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Legal Briefs

A periodic summary of judicial decisions affecting accounting and financial services professionals

Discovery From Testifying Experts: Proposed Federal Rule Amendments Would Conform to New Jersey Rules

IN THIS ISSUE

Proposed changes to Rule 26 of the Federal Rules of Civil Procedure would make it similar to New Jersey's Rule 4:10-2(d)(1) and shield from discovery most communications between an attorney and any expert retained by the attorney. Like the New Jersey rule, the proposed federal rule amendment would prohibit discovery into the collaborative process of preparing the expert's report, including draft expert reports. Pending approval by the U.S. Judicial Conference, the U.S. Supreme Court and Congress, the changes could take effect in late 2010.

The federal rules currently have been interpreted to allow opposing counsel discovery into draft expert reports and attorney-expert communications on the theory that the evolution of an expert's opinions and the attorney's influence on those opinions bear on an expert's credibility. Experience has shown, however, that discovery of attorney-expert communications and draft reports contributes very little to the testing of an expert's opinions and has certain undesirable effects. As most professionals who have served as an expert witness can attest, much time is taken up at expert depositions with questioning into communications between the expert and counsel, though typically little useable information is learned. Resources are also wasted because attorneys often feel compelled to hire a separate consulting expert with whom the attorney may freely communicate under the protection of the work product rule without fear of disclosure. The existing federal rule has also led to other inefficient practices designed solely to limit the amount of discoverable material but which hamper effective communication with the testifying expert, including instructions by the attorney that the expert not take notes or not print hard copies of draft reports before conveying the full content of the report orally to counsel.

The new rule would protect discovery of draft reports regardless of the form, whether oral, written, electronic or otherwise, as well as most attorney-expert communications to allow for free communication between counsel and their experts. The protection would not apply to attorney-expert communications if they: (1) relate to compensation, (2) identify facts or data the attorney provided to the expert and that the expert considered in forming the opinions or (3) identify assumptions that the attorney provided to the expert and that the expert relied upon in forming the opinions. These exceptions were viewed as critical to the testing of an expert's opinions. Supporters of the federal rule change have pointed to widespread approval of New Jersey Rule 4:10-2(d)(1) since its amendment in 2002.

Federal Rule of Civil Procedure 26 would now conform to the New Jersey rule and shield from discovery most communications between an attorney and an expert.

The proposed federal rule amendments would also eliminate a burden often imposed on witnesses who provide both factual and expert testimony. Despite the lack of an explicit mandate under the rules, courts have occasionally required certain witnesses – like a treating physician, a party's employee or a public official – whose testimony includes both factual testimony and expert opinions, to submit reports outlining their opinions. Courts have ordered these reports to allow a party to determine if an expert deposition is necessary and to prepare better for the expert's deposition. Attorneys have found it particularly difficult to motivate these witnesses, who are often subpoenaed to provide testimony, to prepare a report that meets all of the rule's requirements. To address the problem, a proposed amendment to the rule would allow the parties themselves to provide a summary of these experts' facts and opinions.

The proposed changes to Rule 26 will bring greater efficiencies to the use of expert witnesses in litigation. Attorneys and their experts will be able to speak more freely to develop theories, identify case issues and plan strategy. There should be less frequent use of consulting experts as a defensive measure. Further efficiencies will result because testifying witnesses who provide both expert and factual testimony will no longer have to submit an expert report.

For additional information regarding the proposed amendments to the Federal Rules of Civil Procedure, please contact David Wagner at (609) 716-6563 or David.Wagner@dbr.com.

Does a Limitation of Liability in a Professional Services Contract Violate Public Policy?

Professional service firms often include provisions in their contracts or engagement letters that limit their liability for damages. Often the limitations are to a dollar amount or to the amount of the fees paid by the clients. For some professionals, however, these kinds of limitations may be barred by law or relevant ethics provisions. The American Institute of Certified Public Accountants, for example, bars accountants who provide audit or attest services to public companies from including limitations of liability in their engagement letters because of independence concerns. No such restriction exists for services rendered to privately held clients and such liability-limiting terms are not uncommon. But even where contractual liability limitations are permitted, courts may be reluctant to enforce them if they perceive it would be unfair to do so.

