PROSECUTING AND DEFENDING INSURANCE CLAIMS

ROBERT F. CUSHMAN, Esquire
BRUCE ROZNOWSKI, Esquire
WILLIAM E. SIMPSON, C.P.A.
Editors

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&Lybrand

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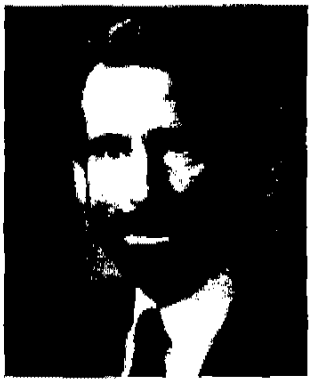
CHAPTER 20

USE OF EXPERT WITNESSES

William E. Simpson, C.P.A.

Thomas M. Neches, C.P.A.



William E. Simpson is a partner in the Los Angeles office of the national accounting and consulting firm of Coopers & Lybrand. As partner in charge of the Litigation Services practice, he offers attorney clients a wide range of assistance, from document gathering and analysis to damage determination and expert witness testimony. Mr. Simpson has testified on numerous occasions on accounting, auditing, business, and statistical issues. He has taught graduate and undergraduate courses at three universities. He received BS and MS degrees from California State University, Northridge, and a JD degree from UCLA School of Law. He is a certified public accountant, a certified management accountant, a certified fraud examiner, and a member of several professional organizations.

Thomas M. Neches is a partner in Coopers & Lybrand, where he is responsible for working with trial attorneys to develop financial, economic, statistical, and other analyses for use in the resolution of claims and in litigation. Mr. Neches specializes in the application of computer-based analytical techniques to litigation issues. He has testified as an expert in state and federal court and in administrative hearings in California, Nevada, and Oregon. Mr. Neches received his BA in mathematics and literature from the University of California, San Diego, his MS in operations research from the University of California, Los Angeles, and is a certified public accountant.

§ 20.1 Introduction

Major insurance litigation frequently boils down to a battle of experts. The side with the better experts—more thorough, better prepared, more credible, more convincing—is likely to prevail. The more complex the case, the more vital experts become: law firms do not maintain a staff of consultants, certified public accountants (CPAs), and other experts with the depth and breadth of experience to evaluate all the business, technical, financial, and economic aspects of a case. Similarly, law firms' clients do not have the resources to support major litigation without risking serious impairment to ongoing operations.

An expert is an individual with "special knowledge, skill, experience, training or education sufficient to qualify him as an expert on the subject to which his testimony relates."[1] Attorneys rely on experts to assist in all phases of litigation. Experts provide knowledge of the industry and its terminology. They assist in drafting or responding to complaints, interrogatories, and requests for documents. They perform investigations, verify and discover information, reconstruct transactions, determine values, calculate damages, render opinions, and testify as expert witnesses.

This chapter discusses the use of experts in major insurance litigation. Because of the universal need in these cases, the chapter emphasizes accounting and analytical expert assistance provided by CPAs and other business experts. Indeed, this is the most common type of expert assistance utilized in insurance litigation. However, most of the concepts discussed apply to the use of all types of experts, including scientific, technological, or medical experts.

[1] Fed. R. Evid. 702; Cal. Evid. Code § 720(a).

The chapter is organized to follow the chronology of expert assistance throughout a litigation: initiation of the case, selection of an expert, drafting of complaint, discovery, trial preparation, expert testimony, and appeal. The chapter concludes with several observations on how to work effectively with experts in major insurance litigations involving multiple parties.

§ 20.2 Cases Requiring Expert Assistance

Accountants can provide beneficial services in virtually any litigation. However, for certain types of major insurance litigations, the use of an accounting expert is essential. These types of litigation include:

Accounting malpractice. When lawyers first think of an accounting expert, they usually imagine themselves prosecuting or defending a lawsuit against an accountant. Accountants may find themselves as defendants in cases of alleged securities law violations, violations of common law, or liability for improper tax advice. In such cases, the plaintiff's attorney should hire an expert before drafting a complaint or agreeing to file suit. Without an expert CPA's guidance on the applicable standards of the profession, the plaintiff's claim may never get to a jury. Similarly, the defendant needs an objective CPA to assess and prepare the case and act as an expert witness.

Improper financial reporting. Accountants can be invaluable in cases involving financial reporting, such as lawsuits alleging fraud under the provisions of the federal securities laws and actions for breach of contract or fraud based on allegations that financial statements were not fairly presented in accordance with generally accepted accounting principles. In these matters, accounting experts can assist both the plaintiff and the defendant in analyzing alleged wrongdoings and preparing or analyzing damage claims.

Directors and officers liability claims. Lawsuits alleging breaches of the duties and responsibilities of officers and directors frequently involve analyses of the financial condition and results of operations of a company. Sustaining or rebutting these claims frequently requires CPAs to make sophisticated analyses which utilize accounting, business, financial, economic, marketing, and other areas of expertise.

Personal liability suits. Claims resulting from personal injury, wrongful death, and wrongful termination often require accounting analyses of

lost income. In addition to determining damages, accountants may be called upon in wrongful termination matters to address whether the plaintiff's dismissal was justified based upon objective measures of her performance.

Damages determination. Damages issues arise in virtually every major insurance litigation. If a case involves a complicated damages issue, accountants may be indispensable. An action to recover losses incurred during a business interruption, for example, may require analyses of production costs, sales patterns, inventory valuations, and other areas familiar to accountants. Similarly, if a case involves valuations of assets, such as in a buy-out, it may be necessary to evaluate an ongoing business enterprise, including its inventory, plant and equipment, goodwill, and liabilities, all of which involve the application of typical accounting analyses. Because of its importance, **§§ 20.8** through **20.21** are devoted to damage analysis.

§ 20.3 Selecting an Expert

An attorney may have the choice of using an expert from her client's organization or an independent expert. Compared to an outside expert, an in-house expert may be more knowledgeable about the client's operations and the particular issues of the case and may be less costly for the client. On the other hand, the in-house expert appears to have a personal stake in the outcome of the litigation. Her objectivity and credibility will no doubt be called into question. Further, ordinarily it is not cost-effective for an expert who has responsibility for the client's ongoing operations to be tied up to the extent required in litigation.

In most cases, the use of an independent expert is preferable. Sources of experts include officers or employees of other firms in the same industry, college and university professors, and representatives from research organizations, accounting firms, and consulting firms. Each source has advantages and disadvantages. Industry experts may possess detailed business and technical knowledge essential to the case, but competitive considerations may mar their testimony. College professors and researchers have an air of academic authority and independence, but often they are unfamiliar with the practical business aspects of an organization and the key issues of the litigation. An accounting or consulting professional, especially one who specializes in litigation assistance, may be best suited to perform the analyses and provide competent testimony. However, she may be expensive and may appear to be a hired gun or professional witness.

