved for summary judgment arguing that Bendectin did not cause birth defects and that petitioners would be unable to offer any admissible evidence establishing that Bendectin did cause birth defects. Id.

The district court, in granting respondent's motion for summary judgment, stated that scientific evidence is admissible only if the principle upon which it is based is "'sufficiently established to have general acceptance in the field to which it belongs."' Daubert, 509 U.S. at 583 (citing 727 F. Supp. 570, 572 (S.D. Cal. 1989), quoting United States v. Kilgus, 571 F.2d 508, 510 (9th Cir. 1978)). The district court decided that petitioners' evidence did not meet the necessary standard. Daubert, 509 U.S. at 583.

***852** The Ninth Circuit Court of Appeals affirmed the district court and noted that expert opinion based on a scientific technique is inadmissible unless the technique is "generally accepted" as reliable in the relevant scientific community. 951 F.2d 1128, 1129-30 (9th Cir. 1991). [FN4] The Ninth Circuit concluded that expert opinion based on a methodology that deviates "significantly from the procedures accepted by recognized authorities in the field...cannot be shown to be 'generally accepted as a reliable technique."' Id. at 1130 (quoting United States v. Solomon, 753 F.2d 1522, 1526 (9th Cir. 1985)).

The United States Supreme Court granted certiorari [FN5] "in light of sharp divisions among the courts" regarding the appropriate standard for the admission of expert opinion. Daubert, 509 U.S. at 585. Compare United States v. Shorter, 809 F.2d 54, 59-60 (applying the "general acceptance" standard), cert. denied, 484 U.S. 817 (1987), with DeLuca v. Merrell Dow Pharmaceuticals, Inc., 911 F.2d 941, 955 (3d Cir. 1990) (rejecting the "general acceptance" standard). The Supreme Court, in noting that the Frye "general acceptance" test was superseded by the adoption of the FRE, stated that ***853** "[n]othing in the text of this Rule [702] establishes 'general acceptance' as an absolute prerequisite to admissibility." Daubert, 509 U.S. at 587-88.

The Supreme Court emphasized that the inquiry envisioned by FRE 702 is a flexible one and acknowledged that "many factors" will bear on the inquiry of whether the reasoning or methodology of the expert can be properly applied to the facts in issue. Id. at 593. Four factors to be considered when determining the admissibility of expert testimony as discussed by the Supreme Court in Daubert include:

(1) whether the expert's theory or technique can be and has been tested;

(2) whether the theory or technique has been subjected to peer review and publication;

(3) consideration of the known or potential rate of error; and

(4) whether the theory or technique has been generally accepted by the relevant scientific community.

Id. at 593-594. [FN6]

The Supreme Court explicitly noted that the four factors mentioned do not constitute a "definitive checklist or test" for assessing the admissibility of expert testimony. Daubert, 509 U.S. at 593. The role of the trial judge is that of "gatekeeper" to assure that all expert testimony is both relevant and reliable before it can be admitted. Id. at 597. In summary, the Supreme Court stated:

"General acceptance" is not a necessary precondition to the admissibility of scientific evidence under the Federal Rules of Evidence, but the Rules of Evidence - especially Rule 702 - do assign to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand.

***854** Daubert, 509 U.S. at 597. The Ninth Circuit's ruling was vacated and the case was remanded to the district court for further proceedings. Id. at 597-98.

B. Kumho Tire Co., Ltd. v. Carmichael, 526 U.S. 137 (1999).

In Kumho, the Supreme Court addressed the issue of whether Daubert applies to expert testimony based upon "technical" or "other specialized" knowledge rather than solely "scientific" knowledge. Kumho, 526 U.S. at 146- 47. Respondent was driving a minivan when the right rear tire blew out, resulting in an accident where one of the passengers died and others were severely injured. Id. at 142. Respondent sued petitioner, Kumho Tire Co., in federal district court based on diversity jurisdiction, claiming liability against the tire maker and its distributor for a defective tire. Id. Petitioner moved the district court to exclude respondent's tire failure analysis expert's testimony arguing that the expert's methodology did not meet FRE 702 reliability requirements. Id. at 145. The district court granted petitioner's motion to exclude the testimony, finding that respondent's expert's methodology failed to satisfy the reliability-related factors mentioned in Daubert - the theory's testability, whether it "has been a subject of peer review or publication," the "known or potential rate of error," and the "degree of acceptance...within the relevant scientific community." Id. at 145 (citing 923 F. Supp. 1514, 1520 (S.D. Ala. 1996); Daubert, 509 U.S. at 592-594).