In a recent unpublished decision, a New Jersey trial court ruled that an architectural and planning firm could not limit its liability for negligence to the amount of the fees it was paid by its client. In *West Essex Highlands Condominium Assoc. v. Construction Design Technologies, P.C.*, (Superior Court, Law Division, Essex County), the plaintiff condominium association retained CDT and its president, a licensed architect and planner, to investigate and develop a program for correcting persistent water leaks throughout the apartment complex. Although the Association spent almost $2 million and several years on the project designed by CDT, the leaks continued. The Association sued CDT, its president and others, claiming breach of contract, professional negligence and unjust enrichment.

Liability-limiting clauses in professional services contracts are disfavored but can be upheld under the right circumstances.

Under CDT's contract with the Association, the amount of its liability was limited to the amount it had been paid for its services – $130,277. The court in *West Essex* refused to enforce the limitation of liability provision, ruling that it violated New Jersey public policy.

The *West Essex* court began by noting that exculpatory clauses in professional services contracts were disfavored because the very nature of the service depended upon the superior expertise, training, knowledge and stature of the professional. Civil liability was seen as the most effective way to ensure that high professional standards were maintained. The court further noted that the Professional Service Corporation Act, *N.J.S.A.* 14A:17-8, under which CDT was incorporated, requires any officer of a professional corporation to "remain personally and fully liable and accountable for any negligent or wrongful acts" of the corporation. Likewise, the professional corporation was made liable up to the full value of its property for any negligent or wrongful acts of its employees. Another factor supporting the court's ruling was the huge disparity between the contractual liability ceiling and the potential damages claimed by the Association. The court viewed the self-imposed limit on CDT's liability for incompetence as tantamount to an illusory bargain that could not be enforced.

To reach that result, the court in *West Essex* had to distinguish some New Jersey precedents, including those that had upheld limitation of liability provisions involving other professionals. The closest precedent, *Marbro, Inc. v. Borough of Tinton Falls*, 297 N.J. Super. 411 (Law Div. 1996), had upheld a $32,000 limitation in a contract between an engineering firm and a municipality for the design and construction of a park. *Lucier v. Williams*, 366 N.J. Super. 485 (App. Div. 2004), voided a contract clause limiting the liability of a home inspection firm to a trivial amount (the lesser of $500 or 50 percent of fees actually paid). *Lucier* held the contract to be unconscionable and in violation of public policy because it was one of adhesion made between parties of grossly unequal bargaining status and because the contract limitation was so nominal that it did not provide a realistic incentive for the home inspection professional to act diligently. The court also cited the legislature's intent to protect home buyers against unscrupulous home inspection providers and a statutory requirement for home inspection businesses to carry at least $500,000 in errors and omissions coverage.

In a later case, *Synnex Corp. v. ADT Security Services, Inc.*, 394 N.J. Super. 577 (App. Div. 2007), reached a different conclusion and upheld a relatively small limitation in a contract for the sale of an alarm system (the greater of 10 percent of the annual service charge or $1,000). A key point was that the *Synnex* contract was negotiated between two sophisticated business entities. In addition, the court believed that exposure to liability for negligence was not necessary to insure reliable service because the alarm provider had a strong interest in maintaining its business reputation. Moreover, the buyer was deemed to be in the best position to know the value of its property and could take steps to insure itself against loss from fire and theft. On the other hand, the court believed that if the alarm company were responsible for the loss of its customer's property, it would be put in the position of selling not only an alarm service but a form of insurance as well. And, unlike the regulatory scheme governing home inspection services, the legislature had required alarm companies to carry only general liability insurance, which ordinarily does not cover a professional negligence claim by one of its customers.