The personal characteristics of the expert, which determine to a large degree whether she will be a credible and effective witness, should be paramount in selecting the expert. The expert should possess excellent credentials, of course. But a long list of academic honors or professional qualifications will not prevail in court if the expert appears arrogant, indecisive, unorganized, inarticulate, or frightened. The expert witness must have good courtroom demeanor and a professional appearance. She must possess the ability to articulate positions precisely and concisely in clear and simple language. In addition, the expert must be able to stay calm under pressure.

Natural abilities may make an expert good, but her capabilities are enhanced through practice. This is why trial attorneys prefer experienced expert witnesses. A trial attorney is better served by an expert with outstanding courtroom presentation skills than an expert with better credentials but a poor courtroom manner.

§ 20.4 —Fee Arrangements

Ordinarily, experts are reimbursed on a time and expenses basis in which fees are charged on an hourly or daily rate. Some types of expert services, for example lost income analysis in wrongful death, may lend themselves to fixed fee or standard cost arrangements.

Attorneys should approach with caution a contingency fee for any expert. Knowledge that an expert has a financial stake not only in winning the case but in the amount of any damages awarded may undermine the expert's credibility in the mind of the trier of fact. However, there may be circumstances involving litigation funding considerations when the attorney is willing to take this risk to obtain the expert assistance necessary to prevail in the case.

Currently, the American Institute of Certified Public Accountants (AICPA) does not allow CPAs to accept litigation engagements on a contingency fee basis.[2] However, the AICPA voted recently to lift its 82-year ban on contingent fees and has submitted a proposed agreement to the Federal Trade Commission for approval. Views on the proposed changes to the AICPA's code of professional ethics are mixed, and it is not clear at the time of this writing what form of contingency fees, if any, will be available for accountants. Many states will continue to bar contingent fee arrangements.

[2] AICPA Professional Standards, Rule 302, American Institute of Certified Public Accountants (1988).

ASSISTANCE IN DISCOVERY

§ 20.5 Complaints, Interrogatories, and Requests for Documents

Experts can assist in fashioning detailed allegations that make complaints motion-proof. Federal courts, for example, impose stringent requirements under Rule 9(b) of the Federal Rules of Civil Procedure with respect to the degree of particularity in the pleading of fraud. An accounting expert can identify specific items presented in financial statements, sections of authoritative pronouncements on auditing standards and accounting principles, provisions of financial reporting principles, and other details of the alleged wrongdoing. This can prompt early settlement or avoid the dismissal of an otherwise solid claim.

A CPA can help ensure that appropriate documents are sought and that they are requested in the correct nomenclature. An expert familiar with a particular industry can suggest sources of information which may not have occurred to the attorneys. In addition, the expert can review the opposition's document production.

Lawyers should not turn over documents without knowing what they contain and how they may affect the case. A CPA can assist by advising lawyers about the contents of financial documents and many other business records. The CPA also can help the attorney narrow document requests and can provide another opinion about the potential jeopardy to a litigant because of the materials. If damaging documents are identified, a timely settlement offer can be made before the case deteriorates.

The expert can be invaluable in reviewing the opposition's document production. An expert may identify missing material which should have been produced by the opposition. For example, the absence of supporting schedules or a memorandum file may be obvious to the CPA, but not to the lawyer.

The accounting expert also can assist in preparing and responding to interrogatories. When the opposition's document production does not provide the information which the expert needs to complete her own analysis, a specific interrogatory drafted by the expert is often the most efficient method to obtain the necessary data. Expert assistance is often essential to respond to interrogatories involving complex accounting or business issues.

§ 20.6 Deposition Testimony and Assistance

A lawyer should not take the deposition of the opposition's expert without expert assistance. The depositions of certain fact witnesses, such as a

financial vice-president or controller, may be more thorough when taken with the assistance of an expert accountant. Financial officers and employees of a company can be interrogated more effectively with precise questions, using the correct technical language and terms of art. The expert may also help to prepare witnesses for depositions. The skepticism and expertise of an accountant can help to prepare a witness by probing vulnerable areas and anticipating questions that may cause the witness the greatest discomfort and the lawyer's case the most adverse result.

§ 20.7 Case Management

Major litigation cases may tax the resources of even the largest law firm. Case management often can be accomplished more cost- and time-effectively by litigation experts, freeing the attorneys to focus on legal rather than on administrative issues. Experts can assist litigators by:

1. Establishing procedures to track and control document discovery
2. Managing and staffing discovery sites
3. Recommending and implementing document indexing and computer support systems
4. Developing and tracking case plans and budgets.

PREPARATION AND ANALYSIS OF DAMAGES CLAIMS

§ 20.8 Overview

One of the most substantial contributions of an accountant providing assistance in a litigation is the determination of damages. Developing a reasonable approach to damages which considers all relevant information and which can be modified quickly as the case shifts benefits both the attorney and the attorney's client. Equally important is evaluating and finding weaknesses in the opposition's damage claims.

Sections 20.8 through **20.21** discuss the determination of damages as encountered most frequently in major insurance litigation. The damage claim principles covered apply equally in rebutting damage claims for the defense or developing damage claims for the plaintiff.

The types of damages found in major information litigation can be categorized into three groups: physical damages, lost profits, and loss of equity. Because physical damages often are easily determined through appraisal or

a compilation of invoices, they are not discussed further in this chapter. The determination of lost profits and loss of equity, however, typically requires expert accounting assistance due to the complex issues which may arise.

§ 20.9 Lost Profits

Profit, not revenue, is the measure of damages.[3] *Revenue* is the total proceeds from sales. *Profit* is the excess of sales revenue after deducting the expenses (such as labor, materials, and rent) associated with generating the revenue. Although these terms are associated generally with businesses, these concepts are equally applicable to claims associated with individuals (for example, personal injury, wrongful death, and wrongful termination). There are different ways profit can be computed, and these differences are significant at trial.

Conceptually, determining lost profits is easy: multiply profit per unit by the number of units lost. Unfortunately, this simple formula disguises a number of complications. To determine the amount of profit lost when an adverse event occurs may involve complex and sophisticated analyses requiring advanced techniques of cost accounting, mathematics, statistics, and economics. To understand this better, **§§ 20.10** and **20.11** cover the two parts of the lost profits equation, profit per unit and number of units lost, in more detail.