The district court then granted respondent's motion for reconsideration. Kumho, 526 U.S. at 145 (citation omitted). In affirming its earlier order declaring the respondent's expert's testimony inadmissible, the district court did, however, agree with respondent that "Daubert should be applied flexibly, that its four factors were simply illustrative, and that other factors could argue in favor of admissibility." Id. at 145-46.

***855** The Eleventh Circuit Court of Appeals reversed, Carmichael v. Samyang Tires, Inc., 131 F.3d 1433 (11th Cir. 1997), and concluded that the Supreme Court's decision in Daubert applied strictly to "scientific principles", that respondent's expert's testimony fell outside the scope of Daubert, and that the district court erred as a matter of law by applying Daubert. Kumho, 526 U.S. at 146 (citing 131 F.3d at 1436).

The Supreme Court granted certiorari and extended the holding in Daubert to apply not only to expert testimony based on "scientific" knowledge, but also to expert testimony based on "technical" and "other specialized" knowledge. 526 U.S. at 141, 146-47. In noting that the list of factors discussed in Daubert were meant "to be helpful, not definitive", the Kumho court stated:

> Indeed, those factors do not all necessarily apply even in every instance in which the reliability of scientific testimony is challenged.
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> ...
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> [T]he trial judge must have considerable leeway in deciding in a particular case how to go about determining whether particular expert testimony is reliable. That is to say, a trial court should consider the specific factors identified in Daubert where they are reasonable measures of the reliability of expert testimony.

Kumho, 526 U.S. at 151-52.

The conclusion of the Supreme Court was that the district court did not abuse its discretionary authority and the ruling of the Court of Appeals was reversed. Id. at 158.

III. RECENT COURT DECISIONS APPLYING DAUBERT, KUMHO AND FEDERAL RULE OF EVIDENCE 702

In securities fraud class actions, one of the primary experts retained by plaintiffs is a damages expert. Damages in

a securities fraud case are measured by the difference between the price at which a stock sold and the price at which the stock would have sold ***856** absent the alleged misrepresentations or omissions. Affiliated Ute Citizens of the State of Utah v. United States, 406 U.S. 128 (1972). The "negative causation" argument, when asserted within the damages valuation context - requires elimination of that portion of the stock price increase or decrease that is the result of forces unrelated to the wrong. In re Executive Telecard, Ltd. Securities Litigation, 979 F. Supp. 1021, 1025 (S.D.N.Y. 1997) (citations omitted). Such forces can be broadly categorized as: (1) company risk - the unique risk that is particular to the subject stock, and (2) market risk - the risk related to market wide variations generally. Id., citing Brealey & Meyers, Principles of Corporate Finance, (5 th ed. 1996) at 173.

Before the Supreme Court decided the Kumho case, Judge Brieant in Executive Telecard, addressed defendant Executive Telecard's motion to exclude the testimony of plaintiffs' damages expert. [FN7] The plaintiffs' expert produced two damages reports, and Judge Brieant ultimately rejected both of them, concluding that the methodologies used by the expert to evaluate both company risk and market risk were "seriously flawed." Executive Telecard, 979 F. Supp. at 1025.

In his first report, the plaintiffs' expert measured class damages by comparing Executive Telecard's actual historical stock price during the class period to the stock's "true value" absent the fraud. Id. at 1024. The expert established the true value by measuring the average stock price during the ten- day period following the revelation of the fraud and by adjusting that price downward to reflect a decline in the Standard & Poor's Long Distance Telephone Index. Id. Finally, the expert plugged the true value ***857** figure into a computer model that reflected adjustments for inflation, float, volume, intra- day trading, and short interest. Id.

The expert's second report employed a slightly different methodology to construct "an alternative measure of damages." Executive Telecard, 979 F. Supp. at 1024. This time, to arrive at the true value, the expert compared the average price of the defendant's stock during the ten-day period after the revelation with the average price for the ten-day period ending roughly a month earlier. Id. at 1024-25. [FN8] The expert then adjusted the true value downward to "reflect market factors, which included the performance of

telecommunications stocks and the market in general." Id. The altered methodology in the expert's second report resulted in a reduction of total class damages from $18.5 million according to the first report to $14.6 million in the second report. Id. at 1024-25.

