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Lack of Expert Loss Causation Evidence is Fatal in Securities Fraud Case

***In re Williams Securities Litigation—WCG Subclass*, 2009 WL 388048 (C.A. 10 (Okla.))(Feb. 18, 2009)**

The securities litigation that came out of the collapse of the telecommunications industry (and is just now reaching resolution) may yet provide precedent for cases that emerge from the current economic turmoil. In particular, the U.S. Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo* (2005) crystallized the need for securities plaintiffs to provide a causal link between any alleged corporate fraud and financial injuries that they suffered. Or, as the Tenth Circuit Court of Appeals explained in this case, "without showing a causal connection that specifically links losses to misrepresentations," the plaintiff in a securities fraud case "cannot succeed."

Financial experts are the key. This case began in the 1980s, when the Williams Companies, a producer and transporter of natural gas, began running fiber-optic cable through decommissioned pipelines. It formed a telecommunications subsidiary to build a coast-to-coast fiber optic network and sold it in 1995, subject to a three-year non-compete. Following those three years and the boom of the telecom industry, the company formed a new subsidiary (WCG) to build another fiber-optic network. After going public, the subsidiary's stock peaked at nearly $69.00 per share in March 2000.

However, in the next four months, its stock price fell by more than 50%, while telecommunications stocks in general declined 28%. In July 2000, the parent company announced that it was spinning off the sub, to "ensure that both our energy and communications businesses have the efficient and effective access to the capital necessary to pursue…substantial growth." By then the subsidiary was trading at $28.50 per share. Less than two years later, it went bankrupt, its stock worth a mere $0.06.

A nationwide class of plaintiffs—those who purchased the subsidiary's stock between the time of the spin-off and the bankruptcy—sued the parent company for securities fraud. In a pattern that is likely to characterize litigation coming out of the current economic crisis, the defendants first moved to exclude the plaintiffs' financial expert under the *Daubert* standard. The U.S. district court granted the motion, because his loss causation evidence failed to establish the critical causal link. That is, under the *Dura* doctrine, the evidence expert did not distinguish between loss attributable to the alleged fraud and loss attributed to the "tangle of factors" that affected the telecom industry and the market in general during the loss period.

Next, the defendants moved for summary judgment on all claims. Although the court found triable issues of fact in connection with liability—without the plaintiffs' financial expert, it found no material issues regarding loss causation and damages, and dismissed the case. The plaintiffs appealed.

Tenth Circuit discusses damages in depth. Plaintiffs in securities litigation bear the burden of demonstrating that any decline in a company's market price was attributable to a draining of the "fraud premium" (the inflation of stock price caused by the company's misrepresentations), the U.S. Court of Appeals for the Tenth Circuit explained. In this case, the plaintiffs' expert presented two scenarios to prove the claims. In the first scenario, he used a "leakage theory" to show how, from the time of the spin-off to the subsidiary's bankruptcy, the market gradually became aware of the parent company's misrepresentations and the sub's "true" value. In the second, he tried to show that during the same time, a series of partial, public disclosures served to correct market perceptions and the subsidiary's "true" price.

Like the district court, the Tenth Circuit found both theories untenable. "For one thing, while [the expert] claimed to remove the market and industry effects on the value of the [subsidiary] stock…, he did not even

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purport, in Scenario 1, to have removed the effects of non-fraud, company-specific information." Instead, his leakage theory attributed *any* decline in value over the two-year period to exposure of the fraud. "This failed to differentiate between losses rooted in causes cognizable under the loss causation doctrine [*Dura*] and losses attributable to industry-specific stresses, the meltdown in the telecommunications sector, and other negative developments unrelated to the specific fraud." The lapse in the expert's theory was "remarkable," the court added.

Similarly, "at its heart, Scenario 2 suffered from the same defects as Scenario 1," the Tenth Circuit held. Because the expert began with the assumption that the subsidiary was virtually worthless on the spin-off date and that any decline in value drained the fraud premium, he "label[ed] any negative information about [the subsidiary] a corrective disclosure and attribute[d] all resulting losses to the revelation of the fraud rather than other possible factors."

Both theories suffered from the same fatal flaw: the financial expert's failure to identify the specific mechanism by which the market learned of the defendants' fraud and the Tenth Circuit confirmed his exclusion and the summary dismissal of the case.