§ 20.10 —Profit Per Unit

In most cases the appropriate measure of damages is the *marginal profit per unit* (that is, profits earned by selling one additional unit) rather than the *average profit per unit* (revenue minus expenses divided by the number of units sold). The distinction is important. In most business situations, some expenses, called fixed expenses (for example, rent), do not increase with a significant increase in sales. As a result, the marginal profit made by selling extra units typically is greater than the average profit of all units sold. Of course, this is not always the case. A factory operating at full

[3] Many cases affirm the principle that net rather than gross profit is the proper element of damages. *See* Noland Co. v. Graver Tank & Mfg. Co., 301 F.2d 43 (4th Cir. 1962). There are exceptions to this general rule, however. Courts have awarded plaintiffs damages based on gross revenues when defendant was unable to determine costs associated specifically with the generation of revenue. *See* Blackman v. Hustler, 800 F.2d 1160 (D.C. Cir. 1980). Gross revenue may be recovered when costs are negligible. *See* Distillers Distrib. Corp. v. J.C. Millett Co., 310 F.2d 162 (9th Cir. 1962).

capacity may not have been able to produce significant additional units without significant capital expenditures, in which case the marginal profit for the additional units may be close to the average profit.

To calculate marginal profit, the accountant undertakes an analysis in which expenses are segregated into fixed, variable, and semivariable components. As mentioned above, *fixed expenses* do not vary when production varies within the range considered in the analysis. *Variable expenses* (for example, direct labor and direct materials) vary directly with the quantity of units produced. *Semivariable expenses* (for example, indirect labor and indirect materials) vary incrementally as production levels cross certain thresholds. Variable and some semivariable expenses are deducted from incremental revenue when determining marginal profit; fixed expenses are not. Assigning expenses to these categories is not a mechanical process. It requires a CPA's judgment and an in-depth understanding of the workings of the business.

Because marginal profit is central in calculating damages, it is often the subject of intense cross-examination during deposition or trial. The opposing attorney may attack the use of marginal profit rather than average profit or may attempt to demonstrate that certain costs excluded by the accountant should have been considered. The expert witness must be prepared to rebut these inquiries by having available immediately the supporting rationale for the calculation of marginal profit.

§ 20.11 —Number of Units Lost

The number of units lost, the second component in the lost profit equation, is also likely to be a topic of controversy. Units lost fall typically into two categories: *historical units lost,* that is, sales that can be shown to have been lost up to the time of trial, and *future units lost,* that is, sales that would have been realized in the future had the damage not occurred.

The expert is called upon to determine what historical and future sales levels would have been but for the opposition's actions. Typically, this is accomplished by projecting unit sales based on sales trends before and after the damage event, as demonstrated in **Figure 20–1**. In **Figure 20–1**, a damage event which occurred in early 1986 caused the trend of sales to be reduced significantly. The top line of the shaded portion of the figure, which represents projected unit sales but for the damage event, is determined by continuing the trend of unit sales established before the damage event. The bottom line of the shaded portion, which represents actual and projected actual unit sales, is determined by identifying and continuing the trend of unit sales after the damage event. The shaded area between the two lines represents lost unit sales.

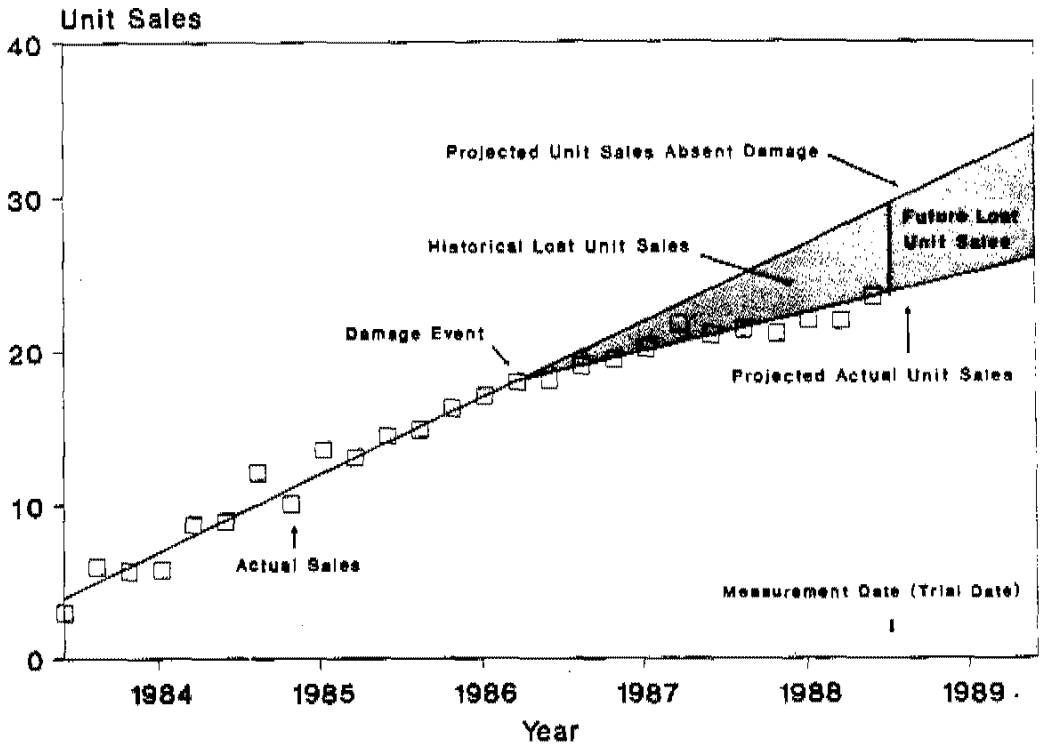


Figure 20–1. Determining lost unit sales.

§ 20.12 —Projection Methodologies

The projections shown in **Figure 20–1** are linear. Linear projections are used frequently in court because they are easy to demonstrate graphically and because they can be generated using linear regression, a standard statistical technique. Using approaches like linear regression reduces subjectivity in developing the projection, thereby increasing the credibility of the projection. Of course, linear projections are not the only type used. Non-linear projection techniques based on percentage changes in sales or other statistical methods are also available. As shown in **Figure 20–2**, the choice of projection methodology used can make an enormous difference in the amount of damages calculated, as does the decision as to how far into the future damages are calculated.

§ 20.13 —Adjusting to Present Value

Regardless of the method used to determine lost profits, a value in today's dollars should be computed for historical and future lost profits.