Judge Brieant began his analysis by examining the FRE 702 standards enumerated by the Supreme Court in Daubert. Executive Telecard, 979 F. Supp. at 1023-24. Recognizing that Daubert "turned on very specific medical and statistical issues in the area of disease causation," Judge Brieant determined that the Supreme Court had limited its guidance to scientific testimony and had not, in fact, intended such factors to apply to "technical, or other specialized knowledge" testimony. Id. at 1024. Judge Brieant, therefore, decided to evaluate the two expert opinions before him by focusing simply on "the reliability of the principles and methodologies used." Id.

***858** Judge Brieant first addressed the issue of company risk, or "the unique risk that is peculiar to the particular stock at issue." Id. at 1025. Such analysis requires that an expert conduct some sort of "event study" to distinguish between fraud related and non-fraud related company-specific influences. Id. Because neither of the reports before the court had indicated whether the expert had conducted an event study, Judge Brieant concluded such reports appeared to be "seriously flawed." [FN9] Id.

After determining that the absence of an event study, standing alone, warranted rejection of the reports, Judge Brieant proceeded to examine the issue of "market risk," or "the risk associated with market-wide variations generally." Executive Telecard, 979 F. Supp. at 1025-27. This analysis, Judge Brieant noted, requires an expert to value a security using a "precisely correlated portfolio of securities." Id. at 1027. The expert reports at bar were further flawed because they had compared defendant's highly volatile stock price to a telecommunications index that consisted of relatively stable, highly-capitalized companies. [FN10]

The Executive Telecard court granted defendants' motion to exclude plaintiffs' expert's testimony but also granted plaintiffs "a reasonable time to enlist the services of a ***859** new damages expert, or alternatively to have the [proposed expert] revisit the issues in order to correct the flaws described" by the court. 979 F. Supp. at 1029.

More recently, in RMED International, Inc. v. Sloan's Supermarkets, Inc., No. 94 Civ. 5587 PKL RLE, 2000 WL 310352, (S.D.N.Y. Mar. 24, 2000), aff'd, 2000 WL 420548 (S.D.N.Y. Apr. 18, 2000), the methodology of plaintiffs' damages expert survived judicial scrutiny. There, the defendant supermarket chain moved to exclude the proposed testimony at trial of plaintiff's damages expert under both FRE 702 and Daubert. RMED, 2000 WL 310352 at *1. Adopting the entire Memorandum Opinion & Order of Magistrate Judge Ellis, Judge Leisure concluded that the expert's testimony was "sufficiently reliable to be admitted." Id. at *10.

Plaintiffs' expert had determined the true value of defendant's common stock during the class period by, first, finding the average closing price of the stock for the five days following defendant's disclosure of the alleged fraud. RMED, 2000 WL 310352 at *4. The expert then adjusted this average to account for external influences by applying the daily percentage of change of an index that consisted of comparable grocery stores. Id. Next, the expert conducted an event analysis that involved painstakingly scrutinizing every company- specific event during the class period that might possibly have influenced the defendant's common stock price. Id. She did this by examining "every piece of public information" available to investors during the class period. Id. The expert then proceeded to calculate the inflation per share for each day of the class period and arrived at the aggregate class damages by analyzing available information about actual class ***860** period transactions and by estimating the remaining class period damages using a computerized trading model. [FN11] Id.

Defendants challenged plaintiffs' expert's methodology on multiple grounds, likening her report to those summarily rejected by the Executive Telecard court. RMED, 2000 WL 310352 at *5. While following Judge Brieant's analysis, Magistrate Judge Ellis determined that, to the contrary, the expert's report at bar contained none of the serious flaws that barred the Executive Telecard reports and "was informed by a detailed factual analysis and grounded on principles generally accepted within the relevant field." Id. at *8. Most importantly, the RMED court observed, the expert's report contained a seventy-page event analysis summarizing every company-specific event that might have affected the defendant's stock price over a seven-year period. Id. at * 6. Further, the RMED court excused the expert's failure to conduct a statistical event

study because it would not have been feasible. Id. Neither the Executive Telecard nor the In re Oracle Securities Litigation, 829 F. Supp. 1176 (N.D. Cal. 1993) decisions mandate a statistical event study analysis as a predicate to admissibility under Daubert. RMED, 2000 WL 310352 at *6. The court also found the expert's choice of indices to be "fairly representative of the way in which [defendant's stock] would have traded absent the alleged fraud." Id. at *9. [FN12]

***861** Magistrate Judge Ellis denied defendants' motion to exclude plaintiffs' expert's testimony. RMED, 2000 WL 310352 at *10. Judge Leisure reviewed Magistrate Judge Ellis' reasoning and declined "to modify or set aside any portion of the Order." 2000 WL 420548 at *2.

