CASE STUDY PREPARED FROM ORIGINAL PUBLISHED OPINION

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Sargon Enterprises, Inc. v University of Southern California 11/26/12

Expert Testimony; Lost Profits; Proper Foundation

Plaintiff Sargon patented a single step dental implant in 1991. In 1996, plaintiff contracted with defendant University of Southern California to conduct a five year clinical study of the implant. In 1999, plaintiff sued defendant alleging breach of contract. In 2003, the action was tried, but the trial court excluded plaintiff's lost profits evidence based on a motion in limine. The jury found defendant had breached the contract and awarded $433,000 in compensatory damages to plaintiff.

Plaintiff appealed and the Court of Appeal reversed the judgment, holding the trial court erred in excluding the lost profits evidence. On retrial, defendant again moved to exclude the testimony of one of plaintiff's experts, James Skorheim, a certified public accountant. In an 8 day pretrial hearing, Skorheim testified he reviewed depositions, financial information from plaintiff and its competitors, and market analyses of the global dental implant market by Millenium Research Group. The expert based his opinion on "market share" which he used to calculate lost profits of between $220 million and $1.18 billion if a favorable clinical study had been completed by USC.

The market share approach was based upon a comparison of plaintiff to six other large, multinational dental implant companies that were the dominant market leaders in the industry, controlling 80 percent of global sales. Although there are 96 dental implant companies worldwide, Skorheim testified they were the innovators and the rest were "copycats." He acknowledged the Millenium report did not describe the six as innovators, but testified their sales success was evidence of their innovative qualities. He went on to testify that plaintiff Sargon

was innovative like the "big six," and not a copycat like the other smaller companies. He acknowledged plaintiff was a smaller company with a peak in profits of $101,000 in 1998, and it had no dedicated research and development department. He testified that Sargon was more innovative than other small companies, and thus comparable to the big six. He predicted Sargon had a very good chance of becoming the market leader within a 10 year period of time. He believed this to be a reasonable certainty. He acknowledged that the big six invested tens of millions of dollars in research and development annually, but stated he was confident Sargon would be able to make the necessary investment over time. Other than R & D, plaintiff's costs were similar to the big six.

The expert did not consider plaintiff's actual profits, instead considering the market leaders' profits. He projected Sargon's profits "ramping up" over the next several years with a successful clinical study. Skorheim did not testify about plaintiff's level of innovation, stating that would depend on the jury determination of the quality of plaintiff's innovation. He provided ranges of lost profits, rather than a single figure. His chart depended on the level of plaintiff's innovation as compared to the big six. Another plaintiff expert confirmed Skorheim's conclusions about the relationship between innovation and market success. A third expert, president of a successful implant company, testified Sargon could have commanded a 15-20 % share of the market if the clinical study had been completed by defendant. Finally, a fourth expert testified the implant was "revolutionary" and would have changed the world market.

Despite this evidence, the trial court, in a 33 page ruling, excluded evidence of lost profits, stating the determination was left to pure speculation. It found the expert's testimony was not based on historical financial results or comparisons to similar companies, and was therefore not the type of matter upon which an expert may reasonably rely. The court noted there <u>are</u> standards to assist a jury in determining whether a product is defective or to determine the percentage of comparative fault. Because there are no standards to determine "degrees of innovation" the question of determining potentially more than a billion dollars in damages is left to pure speculation.

After exclusion of the expert's testimony, the parties stipulated to an identical judgment as the first trial and plaintiff appealed for a second time. By a

two to one vote, the Court of Appeal reversed the trial court ruling. The appellate court found the trial court should have at least allowed the expert to testify about the smallest of the big six companies because it was sufficiently similar to Sargon that a comparison would have been supported by substantial evidence and not speculation. The dissenting Justice would have affirmed the trial court ruling because Sargon was not similar to the big six under any relevant objective business measure.

Defendant's petition for review to the Supreme Court was granted (despite NCAA sanctions) to decide whether the trial court erred in excluding Skorheim's testimony. Justice Ming Chin wrote the opinion for the Court. He began by discussing expert testimony and the job of the trial court to act as gatekeeper. In language attributed to Judge Friendly, he wrote: "Yet it is the jury system itself that requires the common law "judge, in his efforts to prevent the jury from being satisfied by matters of slight value, capable of being exaggerated by prejudice and hasty reasoning … to exclude matter which does not rise to a clearly sufficient degree of value"; "something more than a minimum of probative value is required." 1 Wigmore, Evidence (3d ed. 1940) pp.409-410. These comments are especially pertinent to an array of figures conveying a delusive impression of exactness in an area where a jury's common sense is less available than usual to protect it. (*Herman Schwabe, Inc. v United Shoe Machinery Corp.* (2d Cir. 1962) 297 F.2d 906)