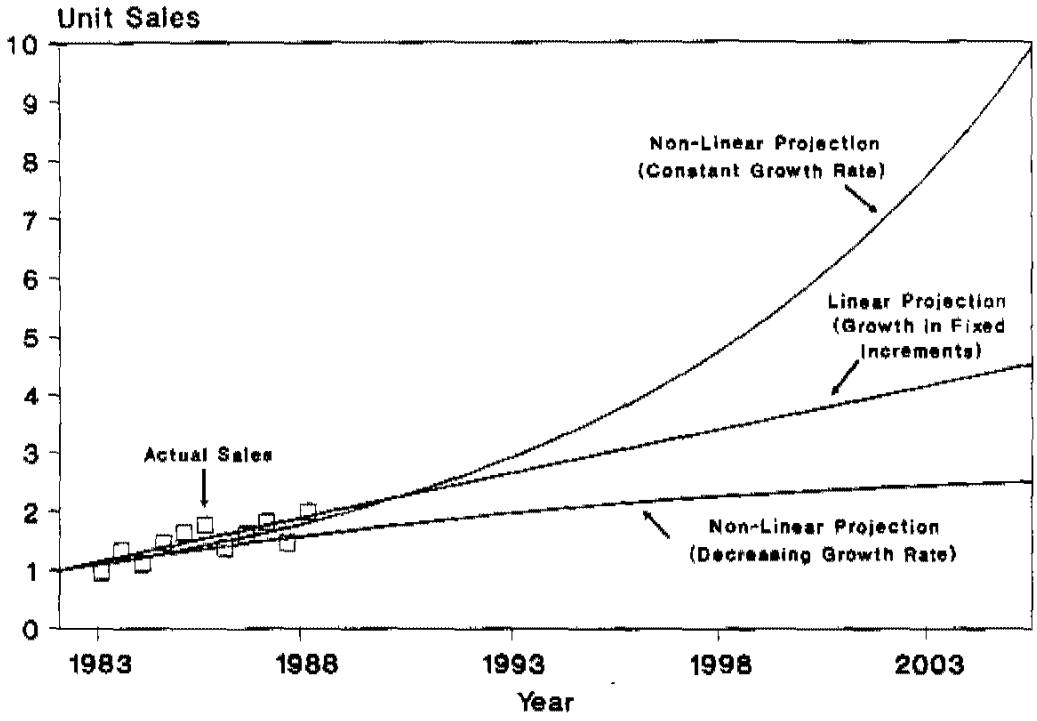


Figure 20–2. Alternative projections of unit sales.

This process, *adjusting to present value,* recognizes that historical lost profits could have been invested in the operations of the company or elsewhere, generating additional profits. Similarly, a future loss can be paid off by a smaller amount invested today. A failure to adjust damages to present value will overstate future damages and understate historical damages. The factor used to adjust damages is called the *discount rate.* The choice of the discount rate has a major impact on the magnitude of damages calculated. The principle of discounting has often been approved by courts.[4]

§ 20.14 Loss of Equity

Accounting experts are called upon frequently to determine damage to the equity, or goodwill, of a company. Before reviewing the methods used commonly to determine these damages, it is important first to clarify the concept of goodwill and to distinguish between loss of future profits and damage to goodwill. These are separate and distinct damages, although

[4] Palmer v. Connecticut Ry. & Lighting Co., 311 U.S. 544 (1941); Lee v. Joseph E. Seagram & Sons, 552 F.2d 447 (2d Cir. 1977).

the difference is subtle. One practical difference is that damages awarded for lost profits are generally taxable as income, but awards for damage to goodwill generally are treated as a nontaxable return of capital.[5]

The value, or *equity*, of a company is its tangible and intangible assets less its liabilities. Goodwill, an intangible asset, is part of this value. *Tangible assets* are physical objects or objects which have a readily determined market value. Examples include cash, receivables, property, and equipment. *Intangible assets* are items such as patents, copyrights, franchises, organization costs, and trademarks. *Goodwill* represents the conglomeration of other resources and conditions that make the overall value of a company greater than the sum of the net fair market values of its individual tangible and intangible assets. Like other intangible assets, it is possible to place a value on the goodwill of a company. However, unlike other assets that can be sold or exchanged individually, goodwill can be identified only with the business as a whole. Elements of goodwill might include:

1. Superior management
2. Outstanding sales personnel
3. Effective advertising
4. A secret process or formula
5. A good reputation in the marketplace.

When the opposition's actions cause a litigant's business to lose sales, this also reduces the value of the business. Simply put, a company which sells 200,000 units per year is less valuable than one which sells 250,000 units per year, all other factors being equal. This reduction in value is a loss of goodwill and does not overlap lost profits. This point is most clearly seen when the defendant's actions caused the termination of the plaintiff's business.

§ 20.15 —Valuation Methodologies

Determining the loss of goodwill requires valuing the business twice: before and after the damage event. There are several generally accepted methods used to determine the value of a business. The approach used to determine loss of goodwill depends on the individual circumstances of the case. Often, more than one approach is used to develop a range of valuations. The three most commonly used methods are the market approach, the adjusted book value approach, and the income approach.

[5] Sager Glove Corp. v. Commissioner, 311 F.2d 210 (7th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963); Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944).

The *market approach* compares the company to similar companies. The expert develops ratios based on statistical and financial data of comparable companies. To determine the value of the company, these ratios are applied to the company's earnings, its cash flow, its book value of assets, or other accounting measures.

In the *adjusted book value approach,* appraisals are first completed on the underlying tangible assets of the company. Rates of return experienced normally in the industry are applied to these appraised values to determine how much income these assets should generate. This amount is subtracted from the firm's actual earnings. The difference is attributable to goodwill.

The *income approach* is based on the theory that the value of a business depends on the future benefits it will produce. This approach may use the discounted present value of future cash flows to determine the value of the company. Although the market and adjusted book value approaches are based primarily on the company's past experience, the income approach can be used when it is necessary to determine the value of a business based upon projected performance which may differ from the historical trend.

§ 20.16 Principles for Preparing Damages Claims

Sections 20.9 through **20.15** underscored the necessity for expert assistance in dealing with the complex analytical issues which may arise in preparing damage claims. A good technical analysis alone does not necessarily translate into a winning presentation in court, however. **Sections 20.17** through **20.21** present several principles which have been applied successfully in developing damage claims and assisting the expert in cross-examination.

§ 20.17 —Assumptions and Estimates

Preparing lost profits or lost equity damage claims requires necessarily making assumptions and estimates. Typical and basic assumptions and estimates which play a major role in the calculated damage amount include:

1. The methodology chosen to project future sales volume
2. How far into the future damages are calculated
3. The factor used to discount damages to present value
4. Assumptions concerning pricing and expenses.

The use of estimates and assumptions is valid in court. Courts have ruled consistently that a litigant cannot be denied compensation for losses

merely because the damages cannot be quantified precisely.[6] Damages may be awarded based on reasonable assumptions. However, the expert witness can expect a vigorous attack on these assumptions.

