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Experts Damages

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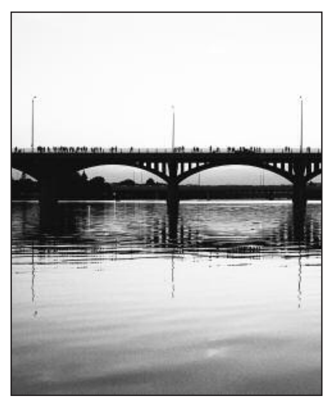

COVER: The Bat Hour, Bat Departure Time at Austin's Congress Avenue Bridge. Photograph by Larry Gustafson, Dallas.

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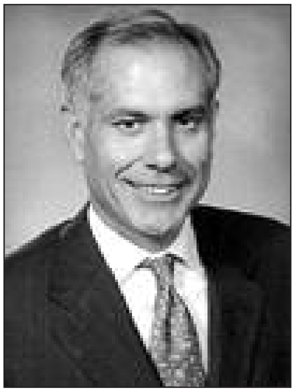

Dear Section Members:

This issue marks the beginning of my term as Section Chair. I am honored to serve and am looking forward to the year ahead. With your help and that of our terrific Section Council, we'll accomplish much. So please don't take Larry Gustafson's fascinating cover photo of the Congress Avenue bats as a sign of things to come!

As you no doubt know, bar organizations are in a period of flux as they redefine their missions in the face of a declining need for traditional member services like CLE. To help us keep the Section vital, we are developing a member survey that we intend to distribute to the membership later this year. When you receive it, please take a moment to complete it—our section plan for the next couple of years will be heavily influenced by what you tell us.

The *Journal* continues to be the most routinely praised activity of the Section. Continuing thanks for this enterprise go to Mike Ferrill, whose efforts as editor cannot be praised enough. This edition continues the long line of success, with new articles on securities (Pecht and Stokes), expert witnesses (Genender and Rinaldi), lost profits (Jay Nelson), and RICO (Joyner and Gordon). Thanks to all for their efforts. If you have an article in mind, please contact Mike Ferrill (amferrill@coxsmith.com)—we're always on the lookout for interesting articles touching on any aspect of business litigation.

In closing, I would like to thank Justice Jim Moseley for his splendid leadership during the last year. He did an outstanding job, and I'll try not to muck his good work up too much!

Best regards,
Randy Gordon
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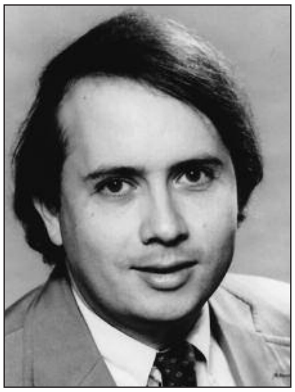

This issue of the Journal features the annual survey articles on securities, RICO and experts and an article by returning author Jay Nelson on lost profits.

As always, we solicit written contributions to the Journal. We currently have commitments for annual survey articles on antitrust, securities, RICO, business torts, class actions, D&O and expert witness developments. If you have an idea for a survey article in another area of business litigation, or an article focusing on a particular aspect of or development in the law (even if it falls within one of the broad survey categories), contact me at 112 E. Pecan, Suite 1800, San Antonio, Texas 78205 (210) 554-5282; (210) 226-8395 (fax), amferril@coxsmith.com.

A. Michael Ferrill
Editor

Fifth Circuit Securities Update

By Gerard G. Pecht and Peter A. Stokes[1]

Gerard G. Pecht

Peter A. Stokes

Since the last survey period, the Supreme Court issued its first major decision regarding the pleading standard for scienter under the Private Securities Litigation Reform Act ("PSLRA"), which will undoubtedly impact future Fifth Circuit jurisprudence in this area. The Fifth Circuit also addressed several important securities-related issues, including: (1) the extent to which loss causation must be established at the class certification stage; (2) whether shareholders may assert "scheme liability" claims against third parties who engage in transactions that allow issuers to inflate their revenues – an issue that the Supreme Court will address next term; (3) whether class certification was proper in an Employee Retirement Income Security Act ("ERISA") claim predicated on the same alleged business irregularities as a recent securities fraud class action in which the Fifth Circuit had affirmed class certification; (4) several issues regarding the statute of limitations for securities fraud claims; (5) whether officials at the Texas State Securities Board are entitled to immunity in civil lawsuits relating to their duties as government officials; and (6) whether an interest rate swap agreement is a "security" for purposes of the Texas Securities Act.

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[2] the Supreme Court addressed the PSLRA's "strong inference" requirement for pleading scienter, which has been the subject of numerous Fifth Circuit opinions. The plaintiffs in this action originally filed suit against Tellabs and several individual defendants under sections 10(b) and 20(a) of the Securities Exchange Act (the "Exchange Act") and SEC Rule 10b-5 after Tellabs announced in June 2001 that it was reducing its projected second quarter earnings, which led to a decline in the stock price.[3] Relying on allegations from 27 "confidential sources," the complaint alleged that Tellabs' CEO, Richard Notebaert, made false statements in 2000 and early 2001 that customer demand for a new product was exceeding expectations, that demand for an earlier model was strong, and that the company's overall growth during that time was robust.[4] The complaint also alleged that Notebaert participated in "channel stuffing" to inflate revenues.[5]

The defendants moved to dismiss, arguing that the allegations were too vague to support a strong inference of scienter and gave rise to competing inferences that the conduct in question was lawful and innocent.[6] The defendants pointed out that Notebaert did not sell any Tellabs shares during the alleged class period and thus had no motive to commit fraud.[7] In addition, the complaint did not specify the date on which Tellabs' management supposedly learned of the alleged problems and relied on a broad definition of "channel stuffing" that arguably included legal as well as illegal conduct.[8] The defendants argued that the vagueness and overinclusiveness of these allegations supported an inference that management had no knowledge of the company's problems at the time the allegedly false statements were made and did not engage in illegal activities. The district court agreed, holding that the allegations did not support a strong inference of scienter. The Seventh Circuit reversed the dismissals as to Tellabs and Notebaert, holding that it was inappropriate for the court to consider inferences favorable to the defendants at the Rule 12(b)(6) stage, and that a complaint should survive dismissal so long as it "alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent."[9] Under this standard, the Seventh Circuit concluded that the complaint adequately stated a claim.[10]

In a majority opinion authored by Justice Ginsburg and joined by five other justices, the Supreme Court held that the Seventh Circuit's standard was too lenient, and that its failure to consider competing inferences was improper. The court vacated the Seventh Circuit's judgment and remanded the case so that the lower courts could consider the allegations using the proper standard.[11] The majority opinion stated that to qualify as "strong," an inference of scienter "must be cogent and compelling, thus strong in light of other explanations. A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged."[12] Rejecting the Seventh Circuit's approach, the Supreme Court held that the district court "must take into account plausible opposing inferences."[13] The fraudulent inference need not be "irrefutable" to survive a motion to dismiss, nor need it be the "most plausible of competing inferences," but it must be at least as strong as any other inferences that could be drawn.[14] The court also concluded that the absence of a motive allegation is not fatal if the "entirety of the complaint" would support a strong inference of scienter.[15] Finally, the Court held that the vagueness or ambiguousness of an allegation will "count against inferring scienter," but that the court must "assess all the allegations holistically" to determine whether a strong inference has been pled.[16] The Court declined to address whether reckless (as opposed to intentional) conduct could satisfy the scienter requirement, nor did it address whether scienter could be imputed to an individual defendant through "group pled" allegations against a multitude of defendants.[17] The Fifth Circuit has previously held that "group pleading" is inadequate under the PSLRA.[18]

The opinion also drew two concurring opinions and one dissent. In the first concurring opinion, Justice Scalia argued that the Court should adopt the "most plausible of competing inferences" test advocated by certain of the circuit courts (including the Sixth Circuit).[19] In the second concurrence, Justice Alito argued that the PSLRA's plain language requires that non-particularized allegations be disregarded in their entirety.[20] In a short dissent, Justice Stevens equated the "strong inference" standard to the "probable cause" standard in criminal cases and argued that the plaintiff's allegations established probable cause to believe that Notebaert acted with the requisite scienter.[21] No other justices joined the dissent.

It remains to be seen how the Fifth Circuit will interpret the *Tellabs* opinion. Notably, in holding that a district court must weigh the allegations collectively in determining whether a "strong inference" has been pled, the Supreme Court favorably cited the Fifth Circuit's opinion in *Abrams v. Baker Hughes Inc.*,[22] thus implying that the Fifth Circuit correctly stated the law on this issue.[23] Moreover, the Fifth Circuit never explicitly endorsed the "most plausible of competing inference" test advocated by the Sixth Circuit, which the Supreme Court declined to adopt in *Tellabs*. One can thus argue that *Tellabs* does not significantly alter the existing standard employed by the Fifth Circuit to evaluate scienter allegations and, if anything, adds a new level of rigor by explicitly requiring district courts to consider "non-fraudulent" inferences in determining whether a "strong inference" has been pled. One can also argue that the difference between the majority opinion's standard and the "most plausible of competing inferences" standard favored by the concurring opinions is not particularly meaningful, as even Justice Scalia expressed "doubt that in this instance what I deem to be the correct test will produce results much different from the Court's. How often is it that inferences are precisely in equipoise?"[24] In any event, given that the Supreme Court declined to address whether the allegations in *Tellabs* actually supported a strong inference of scienter, lower courts will likely continue to disagree over what types of fact patterns will survive dismissal.

In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[25] the Fifth Circuit addressed whether "loss causation" must be established at the class certification stage and, if so, what level of proof must be supplied. The issuer, Allegiance Telecom, was a telephone service provider that suffered a 90% decline in its stock price during the 2001 telecom industry meltdown.[26] After the company declared bankruptcy in 2002, shareholders filed a putative class action asserting claims under sections 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5.[27] The district court held that the plaintiffs adequately established the "fraud-on-the-market" presumption at the class certification stage and certified the class.[28] The fraud-on-the-market theory allows courts to presume that the price of a security traded in an efficient market was fraudulently altered by a defendant's material misrepresentations, thus satisfying the reliance element for all class members who bought the security at the fraudulently inflated price.[29] Whether this presumption applies is a critical issue at the class certification stage because absent a classwide presumption of reliance, individual issues of reliance would predominate over common issues and make certification inappropriate.[30]

The Fifth Circuit granted interlocutory review and reversed the certification order, holding that the district court lacked an adequate basis for applying the fraud-on-the-market presumption.[31] The court emphasized that a plaintiff must demonstrate that the misstatement in question "*actually moved* the market" to qualify for the fraud-on-the-market presumption, which is necessary to establish classwide reliance.[32] "Essentially, we require plaintiffs to establish loss causation" – *i.e.*, that the stock price fell due to a "corrective disclosure" relating to an earlier false statement – "in order to trigger the fraud-on-the-market presumption."[33] The Fifth Circuit thus rejected the district court's holding that loss causation should not be decided at the class certification stage, noting that courts have moved away from "conditional certification" of class actions and now insist that the district court must "find," and not merely "assume," that the Rule 23 requirements have been satisfied.[34] This requirement holds true even if the Rule 23 factors overlap with the merits of the underlying claim.[35] Relying on the Supreme Court's holding in *Basic Inc. v. Levinson*,[36] the Fifth Circuit held that "'*any* showing that severs the link' between the misrepresentation and the plaintiff's loss . . . rebuts on arrival the plaintiff's fraud-on-the-market theory" and thus makes class certification improper.[37]

One way to "sever the link" between the misrepresentation and the stock price decline is to demonstrate that other unrelated negative information caused the loss. In *Greenberg v. Crossroads Systems, Inc.*,[38] the Fifth Circuit held that "plaintiffs must demonstrate that . . . the cause of the decline in price is due to the revelation of the truth and not the release of . . . unrelated negative information."[39] Under the rule announced in *Greenberg*, a plaintiff must prove that: (1) the stock price declined following a corrective disclosure relating to the earlier false statement; and (2) it is "more probable than not that it was this negative statement [the corrective disclosure], and not other unrelated negative statements, that caused a significant amount of the decline."[40] The *Allegiance Telecom* court enhanced this requirement by holding that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence."[41]

