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FAIR VALUE™

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Introduction. In the recent *Howerton v. Arai Helmet* case (filed June 25, 2004), the North Carolina Supreme Court reversed lower decisions by the trial court and N.C. Court of Appeals and held that "North Carolina is not, nor has it ever been, a *Daubert* jurisdiction." Although *Howerton* is a personal injury/product liability case, its ruling as affects the admissibility of expert testimony is far reaching into many other areas, including business valuation. This article will briefly examine the *Daubert* and *Goode* standards for determining the admissibility of expert testimony and the potential ramifications of this case as concerns business valuation. This is particularly important since many attorneys in North Carolina and their valuation experts often times attempt to exclude the flawed valuation reports of opposing experts using the *Daubert* standard.


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History of the Case. In *Howerton*, the plaintiff was paralyzed in an off-road motorcycle accident. The plaintiff offered various experts who opined that the design of the particular motorcycle helmet worn by the plaintiff in the accident was inadequate to protect the plaintiff from the injury suffered. The trial court rejected the experts offered by the plaintiff, stating that they did not meet the requirements (discussed below) of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993). The Court of Appeals affirmed the trial court. Both lower courts indicated that *Daubert* had been adopted by North Carolina. The North Carolina Supreme Court reversed the lower court opinions, holding that North Carolina has never adopted *Daubert*.

Federal History of the Admissibility of Expert Testimony. The *Howerton* court outlined the history and intent of the rules governing the admissibility of expert testimony. Beginning with *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923), "scientific expert testimony was admissible only when based upon 'sufficiently established' principles which had gained 'general acceptance in the particular field in which it belongs.'" The *Howerton* court then noted that *Daubert* superseded *Frye* in an attempt to liberalize (i.e., allow more) expert opinion testimony in federal cases. Under *Daubert*, "the trial court is instructed to preliminarily determine 'whether the reasoning or methodology underlying the [expert] testimony is scientifically valid and…whether that reasoning or methodology properly can be applied to the facts in issue.'" *Howerton* then notes that under *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), "the Court extended the effect of *Daubert* to any type of specialized expert testimony proffered under Federal Rule of Evidence 702, not just expert testimony that is scientific in nature." It is through a combination of *Daubert* and *Kumho Tire* then, that the reports and opinions of business valuation experts are either allowed into or prevented from entering federal courts.

Is *Daubert* Too Restrictive? The *Howerton* court believes that, contrary to its stated liberal intent, *Daubert* is actually more restrictive than *Frye* and makes it more difficult to get an expert opinion into a case. The *Howerton* court states that "application of the 'flexible' *Daubert* standard has been anything but liberal or relaxed and that trial courts, such as the one in the present case, have often been reluctant to stray far from the original *Daubert* factors in their analysis of the reliability of expert testimony." The *Howerton* court notes a number of problems with the application of *Daubert*. Citing 2 Michael H. Graham, Handbook of Federal Evidence § 702.5, at 461-62 (5th ed. 2001): "*Daubert* is a very incomplete case if not a very bad decision. It did not, in any way, accomplish what it was meant to, i.e., encourage more liberal admissibility of expert witness evidence. In

fact, *Daubert* overall in practice actually created a more stringent test for expert evidence admissibility especially in civil cases." The *Howerton* court notes other problems: "The judge's role in a *Daubert* determination [is] fraught with conflict. In most cases, if the court bars the testimony of one party's expert witness or witnesses, that party is unable to present an essential element of his or her claim, or to proffer a defense. Accordingly, judges are aware that applying *Daubert* heavy-handedly has the effect of lightening one's caseload, as a party stripped of its expert often must dismiss the claims or settle the lawsuit." Finally, the *Howerton* court expresses concern that "trial courts asserting sweeping pre-trial 'gatekeeping' authority under *Daubert* may unnecessarily encroach upon the constitutionally-mandated function of the jury to decide issues of fact and to asses the weight of evidence."

A *Goode* Rule in North Carolina? The *Howerton* court dismissed the applicability of *Daubert* in favor of the current test under *State v. Goode*, 341 N.C. 513 (1995). According to the *Howerton* court, the three-step inquiry under *Goode* is as follows: "(1) Is the expert's proffered method of proof sufficiently reliable as an area for expert testimony? (2) Is the witness testifying at trial qualified as an expert in that area of testimony? (3) Is the expert's testimony relevant?" In dismissing *Daubert*, the *Howerton* court stated that "on balance the North Carolina law which has coalesced in *Goode* establishes a more workable framework for ruling on the admissibility of expert testimony under North Carolina Rule of Evidence 702. Long before *Daubert* was decided, North Carolina had in place a flexible system of assessing the foundational reliability of expert testimony, the practicability of which is evidenced by case law. Within this system, our trial courts are already vested with broad discretion to limit the admissibility of expert testimony as necessitated by the demands of each case. Requiring a more complicated and demanding rule of law is unnecessary to assist North Carolina trial courts in a procedure which we do not perceive as in need of repair."

What Does This Mean for Business Appraisers? For the past several years, the existence of *Daubert* and *Kumho Tire* has forced business appraisers to gird themselves against such challenges to their reports and testimony. Our firm has weathered *Daubert* challenges against our reports and testimony and has successfully assisted in having other experts and reports excluded on the basis of *Daubert*. On its face, the *Howerton* court seems to indicate that the *Goode* standard is preferable to the *Daubert* standard as the *Goode* standard is less stringent and will allow more expert testimony into a case. In one sense, this could be an unfavorable development for business valuation as it will make it easier for an inferior business valuation report or an unqualified business appraiser to offer his or her evidence in a particular case. In other words, if you lower the bar, it makes it easier for more people to jump over it.

The More Things Change… It is also possible, however, that the rejection of *Daubert* by *Howerton* will have little or no impact on the issue of admissibility of expert testimony. This possibility is illustrated by the *Howerton* opinion itself. In an opinion that concurs in part and dissents in part with the majority, Justice Parker disagrees with the majority's ruling to remand the case back to the trial court so that the plaintiff's experts can be heard (assuming they meet the *Goode* standard). Justice Parker believes that, the inapplicability of *Daubert* aside, the plaintiff's experts still fail the first prong of the *Goode* test (as enumerated above) and their opinions were therefore correctly excluded. As a result, we have the following situation: the Supreme Court says that *Daubert* is too restrictive, it doesn't apply in North Carolina, and therefore, you have to see if these experts pass the *Goode* test. Justice Parker says, yes, *Daubert* may not apply, however, these experts still fail under *Goode* and therefore were rightly excluded so don't bother remanding this case. In the end, it may not matter whether you are working with *Daubert*, *Goode*, or some other standard – they all are subjective and unpredictable to some extent. As with many other "standards," this issue will boil down to the particulars of each case, the competency of the experts, the skill of the attorneys involved, and what the judge had for breakfast that day.

Summary. By affirming that North Carolina is not a *Daubert* jurisdiction, the Supreme Court has reinforced the *Goode* test as the measure for the admissibility of expert witness testimony. While the *Howerton* court believes that the *Goode* test is more lenient and makes it easier for expert witness testimony to get into a case, it remains to be seen what kind of impact this ruling will have on business valuation and business appraisers. ♦

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