It is important for the damage expert to distinguish clearly between assumptions resulting from uncertainty concerning the amount of damages as opposed to the occurrence of damages, particularly when calculating lost future profits.[7] A mere contingency will not support a claim for damages. For this reason, establishing damages due to lost anticipated profits of a start-up business is difficult. Many courts have classified these damages as speculative and have denied recovery.[8] This rule is not absolute, however, and lost prospective profits may be recovered if reasonable certainty is demonstrated both to occurrence and extent.[9]

If alternative assumptions are equally probable and reasonable, the attorney may ask the expert to provide the judge or jury with a range of damage amounts, together with the expert's best estimate. This provides the trier of fact with additional information which may be used to pick an alternative damage amount when, for whatever reason, the trier of fact does not accept a testified-to damage amount.

§ 20.18 —Establishing Proximate Cause

An explicit assumption underlying analyses of lost profits and loss of equity is that the defendant's actions proximately caused the damage.[10] In personal injury cases, proximate cause is often clear; in business litigation, the issues may be more complex. Defendants argue that other factors, such as increased competition in the marketplace, product obsolescence, or general economic trends explain some or all of the losses experienced by the business for which the plaintiffs seek recovery.

Defenses concerning proximate cause must be countered by testimony on behalf of the plaintiff. Often testimony by the damages expert is coupled with testimony from marketing and industry experts as well as fact witnesses from the client's company. Statistical analyses are often applied to issues of proximate cause (see **§ 20.33**).

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[6] California Lettuce Growers v. Union Sugar Co., 45 Cal. 2d 474, 486–87, 289 P.2d 785, 793 (1955). Smith v. Onyx Oil & Chem. Co., 218 F.2d 104, 110 (3d Cir. 1955).

[7] Story Parchment Co. v. Paterson Parchment Paper Co., 282 U.S. 555 (1931); Wells Truckways, Ltd. v. Burch, 247 F.2d 194 (10th Cir. 1957).

[8] Fredonia Broadcasting Corp. v. RCA Corp., 569 F.2d 251 (5th Cir. 1978), *cert. denied*, 439 U.S. 859 (1978).

[9] Handi Caddy, Inc. v. American Home Prods. Corp., 557 F.2d 136 (8th Cir. 1977); Standard Mach. Co. v. Duncan Shaw Co., 208 F.2d 61 (1st Cir. 1953).

[10] Western Union Tel. Co. v. Hall, 124 U.S. 444 (1888); Lakota Girl Scout Council, Inc. v. Havey Fund-Raising Management, Inc., 519 F.2d 634 (8th Cir. 1975).

§ 20.19 —Principle of Conservatism

Experts developing damage claims often combine a series of assumptions favorable to the client's position to reach an unrealistically high (or low) damage amount. This type of overreaching can be self-defeating. For example, the credibility of an inflated damage calculation may be undermined easily, simply by adjusting certain assumptions within a reasonable range, so that one can arrive at a dramatically different damage amount. Similarly, the credibility of a strong damage claim may be hurt when it is accompanied by additional claims for tangential and speculative damages.

Plaintiffs can be very imaginative in enumerating all the different ways the defendants' actions have hurt their business. The attorney must work with the accounting expert to make sure the damage analysis avoids overreaching and speculative claims. A conservative, fully documented analysis better serves the litigant.

§ 20.20 —Flexibility and Responsiveness

Decisions by the court during the course of trial may require rapid recalculation of the damage amount. For example, the judge may rule on the damage period or categories of damages allowed. The expert must be able to respond as the facts of the case shift. Use of computerized damages schedules capable of rapid adjustment is perhaps the best method to deal with fact changes. Alternatively, the expert should prepare alternative approaches based on anticipated decisions of the court.

§ 20.21 —Substantiation of Damage Testimony

When testifying to very simple or very complex damage issues, there is a temptation simply to state a final damage figure without explaining the calculations which led up to this value. This can be a grave error, as courts have repeatedly denied such damage estimates as speculative or uncertain.[11] On the other hand, a lengthy, technical dissertation by the witness, discussing every detail of the damage analysis, is more likely to bore than inform the judge or jury. The plaintiff or the plaintiff's expert is more likely to fall into this error than an independent expert.

An effective damage presentation may be the following: state the final damage amount (or range of amounts) and provide a brief explanation of the overall approach used to calculate it. In more complex cases, a further

[11] Karlen v. Butler Mfg. Co., 526 F.2d 1373 (8th Cir. 1975); Autrey v. Williams & Dunlap, 343 F.2d 730 (5th Cir. 1965).

discussion of issues raised in the overall explanation may be necessary. Frequently, the damage expert would need to testify on damages in direct examination for less than one hour.

Although the damage expert may not discuss all the details of her damage calculation on direct examination, she must be able to respond quickly to cross-examination concerning any portion of the analysis. The expert also must be able to produce any business records on which her testimony is based.[12] To accomplish this, all damage calculations and supporting documentation should be organized in cross-referenced working papers. An effective format for working papers is a hierarchical structure in which the main results are broken down into a series of subsidiary calculations, each in turn supported by further calculations and original source documentation. Cross-referencing each level of the calculations helps to assure the overall integrity of the damage calculation and eliminate errors and inconsistencies which undermine the overall credibility of the calculation.

FORENSIC ACCOUNTING

§ 20.22 Definition of Forensic Accounting

Broadly speaking, *forensic accounting*, also called investigatory accounting, is any accounting activity for use in a court of law. Forensic accounting can be the acquisition, reconstruction, review, and analysis of the books and records of an entity, and the development of evidentiary materials. In this sense, damage claims preparation and analysis is forensic accounting. **Table 20–1** presents several examples of forensic accounting services.

§ 20.23 Forensic Accountants versus Traditional Accountants

Although many of the tasks of the forensic accountant appear similar to those of the traditional accountant or auditor, there are significant differences. Unlike the traditional CPA, who typically reviews well-documented audit trails, the forensic accountant must work with the sketchy, inaccurate, or even deliberately falsified information often encountered in litigation. Frequently, the accountant must develop missing information based on reasonable assumptions or on analytical

[12] Lee v. Durango Music, Inc., 144 Colo. 270, 355 P.2d 1083 (1960); Quad-States, Inc. v. Vande Mheen, 220 Neb. 161, 368 N.W.2d 795 (1985).