Mixing Methods Renders Expert's Lost Profits Opinion Unreliable

***Fluor Enterprises, Inc. v. Conex International Corp.*, 2008 WL 5860048(Tex. App.)(Dec. 18, 2008)**

A petrochemical company hired a mechanical contractor to perform welding work on a large "Turnaround Project" (the Project) at one of its refineries. The company also hired Fluor Enterprises, an engineering consultant, to oversee the Project, including the contractor's welding. After completion, the company failed to pay the contractor for nearly $2 million of extra work on the Project. The parties settled for less than $400,000, and the contractor sued the consultant for the remainder, claiming business disparagement and interference with contractual relations, costing it not only payment for the extra work but also future lost profits from this Project and others. A jury awarded the contractor over $98 million in damages and the consultant appealed.

The court first considered whether there was sufficient evidence to support the tort claims. It found some evidence for malicious interference, but ultimately ruled that the record was "too weak" to support the verdict on liability, and ordered a new trial on these issues.

Next, the court addressed whether the contractor provided legally sufficient proof to support the jury's damages award, including $8.5 million for past lost profits, $8.5 million for future lost profits (other than those connected with the one project), and $50 million for lost profits connected with the Project. Because it ordered a new trial on liability, the court needed only to determine whether the consultant had provided enough proof to support "the *fact* of lost profits damages, not the [specific] amount" (emphasis added). "At a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits [may] be ascertained," the court said. The bare assertion of lost contracts does not demonstrate a "reasonably certain objective determination of lost profits."

The expert valuation is mixed. The contractor's damages expert was an economics professor who limited his opinion to lost profits—not causation. He analyzed the contractor's average yearly billings with the petrochemical company during the eight-years prior to five-years following the Project, and then applied a 21% profit margin to the difference between the two figures.

Apparently, the expert did not consider the contracts that the contractor actually received during the five-year post-Project period, "nor does it appear that he considered the contracts actually awarded to [other] contractors…for the period that preceded the [Project]," the court said. He also did not consider a downturn in business during the relevant periods, or whether the contractor made competitive bids for future work. "In other words, [the expert] provides no evidence of specific lost sales required to recover for business disparagement." In addition:

- The expert was not familiar with the contractor's "normal" profit margins.
- He did not evaluate the contractor's job cost analysis.
- His calculations did not include any overhead component.
- He included profits from a contract that terminated three years prior to the Project.
- He failed to apply his methodology consistently and objectively.

Overall, the expert "based his opinion of lost future profits on past performance only when it benefitted [the contractor], and he eschewed historically-based averaging when it came to the [Project]," the court said. Moreover, "he did not supply one complete calculation,

but provided piecemeal computations based on different methods….Employing mixed methodologies renders his opinion on lost profits unreliable."

Still, because the contractor offered some testimony (from management) that it suffered some amount of lost profits, the court ruled that the consultant was not entitled to a "take nothing" judgment, and remanded the lost profits damages claims for a new trial.

A strong dissent. The sole dissenting opinion asserted that there was sufficient evidence for the jury to return a verdict for special damages related to the contractor's unpaid work on the project. However, the dissent would have reversed the remainder of the verdict and rendered a "take nothing" judgment as to all other damages. "Generally, lost profits not tied to a specific contract are not recoverable in a business disparagement claim, because they are not the type of special damage for which this tort action provides a recovery."

Courts Voids Non-Compete, Remands $1.1 Million Damages

***Medical Staffing Network, Inc. v. Ridgeway*, 2009 WL 21056 (N. C. App.)(Jan. 6, 2009)**

Two competitors in the healthcare staffing industry vied for the marketplace in Raleigh, North Carolina. One company succeeded in luring the other's top-producing manager, despite knowing that he was bound by a non-compete agreement. Shortly before he left, the employee accessed a number of confidential files from his company's computer network, including its "market action plan" and staffing lists. He also tried to recruit several of his colleagues to follow him. In the year after his departure, his former company saw revenues decline while his new employer enjoyed "significant" revenue boosts, due in part to capturing one of its competitor's major customers.

The former sued the latter (and its former employee) for breach of the non-compete agreement, misappropriation of trade secrets, and tortuous interference with contract. A jury returned a $1.1 million verdict for the plaintiff, and the defendants appealed, claiming that the non-compete was invalid and the damages were speculative.

The enforceability of non-compete turns on balancing act. In examining a covenant not-to-compete, courts generally consider the reasonableness of its time and geographic restrictions by balancing the employer's right to protect its legitimate business interests versus the employee's right to work. In this case, the plaintiff's non-compete prohibited its employee from working in any business within a 60-mile radius that not only competed with the plaintiff, but also any of its divisions, subsidiaries, or affiliates, even if his employment duties were unrelated to these businesses. Likewise, its non-solicitation clause prevented the employee from soliciting "any" of its clients, including those of its affiliates beyond the medical staffing business. Thus, on its face the non-compete was overbroad and unenforceable, the court held, and reversed the jury's decisions on the breach of contract and tortuous interference claims.