Evidence code section 801 provides: "If a witness is testifying as an expert, his testimony in the form of an opinion is limited to such an opinion as is: (a) Related to a subject that is sufficiently beyond common experience that the opinion of an expert would assist the trier of fact; and (b) Based on matter … that is of a type that reasonably may be relied upon by an expert in forming an opinion upon the subject to which his testimony relates, unless an expert is precluded by law from using such matter as a basis for his opinion." The matter relied on must provide a reasonable basis for the particular opinion offered, and an expert opinion based on speculation or conjecture is inadmissible. (*Lockheed Litigation Cases* (2004) 115 Cal.App.4th 558) Thus, the trial court acts as a gatekeeper to exclude speculative or irrelevant expert opinion. The expert's opinion may not be based on assumptions of fact without evidentiary support, or on speculative or conjectural factors. Exclusion of expert opinions that rest on

guess, surmise or conjecture is an inherent corollary to the foundational predicate for admission of the expert testimony: will the testimony assist the trier of fact to evaluate the issues it must decide? (*Jennings v Palomar Pomerado Health Systems, Inc.* (2003) 114 Cal.App.4th 1108)

While Evidence Code section 801 governs the review of the type of matter that an expert may consider, Section 802 governs review of the reasons for the expert's opinion. The trial court may examine experts concerning the matter on which they base their opinion before admitting their testimony. The reasons for the experts' opinions are part of the matter on which they are based just as is the type of matter. Section 802 also permits the trial court to find the expert is precluded "by law" from using the reasons or matter as a basis for the opinion. This means that a court may inquire into, not only the type of material on which an expert relies, but also whether that material actually supports the expert's reasoning. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered. (*General Electric Co. v Joiner* (1997) 522 U.S. 136)

The trial court acts as a gatekeeper to exclude expert opinion testimony that is (1) based on matter of a type on which an expert may not reasonably rely, (2) based on reasons unsupported by the material on which the expert relies, or (3) speculative. The gatekeeping role does not involve choosing between competing expert opinions. The high court warned that the gatekeeper's focus "must be solely on principles and methodology, not on the conclusions that they generate." (*Daubert v Merrell Dow Pharmaceuticals, Inc.* (1993) 509 U.S. 579) When a trial court finds that an expert's testimony is reliable, this does not necessarily mean that contradictory expert testimony is unreliable. The law is broad enough to permit testimony that is the product of competing principles or methods in the same field of expertise. The trial court's preliminary determination whether the expert opinion is founded on sound logic is not a decision on its persuasiveness. The court must simply determine whether the matter relied on can provide a reasonable basis for the opinion or whether that opinion is based on a leap of logic or conjecture.

In short, the trial court's role as gatekeeper is to make certain that an expert, whether basing testimony upon professional studies or personal

experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field. (*Kumho Tire Co. v Carmichael* (1999) 526 U.S. 137) The trial court's ruling excluding or admitting expert testimony is reviewed for abuse of discretion, thus requiring a consideration of the legal principles and policies that should have guided the court's actions. Here, Justice Chin turned to the law relating to lost profits.

The general principle is that damages for the loss of prospective profits are recoverable where the evidence makes reasonably certain their occurrence and extent. (*Grupe v Glick* (1945) 26 Cal.2d 680). Such damages must "be proven to be certain both as to their occurrence and their extent, albeit not with mathematical precision. (*Lewis Jorge Construction Management, Inc. v Pomona Unified School Dist.* (2004) 34 Cal.4th 960) Regarding lost business profits, the cases have generally distinguished between established and unestablished businesses. The loss to an established business may be ascertained with reasonable certainty from the past volume of business and other provable data relevant to the probable future sales. (See *Grupe*, at p. 692)

On the other hand, where the operation of an unestablished business is prevented or interrupted, damages for prospective profits are not recoverable for the reason that their estimation is uncertain, contingent and speculative. Though generally objectionable, anticipated profits dependent upon future events are allowed where their nature and occurrence can be shown by evidence of reasonable reliability. (See *Grupe*, at p. 692-693) Where the ***fact*** of damages is certain, the amount of damages need not be calculated with absolute certainty. The law requires only that some reasonable basis of computation of damages be used, and the damages may be computed even if the result reached is an approximation. This is especially true where it is the wrongful acts of the defendant that have created the difficulty in proving the amount of loss of profits or where it is the wrongful acts of the defendant that have caused the other party to not realize a profit to which that party is entitled. (*GHK Associates v Mayer Group, Inc*. (1990) 224 Cal.App.3d 856)

Justice Chin added the cautionary note that a lost profit inquiry is always speculative to some degree. Inevitably there will be an element of uncertainty. Courts must not be too quick to exclude expert evidence as speculative merely

because the expert cannot say with absolute certainty what the profits would have been. Courts must not eviscerate the possibility of recovering lost profits by too broadly defining what is too speculative. A reasonable certainty only is required, not absolute certainty.