Table 20–1

SAMPLE FORENSIC ACCOUNTING SERVICES

Type of Litigation	Forensic Accounting Service
Lender liability	Determine whether records show bad faith of lender
Embezzlement	Determine nature and scope of defalcation by controller
Trademark infringement	Determine damages suffered by plaintiff
Wrongful death	Determine impact that the death of an executive had on his business
SEC fraud	Trace investor funds, assist in asset recovery, and develop plan of liquidation
Partnership dispute	Determine whether books and records of the general partner reflected improper expense allocations
Antitrust	Determine damages in antitrust claim and also in false advertising counterclaim
Wrongful dismissal	Develop methodology for determining comparative performance
Corporate takeover	Determine whether tender offer materials contained false financial information
Dissenters' rights	Conduct cash flow analysis to determine ability of company to pay judgment

techniques applied to the information available. The forensic accountant must apply creativity and perseverance to reconstruct transactions and records of an entity.

Typically, the forensic accountant begins with only a general idea of the objectives while facing tremendous numbers of records and documents. Often placed under strict time constraints, the forensic CPA must work quickly to obtain an overview of the relevancy of the documents and proceed to formulate a strategy. Although attorneys usually have reviewed at least some of the documents prior to retaining the forensic accountant, they rely on the accountant's greater familiarity with financial and accounting documents to guide the process of selection of documents for review.

For example, in insurance litigation involving a multi-million dollar entity, the litigation team may have access to thousands or even millions of documents. The accountant may first obtain a quick understanding of the entity and its history by arraying five to 10 years of historical profit

and loss statements. This in turn may lead to areas requiring further investigation.

Finally, forensic accountants are familiar with the legal system and comfortable working within it. They understand the laws pertaining to discovery and the presentation of opinions in court. They are familiar with, and may even relish, the rigors of cross-examination, an experience the traditional accountant can fairly be said to dread.

§ 20.24 Advantages of Forensic Accountants

Forensic accountants and their staffs typically are better equipped to review large numbers of records than are litigators and their staffs. Because of their greater familiarity with financial and accounting records, the forensic CPA is in a better position to detect and extract critical information from the records. For example, faced with a large stack of computer printouts from a general ledger, the forensic accountant could identify quickly critical accounts and enter monthly subtotals into a worksheet to identify trends.

Forensic accountants at major CPA firms can marshal enormous resources when needed to perform large tasks in a short time. In one litigation, for example, in a two-month period nearly 40,000 hours of special audit work was performed in 21 cities around the country to meet a tight deadline.

Finally, because the investigatory tasks are performed by staff personnel under the direction and supervision of the forensic accountant, the CPA is in a position to testify as to her findings.

§ 20.25 Forensic Accounting Techniques

The forensic accountant may apply a variety of techniques to perform her analysis. These techniques, which encompass a broad spectrum of accounting and general knowledge, can be adapted strategically to strengthen the case. Forensic accounting techniques include:

1. Audits
2. Reviews
3. Agreed-upon procedures
4. Investigation
5. Inspection
6. Observation

7. Interviews
8. Sampling
9. Comparison.

In addition to these techniques, which are associated with traditional accounting and auditing, the forensic accountant relies on the work of other specialists in performing certain technical analyses (for example, statistical analyses, valuations, cost and price analyses, or economic analyses).

COMPUTERIZED ANALYSIS OF INFORMATION

§ 20.26 Computers in Litigation

When computers are discussed in relation to litigation, attorneys usually think first of automated records management. Indeed, this is an important contribution of computers to litigation. However, the ability of a computer to facilitate the types of analyses discussed in § 20.25 is in many ways more significant. **Sections 20.26 through 20.34** discuss briefly how experts use computers to enhance their effectiveness in litigation.

§ 20.27 Discovery of Computerized Information

Attorneys often seek to discover computerized information. In particular, the financial records and documentation of transactions of most businesses are stored on computers. Hard-copy printouts seldom provide the information in the format needed for analysis by the accounting expert. Large amounts of expensive, error-prone, and time-consuming manual entry of data frequently are required. Expert assistance can make this process more efficient by obtaining information directly in machine-readable format, usually in the form of a computer disk or tape.

§ 20.28 Computer Data Base Analysis

A *data base* is information organized in a logical manner to facilitate retrieval of individual data elements as well as analysis of data through sorting, grouping, selecting, and other manipulation of the data. Data base software programs available on computers, from mainframes through microcomputers, allow analysts to create and analyze millions of individual

records quickly and efficiently. Examples of the use of data base analysis in major insurance litigations are discussed in §§ **20.29** through **20.31**.

§ 20.29 —Tracing Cash Flow

Tracing the cash flow between entities is a common task in many litigations. For example, one way to establish that different companies which appear to be unrelated are in fact alter egos of one entity (that is, piercing the corporate veil) is to analyze the cash flows between the entities involved. Organizing payments and receipts between entities into a computer data base is an efficient method to discover and demonstrate patterns of payments.

For example, based on a review of cash disbursements as shown in **Table 20–2**, at first glance there appears to be no relationship between Company A and Company C. There are no payments between them, although both do business with Company B. **Table 20–3**, however, shows the result of a computer data base analysis of payments which would demonstrate Company B's role as a conduit through which Company A directs funds to Company C.

Table 20–2

DISBURSEMENTS FROM COMPANY A TO COMPANY B AND FROM COMPANY B TO COMPANY C (UNGROUPED)

Disbursements from Company A to Company B		Disbursements from Company B to Company C	
Date	Check Amount	Date	Check Amount
01-Jan-88	$12,453	26-Jan-88	$17,574
13-Jan-88	5,121	11-Feb-88	3,574
06-Feb-88	43,524	20-Feb-88	16,665
14-Feb-88	6,002	28-Feb-88	4,894
26-Feb-88	9,745	11-Mar-88	18,391
02-Mar-88	8,731	30-Mar-88	14,445
08-Apr-88	16,745	09-Apr-88	10,033
14-Apr-88	32,452	12-Apr-88	2,000
		16-Apr-88	11,455
		24-Apr-88	9,988
		29-Apr-88	6,436
		08-May-88	14,465
		12-May-88	4,853

Table 20–3

DISBURSEMENTS FROM COMPANY A TO COMPANY B AND FROM COMPANY B TO COMPANY C (GROUPED)

Disbursements from Company A to Company B		Disbursements from Company B to Company C	
Date	Check Amount	Date	Check Amount
01-Jan-88	$12,453	26-Jan-88	$17,574
13-Jan-88	5,121		
	17,574		17,574
		11-Feb-88	3,574
06-Feb-88	43,524	20-Feb-88	16,665
		28-Feb-88	4,894
	43,524	11-Mar-88	18,391
			43,524
14-Feb-88	6,002		
26-Feb-88	9,745		
02-Mar-88	8,731	30-Mar-88	14,445
		09-Apr-88	10,033
	24,478		24,478
08-Apr-88	16,745		
14-Apr-88	32,452	12-Apr-88	2,000
		16-Apr-88	11,455
	49,197	24-Apr-88	9,988
		29-Apr-88	6,436
		08-May-88	14,465
		12-May-88	4,853
			49,197

§ 20.30 —Distributions in Bankruptcies and Receiverships

Claims of investors in bankruptcies and receiverships may be maintained on a computer data base. The data base can be used to

1. Create claim forms for investors
2. Perform analyses of the impact on classes of investors and other claimants of alternative distribution plans

3. Calculate distributions payments
4. Write checks
5. Perform other administrative procedures.

§ 20.31 —Statistical Data Bases

Computer data bases may be used as the basis of nonfinancial or statistical analyses in litigation. For example, data bases have been used to perform analyses of market share of commercial first-run theaters in support of antitrust motions; analyses of sales, deliveries, and prices in unfair competition disputes; and analyses of terms of lending in actions involving alleged discrimination in lending practices.