On the misappropriation of trade secrets claim, however, the plaintiffs successfully established that the employee had access to its confidential information and that he used it to benefit the defendants, causing the plaintiffs "substantial" harm. Accordingly, the proper measure of damages was the economic loss or the unjust enrichment that the misappropriation caused—whichever was greater. However, the trial court did not apportion any of the $1.1 million damages specifically to the misappropriations claim, and the appellate court remanded the case for a new calculation of damages that would award plaintiffs the greater of its economic losses or the defendants' unjust enrichment.

The plaintiff still bore the burden to show that its damages could be calculated with reasonable certainty, the court added. Its calculations at trial were based on the defendant's revenues, and these were too speculative because they used an arbitrary "midpoint" and they assumed that the plaintiff would have gained all of the defendant's revenues but for the wrongful conduct. "We conclude that [the defendant's] revenues could have increased for a number of reasons unrelated to defendants' conduct," the court said. For example, if any of the plaintiffs' former customers simply expanded their operations and their staffing orders, then these revenues would have increased—a boost that could have no relation to the defendants' bad conduct.

A more reasonably certain measure of the plaintiffs' economic loss (or unjust enrichment) would be the profit that the defendants gained from the ten nurses they acquired from the plaintiff's confidential list. On remand, the trial court should also consider whether the parties' respective market shares changed since the misappropriation, and if so, the measure of profits attributable to such changes. "In calculating profit with reasonable certainty, the trial court must take into account all relevant factors," the court held, including, for instance, the rates paid by the parties' clients as well as those paid to staffing personnel during the relevant period.

Can Personal Goodwill Apply to a Commercial Firm's Value in Divorce?

***Cummings v. Cummings, Inc.*, 2009 WL 331436 (Ark. App.)(Feb. 11, 2009)**

This Arkansas case began with the court appointing a neutral expert, a CPA, to appraise the husband's interest a family owned commercial enterprise. (The appellate court opinion does not detail the specific nature of the business or its industry.) Based on the excess earnings method, the neutral expert valued the company at $421,000. His value was six to seven times the actual value of its tangible assets, he said, a difference he ascribed not to "goodwill" but to the company's "earning capacity."

Under cross-examination, the neutral expert admitted that he did not consider what would happen should the husband leave or be unable to continue operating the business. He also did not account for any "personal goodwill" attributable to the husband, or consider his presence as a "key man" in any assessment of risk, which could have lowered his valuation. On redirect, the neutral expert distinguished the husband's business from professional practices that, in his experience, depended on the presence of a particular licensed professional. The husband's business, he said, obtained worked based on submitting the lowest bid.

The parties retain their own experts. The wife presented a CPA expert, who used a similar income approach to value the husband's business at $430,000. This expert considered the husband's presence in the business as part of her "company-specific risk rate," which would decrease the value of the company, she said. She also conceded that 80% of her valuation was based on the husband continuing to operate the business, without having to pay someone else to do it. Since she had only seen personal goodwill valued in relation to professional practices, she did not assign any to the husband's commercial enterprise. "[A]n owner can establish a successful business, but that does not make it personal goodwill," she said. That a former employee left to start his own business and was beating the husband's company on bids indicated to her that any "[excess value] was corporate goodwill, not personal to the husband."

By contrast, the husband's expert (also a CPA) said the business was worth only $60,674, based on net asset value and how "cheap' it was to enter the particular market. The company had no goodwill, he added. The only reason it earned more than similar businesses was due to the husband's presence and his ability to invite bids. Thus, any buyer would "demand" that the husband remain under an employment contract.

The trial court found that both the neutral and wife's expert valued the company as a going concern, with "business" goodwill. Only the husband's expert used a liquidation value, believing that any goodwill was personal to the husband (and thus non-divisible). This was contrary to Arkansas case law, the court found, which deducted personal goodwill only when valuing professional practices. Without finding a specific value for goodwill, the court averaged the values of the neutral and the wife's expert to conclude the husband's business was worth $425,500.

The husband appealed, reasserting his argument that much of that value was due to his presence and should be deducted as personal goodwill. However, the cases he cited concerned professional practices, the appellate court observed. "Husband could have asked for specific findings of fact concerning the goodwill" of the business, but failing that, the value was within the range of the evidence at trial, and was affirmed.

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