None of these cases appear to support the *West Essex* court's invalidation of a substantial limitation of liability ($130,000). *West Essex* may be an aberrant decision, but it nonetheless should serve to caution accountants and other financial professionals about adopting a contractual limitation of liability in the amount of their fees. Where such limitations are allowed, the court will be more likely to enforce them if: (1) the relative bargaining power of the professional and its client are roughly equal; (2) the terms of the engagement were negotiated; (3) the size of the contract limit is not unreasonable as compared to the potential damages from negligence; (4) insurance is required or available to protect against the consequence of professional negligence; and (5) factors other than civil liability exist to ensure adherence to high professional standards.

For further information or a copy of the *West Essex* decision, please contact Vince Gentile at (609) 716-6619 or Vincent.Gentile@dbr.com.

Court Must Allow Proof of Meaning of Shareholder Buy-Out Terms

A recent New Jersey decision highlights what can happen if a shareholder's agreement is not precise enough in specifying the terms for the repurchase of a shareholder's stock. *Reutter v Dalsey*, (App. Div., June 18, 2009), involved a dispute over the buy-out of Dr. Thomas Reutter's share in a medical practice after his death. The dispute involved the compensation to be provided to Reutter's estate under two agreements – a Deferred Compensation Agreement, which provided for a separation payment in the event of disability or retirement, and a Shareholders Agreement, which provided for a buy-out in the event of death. The two agreements had to be construed in the peculiar factual circumstance – unanticipated by the principals or the drafters of the agreements – in which Reutter died just days after serving his retirement notice.

Under the Deferred Compensation Agreement, a principal separating from the medical practice due to either disability or retirement would receive a monthly payout over 60 months based on the lesser of book value of his shares or the offer by the selling shareholder. The Deferred Compensation Agreement did not cover the death of a shareholder who was still active in the practice. In contrast, the Shareholders Agreement addressed that situation and provided two alternative methods for valuing his stock. The first gave the surviving shareholder a 30-day option to purchase the deceased shareholder's shares and, if that option was not exercised, the medical practice would purchase the shares at book value. The second provision tied the price of the share purchase to the proceeds of insurance if life insurance had been purchased to fund the buy-out of the deceased shareholder. In such a case the price would be the amount of the proceeds, less any corporate tax of the proceeds, if it exceeded the book value or other offer. In *Reutter*, an insurance policy had been purchased on Reutter's life, providing a $400,000 death benefit..

Nine days after giving notice of his retirement, Reutter died. His estate filed suit contending that it was entitled to receive both the 60-month deferred compensation payment (totaling $394,200) as well as the $400,000 insurance death benefit. To complicate things further, the Deferred Compensation Agreement contained an arbitration clause for any dispute arising out of the Agreement, so the trial court had to await the outcome of the arbitration. An arbitrator ruled that Reutter's estate was entitled to receive the deferred payments. When the matter returned to the trial court, the court granted summary judgment for the estate, holding that it was entitled to both the death benefit and the installment payments.

Even clear terms in shareholder agreements may need to be explained by other documents or testimony.

The Appellate Division reversed, finding that the trial court should have permitted Dr. Dalsey and the medical practice an opportunity to submit evidence of the parties' intentions as to how the two agreements were to operate. This evidence was needed to aid in interpreting the meaning of the contract provisions in the unique fact situation. The appeals court found that it was plausible that the two physicians had intended that their agreements be considered together to provide a safety net of benefits, consisting of a maximum award of approximately $400,000 in the event either of them separated professionally from the other (whether by retirement, disability or death). The court placed special weight on a contemporaneous explanatory letter sent by counsel, which the court found "was unmistakably intended to serve as an interpretive guide to decipher what these men intended to create when they commissioned [him] to prepare these contracts." In addition, the lawyer had given deposition testimony that his clients never intended that a separating shareholder would receive both the death benefit and the deferred compensation payment stream.