In determining whether the trial court abused its discretion in excluding plaintiff's expert testimony, the underlying legal requirement to prove lost profits is a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed. (*Kids' Universe v In2Labs* (2002) 95 Cal.App.4th 870) Here the trial court found the expert's methodology was too speculative for the evidence to be admissible. The court assumed that Skorheim's market share approach would be appropriate in a proper case. An expert might be able to make reasonably certain lost profit estimates based on a company's share of the overall market. But plaintiff's expert did not base the estimate on a market share Sargon had ever achieved. Instead, he opined that plaintiff's market share would have increased spectacularly over time to levels far above anything it had ever reached. He based his lost profit estimates on that hypothetical increased share.

Rather than using an objective business metric, such as sales or number of employees, Skorheim made a comparison to the big six based solely on his belief that Sargon, unlike the rest, was innovative, and that innovation was a prime market driver. As the trial court noted, his reasoning was circular. He concluded the big six were innovative because they were successful, and the smaller companies were not innovative because they were less successful. In essence, he said that the smaller companies were smaller because they were not innovative. Justice Chin wrote that the trial court properly considered this circularity in the reasoning as a basis to exclude the testimony under Section 802.

Skorheim based his estimates on the belief that the more innovative a company was, the larger the market share it would achieve. He testified to gradations of innovation with each increase in innovation equaling a step up in market share and thus in future profits. Implicit in this choice is that there is an evidentiary basis for this ranking: an "innovativeness" pecking order. Skorheim also agreed, under examination, that a company with a smaller market share could be more innovative than a company with a larger share. He testified that

certain smaller companies who claimed to have innovative products, were excluded from his "industry leader" market share list because the market disagreed with their claim of "innovativeness." If their products were truly innovative, they would sell more and thus have larger market shares. To the extent this ranking of innovativeness rests on the fact that some have larger market shares, it rests on nothing more than a tautology: the needless repetition of an idea or statement. As there is no evidentiary basis that equates the degree of innovativeness with the degree of difference in market share, to have the expert rank innovativeness and assign a market share has no rational basis.

The expert did not base his claim of future lost profits on evidence of past profit because Sargon was not an established company. He tried to compare Sargon to the big six, but they were not comparable. Before evidence of similar businesses may be used to prove loss of prospective profits, there must be a substantial similarity between the facts forming the basis of the profit projections and the business opportunity that was destroyed. (See, *Parlour Enterprises, Inc. v Kirin Group, Inc.* (2007) 152 Cal.App.4th 281) Here, Skorheim did not base his lost profits estimates on any objective evidence of past volume of business or any other provable data relevant to the probable future sales. Although exactitude is not required in estimating lost profits, the expert's opinion must be based on matter which is of the type properly relied upon by experts, and on opinions reasonably supported by that matter.

Plaintiff's expert assumed Sargon, which had virtually no R & D department, would have developed such a department to permit it to compete with the big six, all of which had large research and development departments. He assumed one of the big six would fall out of that group and Sargon would replace it. He assumed the big six would take no steps to contend with their new competitor. All of these assumptions were speculative. Skorheim's attempt to predict the future was in no way grounded in the past. It involved numerous variables that made any calculation of lost profits inherently uncertain. (*Greenwich S.F., LLC v Wong* (2010) 190 Cal.App.4th 739)

By way of illustration, the Associate Justice asks, "What if Alexander the Great had been killed early in his career at the Battle of the Granicus River, as he nearly was? …. Many serious, and not-so-serious historians have enjoyed

speculating about these what ifs. But few, if any, claim they are considering what would have happened rather than what might have happened. Because it is inherently difficult to accurately predict the future or to accurately reconstruct a counterfactual past, it is appropriate that trial courts vigilantly exercise their gatekeeping function when deciding whether to admit testimony that purports to prove such claims." The Supreme Court's ruling is not tantamount to a flat prohibition on lost profits in any case involving a revolutionary breakthrough in an industry. An expert could use a company's actual profits, a comparison to the profits of similar companies, or other objective evidence to project lost profits. The trial court's ruling merely means that Sargon cannot obtain a massive verdict based on speculative projections of future spectacular success. The ruling came within the discretion of the trial court, and the majority of the Court of Appeal erred in concluding otherwise.

The judgment of the Court of Appeal is reversed and remanded to that court for further proceedings consistent with this opinion.