As in *Greenberg*, Allegiance Telecom's "corrective disclosures" regarding the alleged false statements (which involved supposedly inflated "line-installation counts") were released simultaneously with other unrelated negative information regarding the company's financial performance.[42] To demonstrate that the corrective disclosures (and not the other unrelated information) caused the stock price decline, the plaintiff provided an expert report that relied primarily on contemporaneous statements from analysts emphasizing the importance of the line-installation count corrective disclosure.[43] The expert did not, however, conduct a "post-mortem" empirical analysis to quantify the amount of the stock price decline that was attributable to the line-installation count disclosure as opposed to the other unrelated disclosures.[44] The Fifth Circuit held that it was improper to certify a class in the absence of such an analysis, and that the analysts' "raw" opinions about the materiality of the line-installation count disclosure amounted to mere "speculation" that was insufficient to establish loss causation.[45] Instead, the plaintiff's expert "must offer some empirically-based showing that the corrective disclosure was more than just present at the scene" and must consider "post-mortem data" regarding the market's reaction to the information.[46] In so holding, the Fifth Circuit reasoned that requiring such proof at the class certification stage was more consistent with due process concerns than deferring this inquiry until summary judgment or trial, particularly given the "*in terrorem* power of certification" and the "extraordinary leverage" that a class certification order bestows on plaintiffs in conducting the litigation and creating settlement pressure.[47] The court also reasoned that because "proof" of loss causation is "drawn from public data and public filings," it requires little discovery and can be easily addressed at the class certification stage.[48]

In a dissenting opinion, Judge James L. Dennis argued that under the Supreme Court's decision in *Basic*, it was the defendants' burden to demonstrate that the corrective disclosure did not cause the stock price decline, and that *Greenberg* was therefore wrongly decided to the extent it purports to shift this burden to the plaintiff.[49] Judge Dennis also argued that even if *Greenberg* was correctly decided, it does not stand for the proposition that plaintiffs must demonstrate loss causation to establish the fraud-on-the-market presumption.[50] The dissent also criticized the majority opinion for "effectively requir[ing] a mini-trial on the merits of plaintiffs' claims at the certification stage."[51]

In *Regents of University of California v. Credit Suisse First Boston (USA), Inc.*,[52] the Fifth Circuit overturned the class certification order in the Enron shareholder litigation and held that the plaintiffs' "scheme liability" claims under SEC Rule 10b-5 subparts (a) and (c) were not entitled to the *Affiliated Ute* or "fraud-on-the-market" presumptions of classwide reliance. After recovering more than $7 billion against other defendants in the litigation, the lead plaintiffs in the Enron shareholder lawsuit trained their sights on defendants Credit Suisse, Merrill Lynch, and Barclays Bank ("the Banks") for allegedly entering into transactions and partnerships that enabled Enron to overstate its revenues and conceal its debts.[53] Among these transactions was the so-called "Nigerian Barges Transaction" in which Merrill Lynch bought Enron's interest in electricity-generating barges off the coast of Nigeria in 1999 and then sold its interest back to an Enron-controlled partnership six months later at a premium.[54] The plaintiffs claimed that Enron had a side agreement with Merrill Lynch guaranteeing that Enron would repurchase the barges at a premium, and that the transaction was thus improperly booked as a sale when in fact it was a loan.[55]

Because the Banks did not make direct misrepresentations to investors, the plaintiffs instead pursued a "scheme liability" theory under SEC Rule 10b-5(a) and (c), contending that the Banks knowingly entered transactions "whose principal purpose and effect [were] to create a false appearance of revenues."[56] The district court denied the Banks' motions to dismiss and certified the class, holding that the plaintiffs were entitled to rely on the so-called *Affiliated Ute* presumption of reliance for omissions-based claims as well as on the "fraud-on-the-market" theory.[57] As likewise noted in *Allegiance Telecom* (discussed above), the right to a classwide presumption of reliance is critical at the class certification stage because absent such a presumption, individual issues of reliance would predominate over common issues and make certification inappropriate.[58]

The Fifth Circuit granted leave to pursue an interlocutory appeal and reversed the certification order. As stated in the commentary to Fed. R. Civ. P. 26(f), an interlocutory appeal can be appropriate because a class certification order potentially exposes the defendant to "ruinous liability" and may thus "force a defendant to settle."[59] The Fifth Circuit noted that the settlement pressure in this case was "particularly acute" because the plaintiffs were seeking to hold the Banks liable "for nearly the entirety of securities losses stemming from the Enron class."[60] Accordingly, the Fifth Circuit rejected the plaintiffs' argument that leave for interlocutory appeal was inappropriate.

Turning to the merits of the district court's order, the Fifth Circuit first held that the *Affiliated Ute* presumption did not apply. This presumption is derived from the Supreme Court's decision in *Affiliated Ute Citizens v. United States*,[61] which established a presumption of reliance for omissions-based claims. To qualify for this presumption, a plaintiff must: (1) allege a case primarily based on omissions or nondisclosure and (2) demonstrate that the defendant owed him a duty of disclosure.[62] The Fifth Circuit concluded that the second requirement was not met, as the banks "were not fiduciaries and were not otherwise obligated to the plaintiffs."[63] Accordingly, "[t]hey did not owe plaintiffs any duty to disclose the nature of the alleged transactions," thus precluding the plaintiffs from invoking the *Affiliated Ute* presumption of classwide reliance.[64]

The Fifth Circuit likewise concluded that the plaintiffs were not entitled to the "fraud-on-the-market" presumption.[65] The court held that plaintiffs must not only plead and prove the existence of an efficient market to invoke the presumption– they must also demonstrate that the defendant actually made "public and material misrepresentations; *i.e.*, the type of fraud on which an efficient market may arise."[66] As a result, the district court must inquire at the class certification stage into the merits of whether the defendant made a "public and material misrepresentation" or "deception," thus adding another level of rigor to the class certification analysis.[67]

The Fifth Circuit next rejected the district court's conclusion that the Banks' participation in allegedly fraudulent Enron-related transactions was a "deceptive device" capable of supporting the fraud-on-the-market presumption. In *Central Bank, N.A. v. First Interstate Bank, N.A.*,[68] the Supreme Court held that section 10(b) of the Exchange Act does not authorize a private right of action for "aiding and abetting" liability.[69] The Supreme Court, however, left open the possibility that third parties could potentially be liable as "primary" violators in some circumstances, which has led to a circuit split. The Ninth Circuit, for example, recently held that a third party can be liable as a "primary" violator under section 10(b) for engaging in a "transaction [with the issuer] whose principal purpose and effect is to create a false appearance of revenues."[70] The Eighth Circuit reached the opposite conclusion, holding that "any defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under [section] 10(b) or any subpart of Rule 10b-5."[71]

The Fifth Circuit sided with the Eighth Circuit and rejected the Ninth Circuit's approach. Noting that section 10(b) requires a "manipulative or deceptive device or contrivance," the court agreed with the Eighth Circuit's conclusion that a "deceptive device" must involve "either a misstatement or a failure to disclose by one who has a duty to disclose."[72] Because the Banks did not make any direct false statements and owed no duty of disclosure to Enron's shareholders, the Fifth Circuit concluded the Banks did not engage in a "deceptive device" as required by section 10(b) and *Central Bank*.[73] To the extent that the "scheme liability" provisions in Rule 10b-5(a) and (c) purport to expand the range of liability beyond what is authorized by section 10(b), the language in section 10(b) is controlling.[74] The Fifth Circuit reasoned that while the Banks' alleged conduct was "hardly praiseworthy," allowing liability under these circumstances "would introduce potentially far-reaching duties and uncertainties for those engaged in day-to-day business dealings."[75]

In a concurring opinion, Judge Dennis criticized the majority for reaching the merits of whether the Banks were "primary" actors, which he believed exceeded the court's permissible review of a class certification order.[76] Judge Dennis noted that "there were certainly public misrepresentations that arose out of the banks' allegedly fraudulent transactions with Enron; the rub, of course . . . is that Enron, not the banks, conveyed the misrepresentations to the market."[77] In his view, the question of whether the Banks could be held liable for those misrepresentations was a question of liability that was not necessarily related to the class certification decision and thus beyond the scope of the appellate court's limited interlocutory review under Fed. R. Civ. P. 23(f).[78]

Judge Dennis further argued that the majority's interpretation of the word "deceptive" in section 10(b) was unduly narrow, and that the Supreme Court never expressly held that a "deceptive device" had to be a misrepresentation or omission.[79] As in his *Allegiance Telecom* dissent, Judge Dennis again criticized the Fifth Circuit's prior holding in *Greenberg* for (in his view) improperly shifting the burden of proof for establishing the fraud-on-the-market presumption to the plaintiff.[80] Judge Dennis nonetheless concluded that the district court erred in holding that "where a defendant knowingly engaged in a primary violation of the federal securities law that was in furtherance of a larger scheme, it should be jointly and severally liable for the loss caused by the entire overarching scheme, including conduct of other scheme participants about which it knew nothing."[81] The concurring opinion argued that this standard could potentially hold a defendant liable "for the damages of plaintiffs who were harmed exclusively by the conduct of others, and to whom that defendant could not otherwise be liable at all."[82] This "exceeds the permissible bounds of primary liability" under section 10(b) and amounts to the "impermissible imposition of conspiracy liability" in violation of *Central Bank*.[83]Accordingly, Judge Dennis concurred in the judgment but did not join the majority opinion.

After the Fifth Circuit issued its ruling, the Supreme Court granted *certiorari* in the Eighth Circuit case relied upon by the Fifth Circuit majority, which has been recaptioned *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*[84] The issue before the Supreme Court in *Stoneridge* is whether the *Central Bank* decision "forecloses claims for deceptive conduct . . . where Respondents engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where Respondents themselves made no public statements concerning those transactions." Because the Fifth Circuit essentially adopted the Eighth Circuit's reasoning on this issue, the Supreme Court's opinion in *Stoneridge* could significantly impact the outcome in the Enron litigation. A decision is expected during the next Supreme Court term.

In *Langbecker v. Electronic Data Systems Corp.*,[85] the Fifth Circuit addressed whether a district court properly certified a class in an ERISA fiduciary duty lawsuit premised on the same alleged accounting and business irregularities as a recent securities fraud class action. In 2005, the Fifth Circuit affirmed the certification of a securities fraud class action against Electronic Data Systems, Inc. ("EDS").[86] The same district court that certified the securities fraud action (the Eastern District of Texas) also certified an ERISA action premised on the same alleged irregularities as the securities action.[87] Instead of asserting securities violations, the ERISA plaintiffs alleged that ERS and the individual defendants breached their fiduciary duties to the company's 401(k) defined contribution Retirement Plan (the "Plan") by, among other things, continuing to offer ERS stock as an option for participants in the Plan after learning of ERS's financial problems; directing and approving investments in ERS stock rather than safer investments; investing matching funds in ERS stock after learning of the alleged problems; failing to take adequate steps to mitigate or compensate Plan participants for the risks of their investments in ERS; failing to adequately monitor the committee responsible for administering the Plan; failing to provide such committees with accurate information regarding the company's financial problems; and failing to act in the Plan's best interests.[88] All claims were asserted under ERISA sections 409 and 502(a)(2).[89]

Despite affirming class certification in the securities case, the Fifth Circuit vacated the district court's certification order in the ERISA case. The Fifth Circuit agreed with the district court's conclusion that the plaintiffs' allegations could give rise to a derivative claim on behalf of the entire Plan, with the benefits of any recovery devolving upon the Plan's participants (*i.e.*, the class members).[90] The circuit court disagreed, however, with the district court's findings regarding ERISA section 404(c), which insulates ERISA fiduciaries from liability for losses resulting from an individual Plan participant's exercise of control over the assets in his or her account.[91] The district court concluded that section 404(c) is an individual defense that does not apply to lawsuits brought derivatively on behalf of the Plan.[92] The Fifth Circuit disagreed, holding that "the Plan 'as a whole' is not entitled to recover money damages for breach where an individual participant, suing on his own behalf, could not recover."[93] The Fifth Circuit also held that the district court did not properly consider the impact of releases signed by approximately 9,000 of the putative class members when it certified the class.[94] In addition, while agreeing that the proposed class representatives met the typicality requirement, the Fifth Circuit held that the district court did not adequately consider the potential for conflicts between class members, given that the ERISA claims seek to "second-guess judgments made by the Appellants involving a multitude of considerations over a period of years" that "will have difference consequences for class members' recovery."[95] For example, while some class members lost money on their ERS investments, many class members actually made money on their EDS stock, which rebounded after the downturn that precipitated the securities fraud suit.[96] According to the Fifth Circuit, these conflicts rendered "troubling" the district court's decision to certify classes under Fed. R. Civ. P. 23(b)(1) and (2) without affording absent class members the right to receive notice and opt out, which the Fifth Circuit held "would create an unacceptable risk of unfair treatment of class members."[97] The Fifth Circuit thus vacated the certification order and ordered the district court to reconsider the class certification issue in light of the issues raised in the opinion.[98]