§ 20.32 Financial Modeling

Financial modeling is one of the most common applications of computer analysis in litigation. Models are usually developed using spreadsheet software packages. Spreadsheet software creates an environment for the user equivalent to columnar paper—rows and columns that create cells into which the user may enter data or formulas. Changing an entry in one cell automatically updates all the formulas in the spreadsheet. The results are displayed in table and graphic form for review.

A common application of financial modeling is to automate the financial statements, particularly the balance sheets and income statements, of an entity. Once the basic information has been entered into the computer, it is simple to develop and analyze trends, forecasts and projections, pro forma statements, hypothetical scenarios, and other applications required frequently in litigation.

§ 20.33 Statistical Analysis

Statistical analysis is used frequently in litigation, often in conjunction with data base analysis and financial projections. Linear regression analysis is the most commonly used technique. It is the basis of many projections of future sales and income. Additionally, multiple regression analysis and correlation analysis are applied to liability issues. These techniques may be utilized to provide statistical evidence concerning whether the defendant's actions proximately caused the plaintiff's sales to decline or whether the decline is explained by other factors.

Statistical sampling is used for such diverse applications as public opinion surveys, fraud audits, and other verification procedures. Statistical hypothesis testing, used in conjunction with sampling, is applied in cases

where it is necessary to demonstrate whether there are significant differences between two populations.

§ 20.34 Computer Graphics, Visual Aids, and Displays

The ability of computers to generate graphs, charts, tables, displays, and other visual aids is of tremendous importance in litigation. The ability to create graphs which present summarized data is of great value in performing the analysis itself. A moment's review of a graph can reveal trends, differences, boundaries, and other relevant information to the analyst. Similarly, computers allow the expert to display the results of the analysis to the judge or jury in an easy-to-understand format. Many rulings allow the introduction of charts and graphs in trial.[13]

TRIAL ASSISTANCE

§ 20.35 The Accountant as Expert Witness

The courts uniformly have accepted the accountant, in particular the certified public accountant, as an expert.[14] Trial attorneys, however, have considered the accountant to be a poor expert witness. This perception is often justified. Accountants often seem unable to avoid the use of arcane terminology and detailed qualifications to explain accounting issues. This may make a bad impression on the judge or jury. After all, accounting deals with numbers, and it would seem reasonable to expect a decision based on numbers to be clear, precise, and unqualified.

Accountants are not entirely at fault, however. Often the issues facing accountants are not simple. Most laypersons do not understand the large role that subjective judgment and assumption play in the development of accounting and financial statements. An example of the role of judgment in what at first appears to be a simple arithmetic task is valuing inventory. If the costs of supplies and manufacturing are known, the value of the product would seem easy to calculate. But which value should be used,

[13] State Office Sys. v. Olivetti Corp., 762 F.2d 843 (10th Cir. 1985); L.C.L. Theatres v. Columbia Pictures Indus., 566 F.2d 494 (5th Cir. 1978); Flame Coal Co. v. United Mine Workers, 303 F.2d 39 (6th Cir.), *cert. denied,* 371 U.S. 891 (1962). *See also* Fed. R. Evid. 1006 and 803(B).

[14] Computer Sys. Eng'g, Inc. v. Qantel Corp., 740 F.2d 59 (1st Cir. 1984); Westric Battery Co. v. Standard Elec. Co., 482 F.2d 1307 (10th Cir. 1973).

cost or market? If cost is used, then is historical or replacement cost appropriate? If historical cost is chosen, then what method should be used to compute historical cost: last-in-first-out, first-in-first-out, or some other cost method? If market value is used, should it be based on normal selling price or liquidation selling price? Should the cost to complete the inventory and selling cost be included? The expert witness testifying to the value of inventory clearly has to do more than add up columns of numbers. She must make difficult accounting decisions and explain them to the judge or jury.

For their part, in presenting complex issues in court, accountants often take for granted that the judge or jury understands accounting principles and terminology. Accountants may use technical terms without explaining them adequately, and may dwell on subsidiary issues of minor importance in their overall conclusions. This is a frequent problem among accountants, most of whom spend their time working with other financial professionals. Most accountants are more comfortable with the familiar role of practicing their craft than with the often more difficult task of explaining it to nonaccountants by testifying in a trial.

Many accountants make excellent witnesses. As is true with most technical subjects, accounting transactions can be explained in terms understandable to judges and jurors who have no background in accounting. The attorney should retain the accountant who says, "They bought the tractor with a cash down payment and borrowed the rest," instead of, "The acquisition of the farming machinery resulted in a debit to fixed assets and credits to cash and notes payable."

§ 20.36 Other Trial Assistance

In addition to providing her own testimony, the accounting expert should be present for the testimony of the opponent's expert. In addition, it may be wise to have a CPA present during the testimony of business-related fact witnesses on both sides. The CPA can provide a specialized audience whose critical and objective comments may be most helpful, if not crucial. For example, in one case a witness for the other side testified that certain withdrawals of funds he made from his company were payments of salary for services rendered. The expert accountant, who was present for this testimony, quickly passed a note to his client suggesting he ask whether the witness had declared these payments in his income taxes. The attorney followed up this line of questioning, forcing the witness to recant his testimony, badly hurting the other side's case. During trial, the expert should also prepare for rebuttal testimony, if needed, and review relevant testimony for aspects useful in post-trial motions and potential appeals.

WORKING EFFECTIVELY WITH EXPERTS IN MAJOR LITIGATIONS

§ 20.37 Bring Experts in Early

Often, attorneys delay bringing in an expert until only weeks or even days before trial. The result of such last-minute calls is usually extra effort and cost as well as a weakened ability to present an effective case. The expert may have to redo work already performed by the attorney or the attorney's client because the expert must be able to testify as to her independent analysis of the facts. Experts brought in after the close of discovery may find the credibility of their analyses undermined because important information is not available to them, information which could have been obtained readily if an expert had been available to point out its significance earlier.