IV. CONCLUSION

Defendants can certainly be expected to make Daubert challenges to plaintiffs' damages experts. Tactical litigation strategy may warrant the filing of such motions in certain instances. However, as the Supreme Court noted, "[v]igorous cross-examination, presentation of contrary evidence, and careful instruction on the burden of proof are the traditional and appropriate means of attacking shaky but admissible evidence." Daubert, 509 U.S. at 596 (citation omitted). Although defendants may disagree with the conclusions plaintiffs' damages experts reach, the focus should not be on the conclusions but rather the principles and methodologies utilized. Id. at 595.

The Executive Telecard and RMED courts have set forth a clear road map for plaintiffs' damages experts to follow and survive scrutiny under Daubert. Possibly, with such defined parameters, the mechanical Daubert motions will cease. Stay tuned.

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FN2. In December 1999 the Federal Judicial Conference submitted to the Supreme Court proposed changes to FRE 702 rewriting the rule to reflect the Supreme Court's

decision in Daubert v. Merrell Dow Pharmaceuticals Inc., 509 U.S. 570 (1993). Paul R. Rice, Expert Overhaul Needed Outdated Federal Evidence Rules Require More Than Judicial Tinkering, Legal Times, Jan. 31, 2000 at 51.

FN3. FRE 104(a) provides:
Preliminary questions concerning the qualification of a person to be a witness, the existence of a privilege, or the admissibility of evidence shall be determined by the court, subject to the provisions of subdivision (b) [pertaining to conditional admissions]. In making its determination it is not bound by the rules of evidence except those with respect to privileges.

FN4. The "general acceptance" test was formulated by the Court of Appeals for the District of Columbia in Frye v. United States, 293 F. 1013 (1923). "In what has become a famous (perhaps infamous) passage, the then Court of Appeals for the District of Columbia...declared:
'Just when a scientific principle or discovery crosses the line between the experimental and demonstrable stages is difficult to define. Somewhere in this twilight zone the evidential force of the principle must be recognized, and while courts 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."'
Daubert, 509 U.S. at 586, quoting Frye, 293 F. at 1014.

FN5. 506 U.S. 914 (1992).

FN6. The Daubert Court's discussion focused strictly on scientific expert opinion because that was the nature of the expertise offered. FRE 702 also applies to "technical, or other specialized knowledge." 509 U.S. at 590 n.8.

FN7. Also before the Executive Telecard court were cross-motions for summary judgment. 979 F. Supp. at 1023.

FN8. The expert's second damages report did not explain why the ending day of October 21, 1994 was chosen as opposed to the ending date of November 14, 1994 as used in his first damages report. Executive Telecard, 979 F. Supp. at 1025. The court "presumed that October 21 was chosen because that was the date that Judge Sweet issued

his opinion in the [Executive Telecard] proxy litigation. Id., citing Krauth et al. v. Executive Telecard, Ltd., No. 94 Civ. 7337, 1994 WL 584556 (S.D.N.Y. Oct. 21, 1994) (holding that a proposed Executive Telecard proxy statement omitted a material fact in violation of Section 14(a) of the Securities Exchange Act of 1934).

FN9. The court compared the expert's approach to that same expert's approach in In re Oracle Securities Litigation, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993), where, due to the complete absence of an event study, the Oracle court was unable to employ any meaningful evaluation of the expert's conclusions. Oracle, 829 F. Supp. at 1181.

FN10. The Executive Telecard court explained:
In contrast to the highly capitalized companies like AT&T and MCI included in the Telecom Index, a "small-cap" stock like [Executive Telecard, Ltd] does not trade on reported earnings per share, but instead moves in accordance with the market's expectations and perceptions of its long term economic prospects. Euphemistically, [defendant's] stock could be said to trade on "hope."
979 F. Supp. at 1028 n.3.

FN11. The computerized trading model utilized by plaintiffs' expert simulated the number of shares affected by the fraud by considering factors such as float, trading volume, and trading patterns. RMED, 2000 WL 310352 at *4.

FN12. Plaintiffs' expert chose an index of small grocery stores to factor out general market and industry effects from plaintiffs' damages. The index consisted of a group of small supermarkets specifically chosen as representative of defendant by Coopers & Lybrand Securities ("C&L"), at the direction of defendant, as part of a fairness opinion C&L provided defendant in connection with a merger. RMED, 2000 WL 310252 at *9.

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