In a dissenting opinion, Judge Thomas M. Reavley argued that the district court correctly certified the class. The dissent noted that the Department of Labor's own regulations interpreted section 404(c) as not relieving fiduciaries of their duty of prudence in selecting and monitoring Plan investment options.[99] In Judge Reavley's view, the majority opinion gave insufficient deference to the Department's interpretation.[100] Judge Reavley also argued that the releases did not foreclose class members from recovering their share of benefits awarded to the Plan itself and thus presented no obstacle to class certification.[101] The dissent further noted that other courts have rejected the argument that a section 502(a)(2) ERISA action must allege harm to all of a plan's individual participants to proceed on behalf of the plan as a whole, and that such an argument would be inconsistent with the Fifth Circuit's own holding in the EDS securities action that a proposed class representative who purchased EDS stock after learning of the falsity of the company's earlier disclosures could still adequately represent the class.[102] Finally, Judge Reavley noted that other courts have certified Fed. R. Civ. P. 23(b)(1) classes in ERISA section 502(a)(2) cases on the grounds that allowing multiple individual actions on behalf of the same entity (the Plan) presented a risk of contradictory rulings.[103]

In *Margolies v. Deason*,[104] the Fifth Circuit addressed several issues regarding the statute of limitations for federal securities fraud claims, including: (1) whether the Sarbanes-Oxley Act revives claims that were already time-barred when the Act became effective; and (2) the extent to which a statute of limitations defense can be determined on a motion for summary judgment. The plaintiffs were the largest shareholders in a company known as U.S. Transportation Systems ("USTS").[105] In 1998, USTS was acquired by Precept Business Services, Inc., and plaintiffs received shares of Precept in exchange for their shares of USTS.[106] Thereafter, Precept filed for bankruptcy, which resulted in the plaintiffs' shares becoming worthless.[107]

The plaintiffs filed suit against three individual defendants, asserting claims under sections 11 and 12 of the Securities Act, section 10(b) of the Exchange Act and SEC Rule 10b-5, Articles 581-33(A)(2) and 581-33(F) of the Texas Blue Sky Laws, and common law fraud.[108] The principal allegation was that the defendants transferred property from Precept to themselves for less than market value and for no legitimate business purpose.[109] The defendants moved for summary judgment on all claims based on the applicable statutes of limitations.[110] The district court held that all of the claims were time-barred and dismissed the case, and the plaintiffs appealed.[111]

The Fifth Circuit affirmed the summary judgment on the federal claims but reversed as to the state law claims. With respect to the federal claims, the Fifth Circuit noted that the claims were already time-barred by the three-year pre-Sarbanes-Oxley statute of repose on July 30, 2002, the date when the longer Sarbanes-Oxley statute of limitations for fraud-based claims became effective.[112] Reaching the same conclusion as the Second, Third, Fourth, Seventh, and Eighth Circuits, the Fifth Circuit held that the Sarbanes-Oxley Act does not revive claims that were already time-barred by July 30, 2002, noting that the Act does not meet the test for retroactivity articulated in *Landgraf v. USI Film Products*.[113, 114] The Fifth Circuit also concluded that a section 11 or 12 claim that is based on allegations of "fraud, deceit, manipulation, or contrivance" is subject to the longer Sarbanes-Oxley statute of limitations (two year inquiry notice/five year repose), rather than the shorter statute of limitations in section 13 of the Securities Act (one year inquiry notice/three year repose).[115] The court did not, however, provide any substantive discussion or analysis regarding this issue, and the court's conclusion on this matter had no bearing on the outcome given that the claims were already time-barred when Sarbanes-Oxley became effective.[116]

With regard to the state law claims, the Fifth Circuit held that the defendants failed to demonstrate as a matter of law that the plaintiffs were on inquiry notice of their claims.[117] A claim under Article 581-33(A)(2) or 581-33(F) of the Texas Blue Sky Laws expires after the earlier of "(a) more than three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence; or (b) more than five years after the sale."[118] A common law fraud claim under Texas law must be asserted "not later than four years after the day the cause of action accrues."[119] If the case involves "allegations of fraud or fraudulent concealment," the action "does not accrue until the plaintiff knew or in the exercise of reasonable diligence should have known of the wrongful act and resulting injury."[120] The Fifth Circuit held that whether a party has exercised diligence in discovering fraudulent conduct is ordinarily "a question of fact for the jury" and may not be determined on summary judgment "[u]nless the evidence is such that reasonable minds may not differ as to its effect . . . ."[121] Here, while Precept disclosed that it was selling properties to the defendants at a loss (partly due to repair costs), it did not disclose that it was selling the properties for below market value.[122] Likewise, while Precept also disclosed that it closed two other acquisitions shortly after the USTS-Precept deal, Precept did not disclose any facts demonstrating that it had improperly negotiated these actions during a window of time when it had agreed not to enter into any such agreements or arrangements, as contended by the plaintiffs.[123] Accordingly, the Fifth Circuit held that the disclosures were not sufficiently conclusive to place the plaintiffs on inquiry notice as a matter of law, and that summary judgment therefore was inappropriate.[124]

In *Disraeli v. Rotunda*,[125] the Fifth Circuit addressed whether officials at the Texas State Securities Board ("TSSB") are entitled to immunity in civil lawsuits relating to their duties as government officials. The plaintiff asserted that the defendants violated his due process rights by issuing an emergency cease and desist order barring him from offering certain securities in Texas and from rendering services as an investment adviser without a license, and were thus liable under 42 U.S.C. §§ 1983 and 1985(3) and 28 U.S.C. § 2201.[126] The plaintiff further asserted that the defendants violated federal trademark laws by publishing his name in a disparaging manner without his consent.[127]

The Fifth Circuit affirmed the district court's grant of summary judgment as to all claims and held that the defendants enjoyed absolute immunity from suit based on their status as TSSB officials.[128] The defendants included a TSSB enforcement attorney, the director of the TSSB's enforcement division, and the acting TSSB commissioner at the time.[129] Noting that absolute immunity is available to judges, prosecutors, and "quasi-judicial officers and agencies" who "perform[] certain functions analogous to those of a prosecutor," the Fifth Circuit concluded that the duties of the TSSB defendants were "at the heart of the [agency's] adjudicative process" and therefore were entitled to absolute immunity from suit.[130] The court observed that there was a public interest in protecting TSSB officials from harassment by private citizens, that the plaintiff already enjoyed significant administrative protections that reduced the need for a private damages remedy, that the TSSB officials are shielded from political influence, that the TSSB enforcement proceeding was adversarial and judicial in nature, and that the TSSB's orders are reviewable on appeal, again reducing the need for private damages.[131] Accordingly, the court found that the defendants were entitled to absolute immunity.[132] The court also held that even if the enforcement attorney engaged in "investigative" as well as "adjudicative" activities, his actions were still protected by qualified immunity as long as he acted within his discretionary authority – an issue not briefed by the plaintiff on appeal.[133] Accordingly, the Fifth Circuit affirmed the district court's grant summary judgment.[134]

In *K3C Inc. v. Bank of America, N.A.*,[135] the Fifth Circuit held that an interest rate swap agreement was not a security for purposes of the Texas Securities Act, meaning that no violation of that law could be alleged.[136] An interest rate swap "is a transaction by which a borrower can hedge against the risk of interest rate fluctuations" by agreeing with another party "to exchange fixed rate payments for floating rate payments based on an underlying index such as LIBOR (London Interbank Offered Rate)," thus effectively converting the party's floating rate loan to a fixed rate loan.[137] In a "plain vanilla" swap, one party pays a fixed rate of interest, while the other party assumes a floating rate of interest based on the amount of the principal of the underlying debt.[138] The swap agreement at issue in this case was called a "knockout" swap, in which the obligations of the parties are "knocked out" if the floating interest rate rises above a certain level, meaning that the party making the floating rate payments need not make payments during that period.[139] Under the knockout swap in this case, the plaintiffs were to receive payments from Bank of America if interest rates were between 6.5% and 7.25%.[140] If interest rates rose above 7.25%, no payments would be owed during that period.[141] If interest rates fell below 6.5%, the plaintiffs would owe payments to the bank.[142]

After the parties entered into the swap agreement, interest rates fell far below 6.5%, thus forcing the plaintiffs to make significant payments to the bank.[143] The plaintiffs thereafter terminated the agreement and demanded that the bank repay the money they lost under the agreement, arguing that the bank committed securities violations under the Texas Securities Act, breached its purported fiduciary duty to the plaintiffs, and was liable under various other statutory and common law theories.[144] The bank counterclaimed for payment of the contractually mandated termination fee.[145] After a bench trial, the district court rejected all of the plaintiffs' claims, entered judgment in Bank of America's favor on its counterclaim, and awarded attorneys' fees to the bank.[146]

The Fifth Circuit affirmed the district court's judgment in its entirety.[147] Because there were no Texas cases on point, the court looked to federal securities cases for guidance on whether an interest rate swap agreement is a security and noted that every federal court to consider the issue has held that interest rate swaps are not securities for purposes of the federal securities laws.[148] The court concluded that the federal decisions provided "persuasive guidance" on this issue and thus held that the swap agreement was not a security under the Texas Securities Act.[149] The court also affirmed the trial court's judgment on the non-securities claims as well as on the bank's counterclaim and the attorneys' fee award.[150]

ENDNOTES

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2 __ S. Ct. __, 2007 WL 1773208 (June 21, 2007).

3 *Id.* at *5-6.

4 *Id.*

5 *Id.*

6 *Id.* at *6-7, 11.

7 *Id.* at *11.

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.* at *13.

12 *Id.* at *10.

13 *Id.*

14 *Id.*

15 *Id.* at *11.

16 *Id.*

17 *Id.* at *7 n.3 & 11.

18 *See Southland Securities Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 364 (5th Cir. 2004).

19 *Tellabs*, 2007 WL 1773208, at *13-15 (Scalia, J., concurring).

20 *Id.* at *15-16 (Alito, J., concurring).

21 *Id.* at *17 (Stevens, J., dissenting).

22 292 F.3d 424, 431 (5th Cir. 2002).

23 *See Tellabs*, 2007 WL 1773208, at *9.

24 *Id.* at *14.

25 487 F. 3d 261 (5th Cir. May 16, 2007).

26 *Id.* at 262-63.

27 *Id.*

28 *Id.* at 263.

29 *Id.* at 264.

30 *Id.*

31 *Id.* at 271.

32 *Id.* at 265 (emphasis in original) (collecting cases).

33 *Id.*

34 *Id.* at 267.

35 *Id.* at 267-68.

36 485 U.S. 224 (1988).

37 *Allegiance Telecom*, 487 F.3d at 265 (quoting *Basic*, 485 U.S. at 245).

38 364 F.3d 657 (5th Cir. 2004).

39 *Id.* at 665.

40 *Id.* at 666.

41 *Allegiance Telecom*, 487 F.3d at 269.

42 *Id.* at 262-63.

43 *Id.* at 270-71.

44 *Id.* at 271.

45 *Id.*

46 *Id.*

47 *Id.* at 267-68, 271.

48 *Id.* at 267-68.

49 *Id.* at 274-75 (Dennis, J., dissenting).

50 *Id.* at 275-76 (Dennis, J., dissenting).

51 *Id.* at 277 (Dennis, J., dissenting).

52 482 F.3d 372 (5th Cir. March 19, 2007).

53 *Id.* at 377.

54 *Id.*

55 *Id.*

56 *Id.* at 386.

57 *Id.* at 378-79.

58 *Id.* at 383.

59 *Id.* at 379 (quoting Fed. R. Civ. P. 23(f) advisory committee note).

60 482 F.3d at 379.

61 406 U.S. 128 (1972).

62 *Regents*, 482 F.3d at 384.

63 *Id.*

64 *Id.* at 384-85.

65 *Id.* at 385.

66 *Id.* at 385 (citing *Basic*, 485 U.S. at 245-46).

67 *See id.*

68 511 U.S. 164 (1994).

69 *Id.* at 188.

70 *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006).

71 *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *cert. granted, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 127 S. Ct. 1873 (2007).

72 *Regents*, 482 F.3d at 388 (quoting *Charter*, 443 F.3d at 990).

73 *Id.* at 388-90.