The *Ruetter* case shows that even clear terms in shareholder agreements may need explication – through extrinsic or "parol" evidence of what the parties' intended – in circumstances that may not have been anticipated by the parties. The appeals court took note of "the expansive and liberal standard used to determine the admissibility of extrinsic materials" but cautioned that such materials could only be used to explain and interpret, not to vary or modify the terms of the agreement.

For a copy of the *Ruetter* decision, please contact Brian Waters at (609) 716-6503 or Brian.Waters@dbr.com.

Sale of Securities Is Not Covered by the Consumer Fraud Act

The New Jersey Supreme Court has resolved an unsettled issue, unanimously holding that the sale of a security is not covered by the New Jersey Consumer Fraud Act (CFA) in *Lee v. First Union National Bank*, decided June 3, 2009. The trial court had ruled that the CFA did not cover sale of securities but the Appellate Division reversed on the grounds that the defendant broker's misappropriation of money was an unlawful practice under the Act and that his services fell within the CFA's definition of merchandise. The Supreme Court disagreed.

Despite the seemingly broad sweep of the statutory definition of merchandise to include "any objects, wares, goods, commodities, services or *anything offered, directly or indirectly to the public for sale*," the court found the exclusion of the word "securities" from the definition "carries some measure of ambiguity." Writing for the court, Justice Jaynee LaVecchia then analyzed the legislative history, which revealed that the Legislature had twice considered and twice rejected draft bills that would have expanded the language of "merchandise" to include "securities." The court then rejected the argument that the sale of securities by the defendant bank was a "service" within the meaning of the Act. The court noted that if it were to permit liability for "services" in connection with items that were not covered by the Act, it would provide an "end run around the statutory definition of merchandise . . . [making] the CFA's breadth limitless." The remaining argument – that a securities broker is a "learned professional" and so entitled to the protection of a judicially created exception to liability under the CFA – was only briefly addressed. The court found it unnecessary to resolve that question in view of its holding, although it suggested that it would well be applicable because the uniform regulation of that occupation might conflict with the regulation under the CFA.

The *Lee* decision may show that the judicial pendulum is now swinging back from an ever-expanding interpretation of the Consumer Fraud Act to cover virtually every transaction.

For a copy of the *Lee* decision, please contact Karen A. Denys at (609) 716-6698 or Karen.Denys@dbr.com.

Courts May Not Simply Average Expert Appraisals to Determine Valuation

When value is in dispute, the parties often engage competing experts to assist the court in rendering a decision. A recent New Jersey appellate decision concluded that, at least where real property is concerned, simple averaging of the valuations reached by competing experts "is not an appropriate methodology for assessing divergent values."

In *Pansini Custom Design Associates, LLC, et al. v. City of Ocean City, et al.*, 407 N.J. Super. 137 (App. Div. 2009), a dispute arose between an owner and the city over development of a former United States Coast Guard Life Saving Station designated as a historic structure by the city's zoning ordinance. After litigating over the requirements of the zoning ordinance for some time, the last obstacle to development was the owner's duty under the ordinance to place the property for sale at "fair market value." To determine fair market value, the parties once again returned to the court.

The trial court heard appraisal testimony from three expert witnesses, one for each party and a third for an objector to the development, and criticized all the appraisal methods used. In spite of these criticisms, the trial court established a fair market value by averaging the three highest figures used by the town and objector, and the three lowest figures used by the developer. The objector appealed.

On appeal, the Appellate Division rejected the trial court's decision to simply average appraisals as an "unacceptable" and "flawed" abdication of the court's responsibility to reach "a reasoned, just and factually supported conclusion." The court first held that "a simple mathematical formula" cannot substitute for a court's obligation to weigh the experts' testimony and credibility. Next, the court found that "averaging, whether of appraisals or comparable sales, is not an appropriate methodology for assessing divergent values" because it fails to account for the unique facts and circumstances of the property being appraised. Finally, the court agreed with other courts that accepting averaging would encourage and "result in appraisals slanted to the extreme." The appeals court ordered a new trial on valuation.

Courts may not just average the experts' valuations but must use reasoned and considered valuation techniques.