Both attorney and client benefit by bringing in experts early. On a cost basis alone, the expert's ability to help attorneys avoid unnecessary discovery by pinpointing key documents justifies early involvement.

§ 20.38 Work in Concert on Strategy and Approach

The expert and the attorney must work together to develop the expert's testimony. The good expert witness makes it clear, albeit diplomatically, that she will not say simply what the lawyer wants the witness to say. The attorney must take care not to impose her preconceptions on the expert. In complex litigations, the attorney is far more familiar with the facts of the case initially than is the expert. However, the attorney often has only an incomplete understanding of what the expert potentially could do to assist in the litigation. The attorney should solicit the expert's advice concerning the tasks the expert will perform. At the same time, the expert must be guided by the attorney, who is responsible for presenting the case.

§ 20.39 Preliminary Analysis of Damages

In even the most complicated case, a good expert can develop a rough estimate of damages in a matter of days. This analysis can be refined as further information becomes available. Developing a preliminary damage estimate as soon as possible in a litigation offers several advantages to the client. First, it helps determine the appropriate level of further effort. If the

exposure or potential is lower than first thought, a more detailed damage analysis may not be cost-effective. This information is also extremely useful in settlement negotiations. Second, the preliminary analysis may reveal that further discovery is needed.

A third advantage of developing a preliminary analysis and subsequent updates is that they provide the accounting expert with a basis to testify to her findings even if time or budget constraints do not allow the expert to finish every aspect of the analysis. In a sense it is an insurance policy against the possibility (indeed, a real danger in large litigations involving numerous documents) that the expert will run up large fees while collecting, organizing, and analyzing the data without reaching any opinions.

§ 20.40 Establish and Monitor a Budget

A famous lawyer was once asked, "How much will this case cost to litigate?" His answer was, "Everything you've got." Experts rarely are, or should be, in a position to treat budgets so cavalierly. Insurers take a dim view of exploded budgets for experts, and they respond by refusing to pay the fees of the experts and the attorneys who hired them. Estimated budgets can and should be developed for any litigation task. Attorneys and insurers should be informed before budgets are exceeded so that they may react appropriately, either by authorizing further expenditures or by scaling back the expert's scope of work. Doing this helps protect both the expert and the client against disputes concerning fees. In major litigations, when budgets take a second seat to frantic efforts to meet deadlines, the client and the insurance company should be kept informed on a very frequent basis of fees incurred.

§ 20.41 Confer Frequently

The attorney must be informed of the progress the expert is making, both in terms of the analysis and the fees being incurred. Experience shows that the experts often must take the initiative to contact the attorneys to let them know what they have accomplished and what they intend to do next. When dealing with experts, many attorneys seem to take the attitude that no news is good news, and they may be unpleasantly surprised when the expert's findings or fees were not as expected. Similarly, when using multiple experts, for example, a marketing expert, an accountant, and an appraiser, information must be shared. Lack of communication during preparation of the case can lead to disaster in the courtroom.

§ 20.42 Expert's Primary Contact

Major insurance litigations often involve multiple attorneys and law firms representing different parties in the case. To save costs, several parties may agree to share the services of an expert. Because the interests of parties in litigation rarely converge exactly, the expert may be pulled in conflicting directions. To avoid this potential problem, the litigants should establish one attorney as the primary contact to whom the expert reports and from whom the expert receives her instructions. This attorney also should be responsible for making sure that the experts are provided with the resources (documents and access to individuals) they need to accomplish their tasks. Often this role is delegated to a more junior attorney involved in the litigation. A better choice is the litigator who will examine the expert on the witness stand.

§ 20.43 Involve the Insurance Company

Insurance companies, who are paying the bills for attorneys and experts, frequently hire an independent law firm whose sole role is to monitor the progress of the litigation. Even when the insurance company or its counsel does not take an active role in the litigation itself (and frequently they do not), they should be kept informed of all activities of the expert and should receive copies of any work products delivered by the experts to the attorneys. This helps to reduce any later misunderstandings concerning the tasks the expert performed.

§ 20.44 Rules Governing Discovery of Expert Opinions

Both experts and attorneys should be familiar with the work product doctrine and attorney-client privilege as they relate to the discovery of expert opinions. The laws can differ among states and from the federal rules of evidence. Generally speaking, observations and opinions of an expert employed as a pretrial consultant rather than a potential witness are deemed *work product* of the attorney and are protected from discovery.[15] Once an expert is employed to testify at trial, however, her opinions are relevant evidence and generally are not protected by the work product doctrine.[16]

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[15] Fed. R. Civ. P. 26(b)(3); Scotsman Mfg. Co. v. Superior Court, 242 Cal. App. 2d 527, 531, 51 Cal. Rptr. 511 (1966).

[16] Quadrini v. Sikorski Aircraft Div., 74 F.R.D. 594 (D. Conn. 1977). *See also* Fed. R. Civ. P. 26(b).

The laws can be complex and misunderstandings may have important consequences in a litigation. For example, an expert's examination and analysis of confidential client documents may be privileged, but certain types of direct testimony may constitute a waiver of the privilege and enable the adverse party to cross-examine the expert on the subject of the privileged information.[17]

§ 20.45 Rehearse Testimony

Neither the lawyer nor the expert should surprise the other at trial or during deposition. The expert witness should work with the attorney in framing questions in such a way that the expert can provide answers which are helpful to the case. In complex testimony, attorneys may wish to take advantage of the fact that it is permissible to lead an expert in direct examination. If the expert is testifying for the first time, the expert should spend some time prior to testifying sitting in on the trial (or another trial) to familiarize herself with courtroom procedure.

§ 20.46 Conclusion

Using an expert witness is an integral part of virtually any major insurance litigation. The expert can form an opinion or an inference on complex, unfamiliar, or specialized matters when the layperson would not be able to do so.[18] Although expert witnesses come from many fields, perhaps the most commonly used expert is the accountant. Expert accountants perform valuable services both before and during trial. Attorneys call upon CPAs to explain or interpret complex financial transactions, to trace funds, to estimate value, to calculate damages, to perform technical analysis, and to render opinions. Although most cases do not reach the courtroom, attorneys should always look for an accountant who has the right combination of professional skills and personal characteristics to be an effective expert witness. Finding the right expert witness can make the difference between winning and losing a case.

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[17] People v. Whitmore, 251 Cal. App. 2d 359, 59 Cal. Rptr. 411 (1967).

[18] Welch v. U.S. Bancorp Realty & Mortgage Trust, 286 Or. 673, 596 P.2d 947, 962 (1979).