74 *Id.* at 390.

75 *Id.* at 393 (quoting *Charter*, 443 F.3d at 992-93).

76 *Id.* at 397-98 (Dennis, J., concurring).

77 *Id.* at 397 (Dennis, J., concurring).

78 *Id.* at 397-98 (Dennis, J., concurring).

79 *Id.* at 399-400 (Dennis, J., concurring).

80 *Id.* at 401 (Dennis, J., concurring).

81 *Id.* at 405 (Dennis, J., concurring).

82 *Id.* at 407 (Dennis, J., concurring).

83 *Id.* (Dennis, J., concurring).

84 *See* 127 S. Ct. 1873 (Mar 26, 2007) (granting *certiorari*).

85 476 F.3d 299 (5th Cir. 2007).

86 *See Feder v. Elec. Data Sys. Corp.*, 429 F.3d 125 (5th Cir. 2005).

87 *Langbecker*, 476 F.3d at 304.

88 *Id.*

89 29 U.S.C. § 1109(a) & § 1132(a)(2).

90 476 F.3d at 307-08.

91 *Id.* at 309.

92 *Id.* at 309-310.

93 *Id.* at 312.

94 *Id.* at 313-14.

95 *Id.* at 315.

96 *Id.*

97 *Id.* at 317-19.

98 *Id.* at 319.

99 *Id.* at 320 (Reavley, dissenting).

100 *Id.* at 320-22 (Reavley, dissenting).

101 *Id.* at 323-24 (Reavley, J., dissenting).

102 *Id.* (Reavley, J., dissenting).

103 *Id.* at 325 (Reavley, J., dissenting).

104 464 F.3d 547 (5th Cir. 2006).

105 *Id.* at 549.

106 *Id.*

107 *Id.*

108 *Id.* at 549-55.

109 *Id.* at 554.

110 *Id.* at 549.

111 *Id.*

112 *Id.* at 550.

113 511 U.S. 244 (1994)

114 *Margolies*, 464 F.3d at 551-52.

115 *Id.* at 550.

116 *See id.*

117 *Id.* at 553-55.

118 Tex. Rev. Civ. Stat. Ann. Art. 581, § 33(H)(2).

119 Tex. Civ. Prac. & Rem. Code Ann. § 16.004(a).

120 S.V. v. R.V., 933 S.W.2d 1, 4, 6 (Tex. 1996).

121 *Margolies*, 464 F.3d at 553-54 (internal citations omitted)).

122 *Id.* at 554.

123 *Id.*

124 *Id.* at 554-55.

125 *Id*__ F.3d __, 2007 WL 1696820 (5th Cir. June 13, 2007).

126 *Id.* at *1.

127 *Id.*

128 *Id.* at *2-6.

129 *Id.* at *1.

130 *Id.* at *3.

131 *Id.* at *4-5.

132 *Id.* at *5.

133 *Id.* at *6.

134 *Id.*

135 204 Fed. Appx. 455 (5th Cir. Nov. 6, 2006).

136 *Id.* at 458.

137 *Id.*

138 *Id.* at 458-59.

139 *Id.*

140 *Id.* at 460.

141 *Id.*

142 *Id.*

143 *Id.*

144 *Id.*

145 *Id.* at 458.

146 *Id.*

147 *Id.*

148 *Id.* at 465 (collecting cases).

149 *Id.*

150 *Id.* at 467.

Expert Case Law Review 2006-2007

By Paul R. Genender and Matthew D. Rinaldi[1]

Since January 2006, state and federal courts in Texas have addressed several important and controversial issues relating to the expert witness gatekeeping function of the courts under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*[2] and *E.I. du Pont de Nemours & Co. v. Robinson*.[3] This article provides a survey of the noteworthy decisions.

The Texas Supreme Court Clarifies *Gammill* and *Robinson*

Mack Trucks, Inc. v. Tamez, 206 S.W.3d 572 (Tex. 2006).

Recent Texas appellate opinions have suggested that two distinct tests apply to expert reliability questions—the multiple factor test of *E.I. du Pont de Nemours & Co. v. Robinson*,[4] and the analytical gap test of *Gammill v. Jack Williams Chevrolet, Inc.*[5, 6] In the 2006 case, *Mack Trucks, Inc. v. Tamez*, the Texas Supreme Court directly addressed the utility of these tests and clarified that use of the "analytical gap" test of *Gammill* alone is not sufficient to vet the reliability of expert testimony, and that the use of the *Robinson* reliability factors is appropriate even in a case in which the expert is primarily relying upon his own experience and perceptions.[7]

In *Tamez*, survivors of a petroleum tanker driver who died when his truck burst into flames brought an action against the tanker manufacturer, claiming that diesel fuel from the truck's fuel system was ignited by the truck battery, which then initiated the fire.[8] The plaintiffs designated an expert to address the topic of post-collision, fuel-fed fires.[9] The expert concluded that the truck's battery, which he claimed was improperly located near the fuel tanks, ignited the truck's diesel fuel causing the fire.[10]

The trial court conducted a *Robinson* hearing at which the expert testified and explained his conclusions in general terms.[11] The expert based his testimony on the generally accepted "fire triangle" theory, i.e. that a fire is caused by a combination of oxygen, fuel, and an ignition source.[12] However, he did not provide the methodology for applying that generally understood theory to the accident, so as to identify the diesel fuel as the specific cause.[13] The expert did not develop his theories with a high degree of specificity and did not rule out other potential sources of the fuel for the fire.[14] Therefore, the trial court determined that the expert had provided insufficient support for his methodology to determine reliability and granted the defendant's motion to exclude the expert.[15]

The plaintiffs attempted to cure the deficiencies in their expert's analysis by offering additional evidence in a bill of exception and moving for reconsideration.[16] The trial court denied the requests.[17] The plaintiffs' expert on causation having been stricken, the trial court granted the defendant's no evidence motion for summary judgment.[18]

The Corpus Christi Court of Appeals reversed the trial court's decision and considered ***both*** the evidence from the *Robinson* hearing ***and*** the evidence proffered in the bill of exceptions to conclude that the expert's opinion was based on the application of "his knowledge, training and experience to the underlying data in the case."[19] Interestingly, the court of appeals expressly rejected the use of *Robinson* factors because the expert's analysis did not involve pure science.[20] The court of appeals determined that a better test would be the analytical gap test of *Gammill* and, because the expert had linked his conclusions to the data and physical evidence from the accident, it determined that there was no analytical gap and that the testimony should have been allowed.[21]

The Texas Supreme Court clarified that in *Gammill*, the court "did not mean to imply that the trial court should never consider the *Robinson* factors when evaluating the reliability of expert testimony that is based on knowledge, training or experience, or that the factors can only be applied when evaluating scientific expert testimony."[22] Rather, the specific factors of reliability to be used for the court's gatekeeping function depend heavily on the facts of the case and the area of expertise involved.[23] "Thus, a trial court should consider the factors mentioned in *Robinson* when doing so would be helpful in determining reliability of an expert's testimony, regardless of whether the testimony is scientific in nature or experienced-based."[24]

The Supreme Court explained that the trial court could have considered: (i) whether his theory had been or could be tested; (ii) the extent to which his methodology relied upon subjective interpretation; (iii) the potential rate of error; (iv) whether the theory or methodology was accepted as valid by the appropriate expert community; and

(v) the nonjudicial uses of his methodology.[25] However, the Supreme Court was clear that while the *Robinson* factors can be used whether the testimony is scientific or experience-based, that is not to imply that the trial court was precluded from measuring the expert's methodology by using *Gammill's* analytical gap test.[26]

The *Tamez* decision could be seen as a narrow and case specific decision because the expert's opinion was not developed at the *Robinson* hearing and the trial court did not allow this flaw to be remedied through supplemental evidence from the bill of exception. However, *Tamez* illustrates how important it is for an attorney to make a full and developed record at the initial *Robinson* or, if in federal court, *Daubert* hearing. *Tamez* is also an important directive from the Texas Supreme Court that the *Robinson* multiple factor gatekeeping analysis and the *Gammill* analytical gap analysis are intended to complement each other in the reliability determination. Use of only the analytical gap test itself is improper.

Expert Opinion Rejected When it Invades the Province of the Jury

Pittman v. General Nutrition Corp., No. Civ. A. H-04-3174, 2007 WL 951638 (S.D. Tex. Mar. 28, 2007).

Two individuals formally employed by the defendant as sales managers brought employment discrimination claims under Title VII of the Civil Rights Act of 1964, in connection with, *inter alia*, the defendant's failure to promote them and for their later termination.[27] The plaintiffs offered the expert testimony of a "human resources professional" to support their claims.[28]

The court found testimony that the defendant's conduct was inconsistent with what the expert deemed prevailing human resources standards or the defendant's own personnel policies was admissible based on the expert's experience in human resources.[29] However, the court held that the expert could not testify: (i) that certain facts show an intent to discriminate or retaliate; (ii) that certain facts show "discrimination;" (iii) or that certain facts show "pretext."[30] These matters, the court explained, are within the jury's experience and were inadmissible legal conclusions.[31] Therefore, expert testimony on these matters was precluded.[32]

As *Pittman* makes clear, an expert witness may not be used as the mouthpiece of the proponent's lawyer—especially if the subject matter is grounded in common sense and is within the jury's comprehension.

Physician Not Qualified to Testify on Nurse Practitioner Standard of Care

Simonson v. Keppard, —- S.W.3d —-, No. 05-06-00842-CV, 2007 WL 1586128 (Tex. App. – Dallas June 4, 2007, no pet.).

Carol Keppard went to the emergency room at Methodist Hospital when she suffered a two-week long headache, nausea, and vomiting.[33] Donald Lehman, a nurse at the hospital, diagnosed Keppard with a migraine and released her after administering medication and observing an improvement in her symptoms.[34] Defendant Joan Wilkin, D.O., a doctor at the hospital, signed off on the diagnosis.[35] The following day Keppard was taken by ambulance to Baylor Hospital where she died from a massive brain hemorrhage.[36]

Keppard's family filed a lawsuit against Nurse Lehman, Dr. Wilkin, and the admitting physician at Methodist Hospital.[37] The plaintiffs filed an expert report from a neurosurgeon providing a summary regarding the applicable standard of care, the manner in which the care rendered failed to meet the standard, and the causal relationship between the failure to meet the standard and the injury.[38] The defendants challenged the expert report, among other reasons, on the ground that the expert was not qualified to testify as to the applicable standard of care.[39]

The expert's stated reasons for being familiar with the applicable standard of care were: (i) as a practicing neurosurgeon, he has worked in emergency rooms in some capacity his entire career; (ii) he served as an emergency department staff physician during his training; (iii) he served as a emergency room consulting physician; and (iv) as a practicing neurosurgeon, he frequently assumed the position of an admitting physician as well as attending physician to patients.[40] The court held that the expert was not qualified to testify regarding the standard of care applicable to Nurse Lehman because "[n]owhere in his affidavit does [the expert physician] state that he either has knowledge of the standard of care applicable to nurse practitioners or that he has ever worked with or supervised nurse practitioners."[41] The court stated, "[n]urse practitioners have advanced education in nursing. Although a nurse practitioner may make a diagnosis, he does so within the protocols or other written authorizations signed by a physician. Without familiarity with the protocols for Nurse Lehman, [the expert physician] cannot know the standard of care applicable to Nurse Lehman."[42] The court held that the expert was, however, sufficiently experienced in both neurosurgery and emergency medicine to allow him to opine on the standard of care applicable to the remaining defendants, both physicians.[43]

Simonson illustrates the importance of developing a record highlighting an expert's area of expertise as it relates to specific relevant issues in a case. In *Simonson*, it is not clear that the physician expert was unqualified to render opinions regarding a nurse practitioner standard of care, considering his extensive experience in the medical industry. However, this case illustrates the importance of developing a record showing that the expert was qualified to do so.

Deficient Expert Report Cured by an Opponent's Deposition

McKnight v. Purdue Pharma Co., 422 F. Supp. 2d 756 (E.D. Tex. 2006).