This decision raises a few questions, including the extent to which *Pansini* may be applied to business valuations. Other New Jersey cases involving real property, including some cited by the *Pansini* court, support the proposition that mere averaging of expert valuations is improper. No decisions appear to prohibit averaging in other contexts, however, and at least one trial court in a business valuation dispute has simply averaged the figures offered by two opposing experts, citing difficulty in its ability to draw a distinction between the expert valuations. See *Venturini v. Steve's Steakhouse, Inc.*, 2006 WL 445059 (N.J. Super. Ch. Feb. 17, 2006). Despite *Pansini's* broad language, it is not clear whether the decision extends beyond real property valuation disputes.

Another open issue is the extent to which *Pansini* may constrain a court from accepting part but not all of an expert's opinion or elements from different experts' opinions in arriving at a determination of fair value. In a 2001 decision concerning property tax assessments, the Appellate Division held that a Tax Court judge "was certainly free to utilize those aspects of [an expert's] testimony he found cogent and reject others." *Brae Assoc. c/o Hertz Realty v Park Ridge Borough*, 19 N.J. Tax 306 (App. Div. 2001). The court in *Brae Associates* also found that the Tax Court judge had not erred in using elements of the expert's testimony to reach a different conclusion from that of the expert. The *Pansini* decision does not expressly foreclose a court from parsing expert opinions in a similar fashion. Because *Pansini* requires the valuation decision to be based on a "reasoned and considered valuation techniques," however, it will caution trial courts wrestling with valuation questions in any context that they are not free to pick and choose elements from different valuation experts' testimony to craft a result that is unreasonable or not supported by the facts.

For further information on the *Pansini* decision, please contact Matthew Barndt at (609) 716-6634 or Matthew.Barndt @dbr.com.

Courts Reluctant to Require Defendant to Produce Tax Return Information

One of the many sources of anxiety about litigation is the threat that one's personal tax return information may be disclosed in discovery. But courts are generally reluctant to order such information to be disclosed when the subject matter of the lawsuit does not make the financial condition of the party relevant. A recent federal court decision has reaffirmed the presumption that a party's tax returns should not be disclosed in discovery unless they are germane to an issue in the case.

In *Wiggins v. Clementon Police Dept., et al*, (U.S. District Court for the District of New Jersey, July 30, 2009), plaintiffs sued the Clementon Police Department and several officers alleging civil rights violations, including false arrest and use of excessive force, as a result of a traffic stop. Plaintiffs sought to compel the deposition testimony of one of the police officer defendants, Charles Grover, over his alleged failure to pay taxes on income he earned as a locksmith in his father's business. After acknowledging that he did not report "every cent" to the IRS, defendant refused to answer further questions about the issue. Plaintiffs filed a motion to compel Grover to testify about his income taxes, arguing that his alleged failure to pay income taxes was relevant to his credibility. Defendant Grover argued that whatever probative value that evidence had was greatly outweighed by the likelihood of unfair prejudice to him if the information were disclosed to a jury.

A party's tax information will generally be "off limits" absent a compelling need for disclosure and some relevance to the issues in the case.

The district court recognized that the Federal Rules of Civil Procedure allow for "broad and liberal discovery" of any non-privileged information that is relevant to the claims or defenses in the case. That would include information that may not itself be admissible as evidence at trial so long as the information is "reasonably calculated to lead to the discovery of admissible evidence."

That broad scope of discovery is not unlimited, however. As a matter of public policy, the Third Circuit Court of Appeals treats income tax returns as "confidential communications between a taxpayer and the government" and generally protects them from disclosure. Thus, a district court in the Third Circuit may order the disclosure of income tax returns only if the moving party's need for the information outweighs the other party's privacy interests. First, the court must determine whether the tax information is relevant, *i.e.*, whether the resisting party "has made his or her income an issue in the case." Second, the moving party must demonstrate a compelling need for the tax return information by showing that the same financial information is not readily available from other sources.