The consumer of a prescription narcotic sued the manufacturer of the drug, claiming she had become addicted to the drug and that it caused her various mental and physical problems.[44] The plaintiff designated an expert witness to testify that the plaintiff experienced addiction and suffered from dependence, intoxication and withdrawal.[45] However, the expert's report failed to explain the source of the criteria he used to diagnose addiction, intoxication, or withdrawal, or to "show how reliable principles and methods have been applied reliably to the facts of the case."[46] That is, the expert merely narrated the plaintiff's medical history and, without outlining any basis or methodology, stated his conclusion.[47]

At the *Daubert* hearing, the plaintiff offered no new evidence or explanation in support of the expert's opinion and did not call the expert to testify.[48] However, the defendants introduced the expert's deposition testimony, which revealed that the expert used reliable methodology as the foundation of his opinion and applied them reliably to the facts of the case.[49] That is, his deposition testimony "filled in the gaps in the predicate of Rule 702(2)-(3), which his report had left open."[50] Accordingly, the district court denied the defendant's motion to strike the expert.[51]

McKnight illustrates the precarious position a trial attorney is placed in when deposing an opponent's expert witness who has prepared an expert report that does not disclose sufficient information to render the expert's testimony admissible. An attorney cannot simply avoid deposing an expert where that expert's report is facially defective in the hopes of winning a *Daubert* challenge, lest he face the risks associated with going to trial unprepared to examine the expert. Thus, in the face of a facially and obviously defective expert's report, counsel must depose the expert, allowing the expert to effectively supplement his expert report.

Deficient Expert Report Not Cured by Post-Discovery Affidavits

Avance v. Kerr-McGee Chem. LLC, No. 5:04CV209, 2006 WL 3484246 (E.D. Tex. Nov. 30, 2006).

The plaintiffs in a toxic exposure case filed affidavits for four experts in lieu of calling them as live witnesses at a *Daubert* hearing.[52] The defendant filed a motion to strike, asserting that the plaintiffs were attempting to circumvent Federal Rule of Civil Procedure 26 and the court's scheduling order by submitting revised and additional opinions which significantly differed from their previously submitted expert reports after the expert report deadline, after the expert discovery deadline, after dispositive motions had been filed, and less than a week before the scheduled *Daubert* hearing.[53] The defendant contended that responding to the new contentions of the plaintiffs' experts disrupted their preparation for the *Daubert* hearing and increased the costs of litigating the case.[54] In response, the plaintiffs asserted that their experts had the right to address the alleged shortcomings in their testimony, and disputed the defendant's claim that the affidavits revised prior expert conclusions, or that they proffered new opinions, sources, or methods of analysis.[55]

The expert affidavits offered by the plaintiffs gave revised and additional opinions that differed significantly from parts of the previously submitted expert reports, and even cited new sources not listed in the previous expert reports.[56] For example, one expert included studies and resources that: "(i) were never disclosed by Dr. Gardner in his expert report; (ii) were never disclosed in his deposition; (iii) were cited for the first time in his first untimely affidavit filed on June 28, 2006; and (iv) were expressly disavowed as a resource in his deposition."[57] In striking the new affidavits, the court refused to allow extensive expert report supplementation where the plaintiffs did not demonstrate "substantial justification" as to why the revisions and new affidavits were filed after the expert discovery deadline, after *Daubert* and summary judgment motions were filed, and less than a week from the *Daubert* hearing, stating:

> Even though the Federal Rules of Civil Procedure provide for supplementation, parties do not have infinite time to supplement their expert opinions with new information to respond to challenges to their experts' original evidence. Courts have stricken affidavits to the extent they go beyond opinion expressed in the experts' Rule 26 reports.[58]

The court attributed importance to the fact that the experts were not going to appear to testify live and, therefore, were not available for cross-examination regarding the new theories and opinions addressed in the affidavits, stating:

> The Court agrees with Defendant that allowing the introduction of new information at this time for use in the Court's consideration of the parties' *Daubert* motions would be unfair and prejudicial to Defendant because Defendant would not have an opportunity for cross-examination on those new issues. Although Plaintiffs assert the affidavits at issue are not "wholly new reports," certainly portions of the affidavits present new information, and the Court is not required nor is it willing to parse out those portions of the affidavits that are new and those portions that were timely disclosed or proper as rebuttal or impeachment evidence only.[59]

Thus, while *McKnight* illustrates a situation where a facially defective expert report can be cured with deposition testimony addressing shortcomings in the expert report, *Avance* indicates that a court will not grant a party the same leeway to remedy expert report deficiencies post-discovery.

Rule Allowing Discovery from Testifying Expert Trumps the "Snap-Back" Rule

In re Christus Spohn Hosp. Kleberg, 222 S.W.3d 434 (Tex. 2007) (orig. proceeding).

The Texas "snap-back" rule was designed to address the inadvertent production of privileged documents, particularly in a large document production where a party's screening may have been inadequate to catch all privileged documents.[60] The "snap-back" rule allows a party to recover privileged documents that are accidentally produced to an opponent.[61] However, the Texas Supreme Court recently addressed the situation where privileged documents were inadvertently produced to an expert.[62] In such a case, the "snap-back" rule conflicts with the requirement for disclosure of expert communications, and the expert discovery rule wins that fight.[63]

In *In re Christus Spohn Hospital Kleburg*, a medical malpractice mandamus proceeding, the defendant hospital sought to recover privileged documents that were mistakenly provided to its designated testifying expert witness.[64] In that case, the hospital's investigator prepared summaries of her interviews with employees and correspondence with counsel.[65] These work product documents were sent by a paralegal to the hospital's expert witness.[66] In response to a subpoena duces tecum, the expert brought the documents to her deposition and admitted she had "glanced through" them and had determined they were not relevant to her opinion.[67] The hospital claimed the documents were subject to work product protection, were disclosed inadvertently under Texas Rule of Civil Procedure 193.3(d), and should be returned or "snapped-back."[68] The plaintiff argued that the hospital was required to produce the documents under Texas Rule of Civil Procedure 192.3(e)(6), which mandates discovery of documents "that have been provided to, reviewed by, or prepared by" or for a testifying expert.[69]

The Supreme Court held that the inadvertent nature of the production of the documents preserved privilege under Rule 193.3(d).[70] However, Rule 192.3(e)(6) trumped Rule 193.3(d) where the designated expert was to testify at trial.[71] The court found it particularly important that the disclosure be produced in order to allow the opponent to properly challenge the expert's opinion.[72] Discoverability does not turn on the expert's choice to actually utilize the documents, because "[m]aterials both accepted and rejected by an expert are indicative of the process by which the expert went about forming his or her opinion and may provide an effective basis for cross-examination."[73] The court stated:

> [T]he expert witness paints a powerful image on the litigation canvas. And it is typically the hiring attorney who selects the materials that will provide color and hue. Just as a purveyor of fine art must examine the medium used in order to distinguish masterpiece from fake, a jury must understand the pallet from which the expert paints to accurately assess the testimony's worth. Given the importance that expert testimony can assume, the jury should be aware of documents and tangible things provided to the expert that might have influenced the expert's opinions. In terms of determining what effect documents provided to an expert had in shaping the expert's mental impressions and opinions, the attorney's intent in producing the documents is irrelevant.[74]

The court provided the obvious and simple solution to an attorney who inadvertently discloses privileged documents through a testifying expert:

> We are sympathetic to the Hospital's concerns over losing valuable work-product protections when documents are produced to a testifying expert by mistake. But the producing party in such a situation is not without a remedy. An attorney who discovers that privileged documents have been inadvertently provided to a testifying expert may presumably withdraw the expert's designation and name another. Although such a course may entail additional expense and perhaps delay, these concerns do not outweigh countervailing concerns that require full disclosure from an expert who will testify.[75]

That is, an attorney who inadvertently discloses privileged documents to an expert is faced with the choice of producing those documents or designating another expert to testify at trial.

Expert Side-Switching and Disqualification

Formosa Plastics Corp., USA v. Kajima Int'l, Inc., 216 S.W.3d 436 (Tex. App.—Corpus Christi 2006, pet. filed) (en banc).

In a complex construction claim, the Corpus Christi Court of Appeals addressed the question of whether disqualification should follow if an expert "switches sides" in litigation.[76] The plaintiff, an industrial construction company, constructed a plant expansion for the defendant, a plastics manufacturer.[77] However, millions of dollars of cost overruns were incurred by the plaintiff when the project took much longer than expected.[78] When the prospect of litigation arose, the defendant contacted an expert in heavy construction named Steven Huyghe.[79] Huyghe and his assistant met with the defendant's counsel to discuss strategy and later submitted a bill for $22,000 for their services.[80] Huyghe also recommended an associate, Chip Hutchison, from another consulting group, which later merged with the Huyghe's company, and copied Hutchison on his correspondence with the defendant.[81] The defendant subsequently transferred its defense to another firm, which ultimately decided not to hire Huyghe.[82] The plaintiff later contacted Huyghe, who signed an affidavit saying his firm had received no confidential information, and then hired Hutchison.[83]

The defendant moved to disqualify Hutchison and his firm.[84] The court of appeals addressed two issues of first impression: (i) whether an expert should be disqualified if he is somehow "related" to an expert previously retained by the other party, and (ii) whether an entire firm of experts should be disqualified if an individual member of the firm is subject to disqualification.[85] While an attorney would be disqualified under similar circumstances, the court of appeals ultimately adhered to a less stringent standard and a less restrictive result for expert witnesses, adopting a two-part test it claimed was followed by the majority of jurisdictions, i.e. the expert would be disqualified if (i) the moving party had an objectively reasonable basis to believe that it had a confidential relationship with the expert, and (ii) confidential or privileged information was provided to the expert.[86] Thus, the court of appeals held that the rule allowing disqualification of a law firm for imputed knowledge was inapplicable to cases addressing the issue of disqualification of experts. Because no confidential information was actually sent by the defendant to Hutchison, the defendant could not meet its burden of showing the expert should be disqualified.[87]

Kajima International highlights the potential problem an attorney might face when divulging information about a case in preliminary meetings with potential expert witnesses. While the attorney must provide the prospective expert sufficient information to allow the expert to form a preliminary opinion, he does not want to risk the disclosure of confidential information or privileged information should the attorney ultimately decide not to hire the expert, lest the expert be retained by the opposing party. To protect against this potential pitfall, an attorney should obtain a tight and strongly worded confidentiality agreement from the expert witness at the outset of the relationship.

Conclusion

In 2006 and 2007, Texas state and federal courts have defined and sculpted the courts' expert witness gatekeeping function in several respects. *Tamez*, *Pittman*, and *Simonson* set strict standards of reliability for expert witness testimony, *McKnight* and *Avance* clarify when materials to be used in a reliability determination may be introduced, and *In re Christus Spohn* and *Kajima International* show the broad scope of discovery that will be allowed from experts so that the reliability of expert witnesses can be properly vetted.

ENDNOTES

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2 509 U.S. 579 (1993)

3 923 S.W.2d 549 (Tex. 1995)

4 *Id.*

5 972 S.W.2d 713 (Tex. 1998)

6 *See, e.g., Halim v. Ramchandani*, 203 S.W.3d 482, 490 (Tex. App. – Houston [14th Dist.] 2006, no pet.).

7 *See Mack Trucks, Inc. v. Tamez*, 206 S.W.3d 572 (Tex. 2006).

8 *Id.* at 575-76.

9 *Id.* at 576.

10 *Id.*

11 *See id.* at 580.

12 *See id.*

13 *See id.* at 580-81.

14 *See id.*

15 *Id.* at 576.

16 *Id.*

17 *Id.*

18 *Id.*

19 *Tamez v. Mack Trucks, Inc.*, 100 S.W.3d 549, 555-56 (Tex. App.—Corpus Christi 2003), *rev'd*, 206 S.W.3d 572 (Tex. 2006).

20 *Id.* at 556.

21 *Id.* at 556-58.

22 *Tamez*, 206 S.W.3d at 579.

23 *Id.*

24 *Id.*

25 *Id.* at 579-80.

26 *Id.* at 580.

27 *Pittman v. General Nutrition Corp.*, No. Civ. A. H-04-3174, 2007 WL 951638, at *1-*2 (S.D. Tex. Mar. 28, 2007).

28 *Id.* at *2.

29 *Id.* at *5.

30 *Id.*

31 *Id.* at *3-*4.

32 *Id.* at *5.

33 *Simonson v. Keppard*, —- S.W.3d —-, No. 05-06-00842-CV, 2007 WL 1586128, *1 (Tex. App. – Dallas June 4, 2007, no pet.).

34 *Id.*

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*; *see also* TEX. CIV. PRAC. & REM. CODE § 74.351(r)(6).

39 *Simonson*, —- S.W.3d —-, 2007 WL 1586128, at *2.

40 *Id.*

41 *Id.* at *4.

42 *Id.* (*citing Cox v. Vanguard Health Sys., Inc.*, No. 04-04-00762-CV, 2005 WL 2367582, at *5 (Tex. App. – San Antonio, Sept. 28, 2005, pet. denied) (mem. op.) (holding expert report inadequate because expert gave no indication that he was familiar with practice of nurse in emergency room); *Jones v. Ark-La-Tex Visiting Nurses, Inc.*, 128 S.W.3d 393, 396-97 (Tex. App. – Texarkana 2004, no pet.) (expert report failed to show that physician expert had any familiarity with standard of care for nurses monitoring patient in home healthcare setting)).

43 *Id*. at *7.

44 *McKnight v. Purdue Pharma Co.*, 422 F. Supp. 2d 756, 757 (E.D. Tex. 2006).

45 *Id*.

46 *Id*. at 759.

47 *Id*.

48 *Id*.

49 Id.

50 *Id*.

51 *Id*. at 760.

52 *See Avance v. Kerr-McGee Chem. LLC*, No. 5:04CV209, 2006 WL 3484246, at *1 (E.D. Tex. Nov. 30, 2006).

53 *Id*.

54 *Id*.

55 *Id*.

56 *See id*. at *2-*5.

57 *Id*. at *4.

58 *Id*. at *7.

59 *Id*. (emphasis in original).

60 *See generally* TEX. R. CIV. P. 193.3(d).

61 *Id*.

62 *In re Christus Spohn Hosp. Kleberg*, 222 S.W.3d 434 (Tex. 2007)(orig. proceeding).

63 *See id*.

64 *Id*. at 436.

65 *Id*.

66 *Id*.

67 *Id*.

68 *Id*. at 437; *see also* TEX. R. CIV. P. 193.3(d) ("A party who produced material or information without intending to waive a claim of privilege does not waive that claim under these rules or the Rules of Evidence if – within ten days or a shorter time ordered by the court, after the producing party actually discovers that such production was made – the producing party amends the response, identifying the material or information produced and stating the privilege asserted. If the producing party thus amends the response to assert a privilege, the requesting party must promptly return the specified material or information and any copies pending any ruling by the court denying the privilege.")

69 *Id*. at 437; see also TEX. R. CIV. P. 192.3(e)(6).

70 *Id*. at 445.

71 *See id*.

72 *See id*.

73 *Id*. at 444.

74 *Id*. at 440.

75 *Id*. at 445.

76 *Formosa Plastics Corp., USA v. Kajima Int'l, Inc.*, 216 S.W.3d 436 (Tex. App.—Corpus Christi 2006, pet. filed) (en banc).

77 *Id*. at 444.

78 *Id*.

79 *Id*. at 445.

80 *Id*. at 446.

81 *Id*.

82 *Id*.

83 *Id*.

84 *Id*.

85 *See id*. at 448-51.

86 *Id*.

87 *Id*. at 451.

Recovery Of Lost Profits: Unpacking The Reasonable Certainty Rule

By Jay Nelson[1]

Recovery for business torts, as well as for benefit-of-the-bargain damages for breach of contract, is usually measured by calculating the lost profits of the plaintiff's business. The basic rule of law governing such recovery is a deceptively simple formula: lost profits may be awarded when they are proven by competent evidence with reasonable certainty.[2] But these few words raise a number of issues, some obvious, some less so. This article identifies and summarizes many of those issues, provides some illustration of methods used by courts and commentators to deal with them, and collects authority for further study.

The reasonable certainty rule recognizes that a tort or breach frequently interrupts the ordinary workings of the plaintiff business to a degree that makes it impossible to be truly certain what profits would have been earned had there been no such interruption.[3] Because insistence on complete substantiation of losses caused by the tort or breach would effectively deny full compensation to the injured party where the incompleteness is due to the defendant's own acts, courts permit recovery of lost profits that are only "reasonably certain."[4] But the rule does not stand alone. It rests on a showing that adequately demonstrates the fact of loss; once that showing has been made, a degree of uncertainty as to the amount of loss is permitted.[5] The result is a "just estimate of the amount of profit which would have been made"[6] in the absence of the tort or breach.

The Texas version of the rule was first articulated in 1938 in *Southwest Battery Corp. v. Owen*[7] and repeated in 1994 in *Texas Instruments, Inc. v. Teletron Energy Management, Inc*.[8] As noted in *Teletron*, the Supreme Court of Texas has "consistently reaffirmed the *Southwest Battery* decision."[9] It is fair to say, though, that the reiteration of the rule has been accompanied by increased emphasis on the instances of what could be termed per se speculation embedded in the *Southwest Battery* rule itself and more exacting assessment of the "competent evidence" required as a foundation for the reasonable certainty of lost profits.[10]

Southwest Battery reviewed a lost profits award made to a distributing company that had contracted to buy automobile batteries from Southwest. When Southwest sued on a sworn account to recover unpaid invoices, the distributor counterclaimed, contending that Southwest's failure to deliver enough of its products to fill customer orders caused the distributor to lose customers and, eventually, to go out of business. The jury found for both parties, resulting in a small net award to Southwest, and the Texarkana Court of Civil Appeals affirmed.[11] In the Supreme Court, Southwest contended that both "the pleadings and the evidence are insufficient to support the recovery of lost profits by [the distributor].[12] Although the Supreme Court's opinion does not so specify, the challenge to the pleadings rested on the contention that the distributor's business was "new and unestablished":

> In such circumstances, it is said that there is no basis for estimating the profits that would have been earned, and that it is not certain that any profits would have been made.
>
> The uncertainty does not depend upon the difficulty of proof as to the exact amount of damages in such cases, but upon the determination of the fact as to whether or not there would have been any profits at all.[13]

The Texarkana court declined to apply the "new and unestablished" rule to deny recovery to the distributor. Conceding that the business was new, the court held that evidence of outlays of storage and transportation, successful negotiation of customer accounts, and, particularly, the generation of orders for Southwest's products showed sufficient "establishment" of the distributor's business to apply the reasonable certainty rule.[14]

To explain its affirmance of the Texarkana court's judgment, the Supreme Court announced, as the rule in the case, more than a page of excerpts from legal encyclopedias, treaties and out-of-state cases containing the general rule,[15] the Texas decisional rule,[16] the "early… rigid" rule,[17] the "relaxation of that hard rule,"[18] and the survival of the "new and unestablished" rule.[19] It also observed that "[i]n a case of this kind the real difficulty lies not so much in the statement of the rules as it does in the application of the correct rule."[20] Finally, the court rather breathtakingly extrapolated from the evidence cited below and decided:

> Where, as here, it is shown that the business was a going concern, and was making a profit, when the contract was breached, such pre-existing profit, together with other

> facts and circumstances, may be considered in arriving at a just estimate of the amount of profit which would have been made if [Southwest] had not breached its contract under the facts of this case, it cannot be said, as a matter of law, that defendants were not entitled to a recovery for the loss of their profits. The evidence presented a question of fact to be determined.[21]

In *Teletron*, Justice Hecht quoted nearly all of S*outhwest Battery*,[22] then distinguished it, noting that it and other earlier cases involved established lines of business, whereas Teletron sought lost profits for "the proposed sale of a new and unique product which had never been sold before," and had never operated at a profit at any time.[23] Along the way, the court noted that the reasonable certainty rule "is intended to be flexible enough to accommodate the myriad circumstances in which claims for lost profits arise"[24] and cited two other cases emphasizing "facts and circumstances"[25] and "fact intensive determination."[26] But the opinion also insisted that the reasonable certainty test does not "[lack] clear parameters" [27] and identified certain circumstances in which a plaintiff is unlikely to meet the test:

> Profits which are largely speculative, as from an activity dependent on uncertain or changing market conditions, or on changing business opportunities, or on promotion of untested products or entry into unknown or unviable markets, or on the success of a new and unproven enterprise, cannot be recovered. Factors like these and others which make a business venture risky in prospect preclude recovery of lost profits in retrospect.[28]

Further, in the course of reiterating that "[t]he fact that a business is new is but one consideration,"[29] the court cautioned that "[t]he mere hope for success of an untried enterprise, even when that hope is realistic, is not enough for recovery of lost profits."[30] "Firmer reasons"[31] for expecting profits are required. Taken together, the *Teletron* factors virtually guarantee that the only new ventures that may legitimately hope to recover lost profits are those that are new in name only, like subsidiaries and spin-offs,[32] and those that have at least a brief and profitable track record before the effects of a tort or breach are felt.[33]

Assuming that the foregoing discussion reveals some defining characteristics of the phrase "reasonable certainty" itself, the rule remains opaque until its comparison phrase," competent evidence" receives similar treatment. Both logically and practically, the requisite confidence in a lost profits calculation depends on the character of the data and method deployed to support it. In fact, in *Holt Atherton*,[34] the Texas Supreme Court conflated the standard with the evidence when it observed, "what constitutes reasonably certain evidence of lost profits is a fact intensive determination."[35] Even though this formulation changes the meaning of the original rule, later cases have repeated it without comment or critique.[36]

From the time when the former rule denying lost profits as too speculative gave way to the reasonable certainty standard, courts have assumed that expert testimony would play an important role in reducing uncertainty to reliability.[37] Perhaps for this reason, Texas courts have long engaged in a proto-*Daubert*[38]/*Robinson*[39] analysis of the evidence offered by damages experts in lost profits cases. For example, in *Automark* of *Texas v. Discount Trophies*,[40] the Dallas Court of Appeals held that the "complete absence from the record of objective facts, figures, and data" underlying the expert's opinion made it impossible to show a "correlation" between the plaintiff's lost profits and the defendant's breach.[41] Though the fit between the *Automark* analysis and the *Robinson* rule is not exact, *Automark's* requirement of both a reliable factual predicate and demonstrable links between facts and result foreshadowed the later rule in significant respects. The Supreme Court picked up the *Automark* "facts, figures, or data" requirement in *Holt Atherton*,[42] and the courts have demonstrated that they can and will query damages experts' methodology, with or without explicit reference to the *Robinson* line.[43] This may account for the relative dearth of *Robinson* challenges to damages experts.[44] Texas does impose a unique methodology requirement: a party may not rely on "pieces of several different methods of calculating lost profits.... Recovery... must be predicated on one complete calculation."[45]

The handful of cases that explicitly rely on *Robinson* and its progeny to assess lost profits experts demonstrate the complexity of interweaving the substantive law and the evidentiary standard. Most recently, the Austin Court of Appeals held that a defendant did not waive its right to challenge the legal and factual sufficiency of the evidence underpinning a lost profits award by failing to make a *Robinson* objection at trial.[46] Because the defendant did not object to the reliability of the expert's opinion but to its adequacy under the objective data requirement of the *Holt Atherton/Teletron* test, no *Robinson* objection was required.[47] The court went on to hold that the principal expert's testimony overly relied on unsupported assumptions and reversed the lost profits award.[48]

Although the sufficiency analysis seems unobjectionable, there is little, if any, conceptual space between the objective data requirement of the reasonable certainty rule and the reliable foundation requirement of *Robinson*. When the issue is foundational data, defendants appear to have two chances win.[49] A Fort Worth case[50] illustrates the procedural obverse of *Capital Metro* and, thereby the efficacy of the road not taken in that case. In it, the trial court heard and sustained a motion to exclude the experts' testimony, then granted a no-evidence summary judgment motion on lost profits damages on three of the plaintiffs' claims[51]. The court of appeals carefully recited - separately - the *Robinson* precedents[52] and the reasonable certainty precedents,[53] then engaged in a "discussion" that ultimately affirmed the exclusion of the experts' evidence, citing reasonable certainty cases in support of its ruling.[54] Clearly, there is some conceptual confusion here; the boundary between excluding evidence and overturning jury awards for insufficiency needs better demarcation. So far, though, because the fulcrum in each case was foundational data, it does not appear that the confusion has done any real harm.

Because the reasonable certainty and competent evidence inquiries both require close contextual analysis, generalization is difficult and full explication of the case law would be ponderous. Accordingly, I have chosen to report the cases since *Teletron* in two footnotes. One lists cases in which lost profits have been upheld in whole or substantial part;[55] the second lists those in which lost profits awards have been overturned.[56] Both lists include parenthetical descriptions in the hope that they will help the reader select the authorities most pertinent to individual situations. It is worth noting, however, that the first list is much shorter than the second, the awards in it are much smaller, and their subsequent histories suggest post-appeal settlement rather than Supreme Court review. Moreover, two cases, one from each list, deserve scrutiny by counsel for plaintiffs and defendants alike. The *VingCard* case[57] provides the best paradigm for holding onto (most of) a lost profits award.[58] By contrast, the *Ramco* case[59] goes beyond the common run of weak-foundation cases to flesh out what the *Teletron* court meant by uncertain market conditions and changing business opportunities.[60]

ENDNOTES

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2 *See, e.g., Szczepanik v. First Southern Trust Co.*, 883 S.W.2d 648, 649 (Tex. 1994); *see also* Restatement (Second) Of Torts §549(2) & cmt. (1977) (fraudulent inducement).