Here, the court found that plaintiffs' need for the information did not outweigh the defendant's privacy interests. The court rejected plaintiffs' argument that the tax information should be disclosed because it was relevant to defendant Grover's credibility, since, as the court explained, credibility is at issue in virtually all cases. If plaintiffs' position were correct, then almost every party to a lawsuit would be required to disclose its tax return information, eviscerating the public policy favoring non-disclosure. In *Wiggins*, the court also found that defendant Grover had not put his income at issue in the case and further noted that the nature of plaintiffs' claims for civil rights violations were not related to defendant's income.

As this case demonstrates, a litigant's tax information is generally off limits unless the moving party can demonstrate a compelling need for its disclosure and the information is relevant to an issue in the case. Absent those conditions, courts in the Third Circuit will continue to protect tax return information from discovery.

For a copy of the *Wiggins* case, please contact Brian Waters at (609)716-6503 or Brian.Waters@dbr.com.

New Jersey Expands Public Access to Court Records

The New Jersey Supreme Court has just expanded public access to court records, creating a presumption that all judicial records are open to the public. Revised Rule 1:38 will impose new obligations and requirements in connection with any document filed with the court and will limit a party's ability to file documents under seal.

The revised Rule will prohibit any "confidential" personal identifiers (SSN, Driver's License No., License Plate No. and other similar information) from any document submitted to the court.

Under the revised Rule a "court record" is defined broadly as "any information maintained by a court in any form in connection with a case or judicial proceeding, including but not limited to pleadings, motions, briefs and their respective attachments, evidentiary exhibits, indices, calendars, and dockets." This would include administrative records maintained by the courts but would continue to exclude unfiled discovery materials. The Rule exempts from public access several categories of documents relating to civil litigation, including records required to be kept confidential by statute, rule or prior case law; notes, draft opinions and other working papers maintained by or for the use of a judge or judicial staff; records pertaining to mediation sessions and alternative dispute resolution proceedings; records that are sealed or subject to a protective order; and completed jury questionnaires and the preliminary list of eligible jurors who may be called to comprise any venire.

One of the most significant changes made by the revised Rule is to prohibit any "confidential personal identifiers" in any document or pleading submitted to the court. These are defined as a social security number, drivers' license number, vehicle plate number, insurance policy number, active financial account number or active credit card number (although the Rule still permits use of some personal identifiers in judgment collection proceedings). The Rule will require counsel to certify in the Case Information Statement filed with an initial pleading that any confidential personal identifiers have been redacted and will not be included in any subsequent filings. Counsel must now carefully review any documents to be submitted to the court, particularly any exhibits attached to certifications or affidavits, to insure that such information has been redacted. There is no stated consequence for non-compliance, although presumably a court would have the power to sanction an offending party or its counsel and to reject a non-conforming filing. While the Rule is intended to facilitate public access to court records, the court will be required to redact confidential personal identifiers before permitting the public release of any document.

Another important change made in the revised Rule is a new two step "good cause" test for sealing a court record. "Good cause" is defined to exist when (1) disclosure will likely cause a "clearly defined and serious injury" to any person or entity and (2) the person or entity's interest in privacy substantially outweighs the presumption of public access. This standard incorporates the holdings of recent New Jersey decisions, which have held that the mere desire for privacy and to avoid embarrassment do not outweigh the public interest in disclosure. Under the new Rule, the proponent of sealing bears the burden of proving that good cause exists or continues to exist. The case law requires the party proposing sealing to make a compelling showing of the need to shield the particular document, for example, because it would reveal purely personal or competitively sensitive, trade secret or proprietary material.

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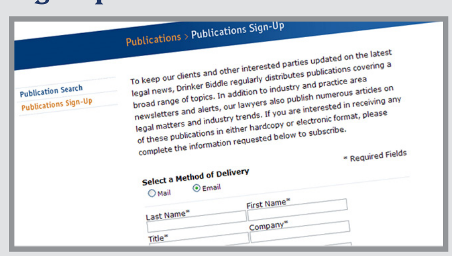

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