3 *See, e.g.* Restatement (Second) Of Contracts §352, cmt. a, at 145 (1981).

4 *See id.*

5 *See id.*

6 *Southwest Battery Corp. v. Owen*, 131 Tex. 423, 115 S.W.2d 1097, 1099 (1938).

7 *Id.*

8 877 S.W.2d 276 (Tex. 1994); *see also Holt Atherton Indus. Inc. v. Heine*, 835 S.W.2d 80 (Tex. 1992); *White v. Southwestern Bell Tel. Co.*, 651 S.W.2d 260 (Tex. 1983); *Pace Corp. v. Jackson*, 155 Tex. 179, 284 S.W.2d 340 (1955); *Whiteside v. Trentman*, 141 Tex. 46, 170 S.W.2d 195 (1943).

9 877 S.W.2d at 279.

10 *See, e.g., id.* at 280-81; *see also Formosa Plastics Corp. v. Presidio Eng'rs & Contractors, Inc.* 960 W.W.2d 41, 49-51 (Tex. 1998) (fraudulent inducement); *Szczepanik*, 883 S.W.2d at 649-50.

11 *See Southwest Battery Corp v. Owen*, 47 S.W.2d 306 (Tex. Civ. App. – Texarkana 1936), *rev'd*, 115 S.W.2d 1097 (1938).

12 115 S.W. 2d at 1098.

13 97 S.W.2d at 309 (quoting 13 Tex. Jur. §244, at 216).

14 *See id.* at 309-10.

15 *See* 115 S.W.2d at 1098.

16 *See id.* at 1098-99.

17 *See id.* at 1099.

18 *Id.*

19 *See id.*

20 *Id.*

21 *See id.* (emphasis supplied).

22 *See* 877 S.W.2d at 278-81.

23 *See id.* at 280.

24 *Id.* at 279.

25 *Id.* (citing *Whiteside*, 170 S.W.2d at 197).

26 *Id.* (citing *Holt Atherton*, 835 S.W.2d at 84).

27 *Id.*

28 *Id.*

29 *Id.* at 280.

30 *Id.*

31 *Id.*

32 The court explicitly observed that a new subsidiary organized to pursue a pre-existing line of business could recover lost profits. *See id.* The same logic would apply if the activity were continued under new ownership.

33 *See, e.g., Southwest Battery*, 115 S.W.2d at 1099. The Supreme Court has recognized that "other objective data, such as future contracts" may provide a basis for reasonable certainty. *See Helena Chemical Co. v. Wilkins*, 47 S.W.3d 486, 505 (Tex. 2001); *see also Orchid Software, Inc. V. Prentice-Hall, Inc.*, 804 S.W.2d 208, 210-11 (Tex. App.– Austin 1991, writ denied) (collecting "other data" cases).

It is theoretically possible that a new-business plaintiff might satisfy the reasonable certainty test by resort to market reconstruction, as is permitted in patent cases. A patent plaintiff may recover lost profits from an infringer even if it has not marketed a product incorporating the patent where it can show: (1) demand for the product, (2) absence of non-infringing substitutes, (3) manufacturing and marketing capability to exploit the demand, and (4) the amount of profit it would have made. *See Panduit Corp v. Stahlin Bros. Fibre Works*, 575 F.2d 1152, 1156 (6th Cir. 1978). In a mature market, reconstruction might be able to supply sufficient indicators to establish and measure the loss from a tort or breach in a similar fashion, relying on the track records of the other participants in the relevant market to prove and measure impact on the plaintiff, so long as it was ready and able to do business and prevented from doing so only by defendant's acts. But it would be the unusual case in which there would be sufficient market data to make such proof and measurement yield a reasonably certain result. Something like this was attempted in *Cal-Tex Lumber Co. v. Owens Handle Co.*, 989 S.W.2d 802 (Tex. App.– Tyler 1999, no pet.), and the court seemed receptive to the general approach but remanded because the damage model was incomplete. *See* note 45, *infra*.

34 *Holt Atherton Indus., Inc. vs. Heine*, 835 S.W.2d 80 (Tex. 1992).

35 *Id*. at 84.

36 *See, e.g., Szczepanik*, 883 S.W.2d at 649; *Teletron*, 877 S.W.2d at 279; *El Dorado Motors, Inc. v. Koch* 168 S.W.3d 360, 366 (Tex. App.– Dallas 2005, no pet.)

37 *See* Restatement (Second) Of Contracts §352, cmt. a (1981).

38 *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579 (1993).

39 *E.I. duPont de Nemours & Co. v. Robinson*, 923 S.W.2d 549 (Tex. 1995); *see also Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713, 726 (Tex. 1998) (although *Robinson's* six factor formula is not used on all contexts, trial court must assess reliability of expert tetsimony); *Merrell Dow Pharms., Inc. v. Havner,* 953 S.W.2d 706, 714 (Tex. 1997) (either unsound foundational data or unsound methodology for analyzing it renders expert's opinion unreliable).

40 681 S.W.2d 828, 830 (Tex. App.– Dallas 1984, no writ).

41 *Id*. at 830.

42 *See* 835 S.W.2d at 84.

43 *See e.g. Szczepanik*, 883 S.W.2d at 649-50 (rejecting both data and methodology); *Turner v. PV Int'l Corp.*, 765 S.W.2d 455, 465 (Tex. App.– Dallas 1988), writ denied per curiam 778 S.W.2d 865 (Tex. 1989) (evidence of lost gross profits improper); *Village Square, Ltd. v. Barton*, 660 S.W.2d 556, 559-60 (Tex. App.– San Antonio 1983, writ ref'd n.r.e.) (conclusory evidence at total lost profits legally insufficient).

44 See text accompanying notes, *infra*.

45 *Holt Atherton*, 835 S.W.2d at 85. The "one calculation" requirement does not mean that *only* one calculation may be offered; "there is more than one correct way to calculate lost profits." *Texaco, Inc. v. Phan*, 137 S.W.3d 763, 771 (Tex. App.– Houston 2004, no writ). But each calculation or variant must make it possible for the fact finder to "get to the bottom line."

A University of Tennessee law professor favors *requiring* damages experts to consider alternative scenarios as a condition of *Daubert* reliability. *See* Robert M. Lloyd, *Proving Lost Profits After* Daubert: *Five Questions Every Court should Ask Before Admitting Expert Testimony*, 41 U. Rich. L. Rev. 379, 380, 414-22 (2007).

46 *See Capital Metro. Transp. Auth. v. Central of Tennessee Ry. & Navigation Co.*, 114 S.W.3d 573, 577-78 (Tex. App.– Austin 2003, pet. denied).

47 *See id*. at 578.

48 *See id*. at 582.

49 *See also SBC Operations, Inc. v. The Business Equation, Inc*. 75 S.W.3d 462 (Tex. App.– San Antonio 2001), in which the majority relied solely on *Teletron* analysis to hold the plaintiff's expert evidence inadmissible, *see id*. at 466-69, while the dissent argued that the trial court had properly performed its gatekeeping function under *Robinson* and *Gammill*. *See id*. at 469-73 (Hardberger, C.J., dissenting).

50 *Fraud-Tech, Inc. v. Choicepoint, Inc.*, 102 S.W.3d 366 (Tex. App. - Fort Worth 2003, pet. denied).

51 *See id*. at 372.

52 *See id*. at 381.

54 *See id*. at 382-85 & nn. 62-64.

55 Cases upholding lost profits awards: *Toshiba Machine Co., America v. SPM Flow Control, Inc.*, 180 S.W.3d 761 (Tex. App.– Fort Worth 2005, pet granted & cause remanded, Mar. 31, 2006) (expert testified concerning "los[t]... sales of proven products to existing customers).

VingCard A.S. v. Merrimac Hospitality Systems, Inc., 59 S.W.3d 847 (Tex.App.– Fort Worth 2001, pet denied)

Friedman, Clark & Shapiro, Inc. v. Greenberg, Grant & Richards, Inc., 2001 WL 1136169 (Tex. App.– Houston [14th Dist.], Sept. 27, 2001, pet. denied) (award of $162,500 upheld in covenant not to compete breach where expert offered two alternative calculations between $865,000 and $930,000)

Checker Bag Co. v. Washington, 27 S.W.3d 625 (Tex. App.– Waco 2000, pet. denied) (some customer-based evidence to support the plaintiff's projections of anticipated sales).

Knox v. Taylor, 992 S.W.2d 40 (Tex. App.– Houston [14th Dist.] 1999, no pet) (award of $2.7 million upheld in tortious interference case where model based on actual sales figures suggested lost profits of $11 million)

Ishin Speed Sport, Inc. v. Rutherford, 933 S.W.2d 343 (Tex. App.– Fort Worth 1996, no pet.) ($225,000 award to plaintiff upheld even though "new business" because damage projections based on histories of other celebrity-owned race driving schools).

56 Cases disallowing lost profits awards: *Huynh v. Phung*, 2007 WL 495023 (Tex. App.– Houston, Feb. 16, 2007) (only evidence of lost profits to investor was of anticipated sale of business invested in)

Ramco Oil & Gas Ltd. v. Anglo-Dutch (Tenge) L.L.C., 207 S.W.3d 801 (Tex.App.– Houston [14th Dist.] 2006, pet. denied) (future profits dependent on purchase, financing, governmental approval and successful development of oil/gas prospect in Kazakhstan).

Hyperoam, Inc. v. Valley Wireless Internet, 2005 WL 1981 505 (Tex. App.– Corpus Christi, Aug. 18, 2005, no pet.) (claim based or anticipated contracts with unrealistic percentage of potential customers, gross rather than net profits).

Atlas Copco Tools, Inc. v. Air Power Tool & Hoist, Inc., 131 S.W.3d 203 (Tex. App.– Fort Worth 2004, pet. denied) (damage model injured contract terms, included abandoned and discontinued sales territories, gross rather than net profits).

Fraud-Tech, Inc. v. Choicepoint, Inc., 102 S.W.3d 366 (Tex. App.– Fort Worth 2003, pet. denied) (all damages evidence rested on ipse dixit of one witness; *Robinson* rule invoked).

SBC Operations, Inc., 75 S.W.3d 462 (Tex. App.– San Antonio, 2001, pet. denied) (elaborate mathematically precise models based on assumptions, not actual data).

Aquila Southwest Pipeline, Inc. v. Harmony Exploration, Inc., 48 S.W.3d 225 (Tex. App.- San Antonio 2001, pet. denied) (standard methodology, but no actual data).

Teleresource Corp. v. Frontier Computer Corp., 2000 WL 799074 (Tex. App.– Dallas 2000, pet denied) (mathmatically precise model based on unwarranted and optimistic assumptions; new business for both supplier and principal customer).

Fryer v. Cantu, 1999 WL 33320965 (Tex. App.– Corpus Christi, Aug. 5, 1999, no pet.) (damage model based on business plan and "piecemeal" sales data).

Metropolitan Life Ins. Co. v. Haney, 987 S.W.2d 236 (Tex. App.– Houston [14th Dist.] 1999, no pet.) (plaintiff's evidence of lost sales based on conjecture)

Dobson v. Poor, 1998 WL 300530 (Tex. App.– San Antonio, June 10, 1998, no pet) (award based on gross revenues, unsupported assumptions)

Thedford v. Missouri Pac.R.Co., 929 S.W.2d 39 (Tex. App.– Corpus Christi 1996, writ denied) (no evidence of sales, contracts, or existing market data)

Hoechst Celanese Corp. v. Arthur Bros., Inc., 882 S.W.2d 917 (Tex. App.– Corpus Christi 1994, writ denied) (insufficient link between sales in test years, year affected by fraud)

Barnes v. Cumberland Int'l Corp., 1994 WL 416563 (Tex. App.– Houston [14th Dist.], Aug. 11, 1994, writ denied) (projected profits were for new product from company that had been operating at a loss for 3 years).

57 59 S.W.3d 847 (full citation in note 55, *supra*).

58 59 S.W.3d at 862-65.

59 207 S.W.3d 801 (full citation in note 56, *supra*).

60 *See generally id*. Almost the entire opinion is devoted to various contingencies that undermine the reasonable certainty of the lost profits claimed.

Annual RICO Update

By Randy D. Gordon and Samuel E. Joyner[1]

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The Fifth Circuit has not issued a substantive civil RICO opinion since *Sandwich Chef of Texas, Inc. v. Reliance National Indemnity Insurance Co.*[2] And the reported RICO opinions issued by the district courts over the last several years have done little to expand in any meaningful way this area of the law. In February 2007, the Fifth Circuit broke its silence with a lackluster opinion that nevertheless underscores the liberal pleading standard with which a plaintiff's civil RICO claim not involving fraudulent predicate acts must be viewed.

Misrepresentations concerning jobs could be pattern of racketeering activity

In *Abraham v. Singh*,[3] a group of workers from India alleged that Chad Chandler recruited them to travel to the United States to work for his company, Falcon Steel Structures, Inc. According to the complaint, Chandler made various misrepresentations regarding the terms of the workers' employment and their permanent resident status. The workers claimed that Falcon Steel obtained H2B visas that purportedly bound them to work for the company and arranged their transportation from India to Louisiana. In return, the workers purportedly paid Chandler between $7,000 and $20,000.[4]

Upon their arrival to the United States, the workers learned that Falcon Steel was not a manufacturing facility and had no jobs for them. The workers alleged that their passports were confiscated and that they were housed in poor conditions with little food. According to the complaint, Chandler threatened to punish the workers for complaining about the lack of employment or living conditions. Workers who found employment elsewhere, often being "farmed out" by the Falcon Steel to other businesses, were assessed arbitrary fees and had their wages skimmed. Chandler also purportedly demanded additional money from the workers for their already promised permanent resident status.[5]

The workers sued Chandler and Falcon Steel, among others, for breach of contract, fraudulent inducement, human trafficking, and RICO violations. Specifically, the workers claimed that the defendants violated 18 U.S.C. § 1962(a), (b), (c), and (d). These RICO subsections state that:

(a) a person who has received income from a pattern of racketeering activity cannot invest that income in an enterprise;

(b) a person cannot acquire or maintain an interest in an enterprise through a pattern of racketeering;

(c) a person who is employed by or associated with an enterprise cannot conduct the affairs of the enterprise through a pattern of racketeering activity; and

(d) a person cannot conspire to violate subsections (a), (b), or (c).[6]

The alleged racketeering acts included money laundering, peonage, visa fraud, immigration violations, Travel Act violations, and Hobbs Act extortion.[7] A motion to dismiss the complaint was filed by the defendants for failure to state a claim. Concluding that the workers had not shown that the predicate acts posed a threat of continuing racketeering activity, the district court granted the motion with respect to the federal claims and declined to exercise supplemental jurisdiction over the state law claims.[8] The workers appealed the district court's dismissal of their RICO claim.

No strict pleading requirement for continuity

The central issue on appeal was whether the workers adequately pled a "pattern of racketeering activity."[9] "Racketeering activity" consists of two or more predicate criminal acts that are (1) related and (2) "amount to or pose a threat of continued criminal activity."[10] The district court determined that the workers had sufficiently alleged that the predicate acts were related. Regarding the continuity prong, however, the district court found that the predicate acts did not prose a threat of continuing activity.[11]

The Fifth Circuit began its analysis of the continuity prong by contemplating *H.J., Inc. v. Northwestern Bell Telephone Co*.[12] In that case, the Supreme Court held that "[c]ontinuity is both a closed- and open-ended concept, referring either to a closed period of repeated conduct, or past conduct that by its nature projects into the future with a threat of repetition."[13] In this case, the Fifth Circuit concluded that the workers "alleged open-ended continuity, which can be shown by demonstrating either that the predicate acts establish a 'specific threat of repetition extending indefinitely into the future' or 'that the predicates are a regular way of conducting the defendant's ongoing legitimate business.'"[14] The district court found that the workers' RICO claim failed for lack of continuity, reasoning that the defendants' "actions were part of a single transaction because the predicate acts—recruiting, collecting fees, and obtaining fraudulent visas—all took place in the past."[15] Thus, the district court concluded that the predicate acts neither threatened long-term criminal activity nor constituted the defendants' regular way of conducting business.[16] The Fifth Circuit disagreed.

According to the Fifth Circuit, "[i]n light of the liberal pleading standard with which the [workers'] allegations must be viewed . . . the district court erred in turning the Supreme Court's explanation of the continuity prong into a stringent pleading requirement."[17] For pleading purposes, the district court should have determined "whether a pattern of racketeering has been alleged that is sufficiently similar to what the Supreme Court contemplated in its *H.J., Inc*. discussion and what this Court has held to constitute a pattern of racketeering activity."[18] Based on these standards, the Fifth Circuit concluded that the workers sufficiently pled "a continuity of racketeering activity, or its threat."[19] The workers did so by alleging that the defendants "engaged in at least a two-year scheme involving repeated international travel to convince up to 200 or more Indian citizens to borrow thousands of dollars to travel to the United States only to find upon their arrival that things were not as they had been promised."[20] Additionally, the allegations included the workers' treatment in the United States. Here, unlike other precedent identifying a single illegal transaction, the Fifth Circuit found that "there are multiple victims, and there is no reason to suppose that this systematic victimization allegedly begun in November 2000 would not have continued indefinitely had the [workers] not filed this lawsuit."[21]

Next the Fifth Circuit addressed the defendants' claim that the workers failed to adequately allege violations of sections 1962(a), (b), (c), and (d). Despite the liberal pleading standards that applied in this instance, the appellate court determined that the complaint failed to state a claim under sections 1962(a) and (b), but the workers adequately alleged violations under sections 1962(c) and (d).

Conclusory Allegations will not support a claim under Section 1962(a)

To state a claim under section 1962(a), the complaint must allege an injury from "the use or investment of racketeering income."[22] The Fifth Circuit made clear that an injury arising "solely from the predicate racketeering acts themselves is not sufficient."[23] In this case, the workers alleged nothing more than that their injuries were caused by the defendants' "use and investment of income derived from the pattern of racketeering activity."[24] According to the appellate court, the workers' "alleged injuries stem[med] not from the use or investment of racketeering income, but from the [d]efendants' alleged predicate acts of visa fraud, immigration violations, Travel Act violations, and money laundering."[25] Thus, the Fifth Circuit determined that the workers' conclusory allegations were insufficient to state a claim under section 1962(a).

There must be a nexus between the alleged RICO violation and the injury suffered.

In order to state a claim under section 1962(b), the workers needed to show that their injuries were "proximately caused by a RICO person gaining an interest in, or control of, the enterprise through a pattern of racketeering activity."[26] The complaint, again in conclusory terms, averred that the defendants "have, through a pattern of racketeering activity, maintained . . . an interest in or control of an enterprise."[27] Because the workers described no facts that would show a causal connection between their injuries and the defendants' acquisition or maintenance of an interest in the enterprise, the Fifth Circuit dismissed the section 1962(b) claim.

The workers alleged sufficient facts to state a claim under Section 1962(c) and (d)

Section 1962(c) prohibits any "'person employed by or associated with any enterprise' from participating in or conducting the affairs of the enterprise through a pattern of racketeering activity."[28] To state a claim under this subsection, a plaintiff must show that the RICO person and RICO enterprise are distinct.[29] The workers satisfied this requirement by identifying Chandler, an individual employee of Falcon Steel, as the RICO person and Falcon Steel, the corporation itself, as the RICO enterprise.[30] Accordingly, the Fifth Circuit concluded that the workers alleged sufficient facts to state a claim under section 1962(c).

Lastly, the workers alleged that the defendants conspired to violate sections 1962(a), (b), and (c). To plead a RICO conspiracy, a plaintiff must demonstrate that two or more people agreed to commit at least two predicate acts of racketeering.[31] Since the complaint specifically alleged that "the [d]efendants entered into an agreement and that each agreed to commit at least two predicate acts of racketeering," the Fifth Circuit concluded that the workers stated a RICO conspiracy claim.[32]

In sum, the Fifth Circuit determined that the workers adequately pleaded continuity and violations of sections 1962(c) and (d). Accordingly, the Fifth Circuit reversed and remanded the district court's order dismissing the workers' RICO claim.[33]

Abraham reminds defense counsel that where civil RICO claims are grounded on other than fraud a plaintiff need only satisfy the liberal pleading requirements of Federal Rule of Civil Procedure 8. Put differently, such claims will likely survive a Rule 12(b)(6) challenge forcing the defendant to participate in costly discovery.

Recent Fifth Circuit opinions

As in the past years, we have categorized the reported opinions from courts within the Fifth Circuit under the specific RICO elements to which those opinions provide further clarification.[34] To this end, we examine those opinions addressing requisite injury under section 1964 and then section 1962 violations and their constituent elements.

Section 1964(c)—Injury to business or property by reason of prohibited conduct

Reliance

Where civil RICO damages are sought for injuries resulting from fraud, plaintiff must plead that it relied on particular communications causing injury. *Alpert v. Riley*, No. H-04-CV-3774, 2007 U.S. Dist. LEXIS 22950, at *54 (S.D. Tex. Mar. 29, 2007).

Causal Connection

To properly allege a civil RICO claim, plaintiff must allege a proximate causal relationship between the RICO predicate acts and the plaintiff's damages. *Hewlett-Packard Co. v. byd:sign, Inc.*, No. 6:05-CV-456, 2007 U.S. Dist. LEXIS, at **17-18 (E.D. Tex. Jan. 25, 2007) (citing *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991 (2006)).

Section 1962(c)—Conduct of an enterprise through a pattern of racketeering

Enterprise-Person Distinction

Sole owner and president of a corporation was considered distinct from the corporation for RICO purposes. *Transfirst Holdings Inc. v. Phillips*, No. 3:06-CV-2303-P, 2007 U.S. Dist. LEXIS 36590, at *11 (N.D. Tex. May 18, 2007).

Enterprise-Racketeering Activity Distinction

"While a corporation may be a RICO person or a RICO enterprise, the law is clear that they cannot be both at the same time: the person or persons must be distinct from the enterprise." *Transfirst Holdings Inc.*, 2007 U.S. Dist. LEXIS 36590, at **12-13.

Association-in-Fact Enterprise

By alleging how the association-in-fact enterprise existed apart from pattern of racketeering, how the enterprise operated, and how the enterprise will continue to operate in the future, plaintiffs alleged that poultry processing plant and a bank could have associated to defraud plaintiffs as to the proper value of their land. *Do v. Pilgrim's Pride Corp.*, No. 9:05CV238, 2006 WL 2290556, at **4-5 (E.D. Tex. Aug. 9, 2006).

Section 1962(d)—Conspiracy to violate sections (a), (b), or (c)

Plaintiff failed to plead the elements of a RICO conspiracy merely by alleging that defendants "conspired to commit mail fraud." *Trugreen Landcare, L.L.C. v. Scott*, No. 3:06-CV-0327-D, 2007 U.S. Dist. LEXIS 18717, at **27-29 (N.D. Tex. Mar. 16, 2007).

A plaintiff's failure to allege a violation of section 1962(c) is fatal to that plaintiff's conspiracy claim under section 1962(d). *Transfirst Holdings Inc.*, 2007 U.S. Dist. LEXIS 36590, at **20-21.

ENDNOTES

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2 319 F.3d 205 (5th Cir. 2003).

3 480 F.3d 351 (5th Cir. 2007).

4 *Id.* at 353-54.

5 *Id* at 354.

6 *Id.* at 354-55.

7 *Id.* at 354.

8 *Id.*

9 *Id.* at 355.

10 *Id.*

11 *Id.*

12 492 U.S. 229 (1989).

13 480 F.3d 351, 355 (5th Cir. 2007) (quoting *H.J., Inc.*).

14 *Id.* at 355.

15 *Id.*

16 *Id*.

17 *Id*. at 355-56.

18 *Id*. at 356.

19 *Id*.

20 *Id*.

21 *Id*.

22 *Id*.

23 *Id*.

24 *Id*. at 356-57.

25 *Id*. at 357.

26 *Id*.

27 *Id*.

28 *Id*.

29 *Id*.

30 *Id*.

31 *Id*.

32 *Id*.

33 *Id*. at 358.

34 The individual elements of section 1962 are catalogued in “Parsing Civil RICO,” which appeared in the Fall 2001 issue of this publication. It is available at www.texbuslit.org/members/newsletter.

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By Gregory S.C. Huffman

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