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A Changing of the Guard

By Hillary Frommer

One of the biggest differences between pretrial discovery in state court and pretrial discovery in federal court is expert disclosure. The limited disclosure under CPLR 3101(d) is often seen as both a blessing and a curse. Unlike under Rule 26(a)(2) of the Federal Rules of Civil Procedure, a party does not have to produce an expert report, or her expert for a deposition. And, where good cause is shown, courts have allowed experts to testify even where the party discloses the expert on the eve of trial.[1] On the other hand, without a deposition, and with nothing more than a CPLR 3101(d) statement stating broadly that the expert will testify as to damages (something almost all state court practitioners have seen at least one in their careers), it becomes challenging to adequately preparing to cross-examine that expert at trial. This problem has increased in complex commercial matters where the dollars at stake are in the tens of millions, and the experts become the most important witnesses.

The Commercial Division of the New York Supreme Court has recognized that expert disclosure under CPLR 3101(d) is insufficient in these cases, which often involve complicated business valuations or real estate appraisals. To remedy this problem, it has implemented Rule 13 of the Commercial Division Rules. This new rule bears a striking resemblance to Federal Rule 26(a)(2). To those who rarely practice in the Commercial Division or those who are entering the Commercial Division for the first time, beware.


Hillary Frommer

Under Rule 13(c), if a party intends to introduce expert testimony at trial, she must, within 30 days after fact discovery is completed, confer on a schedule for expert disclosure. That schedule includes identifying the experts, exchanging expert reports, and completing depositions of testifying experts. Yes, now expert depositions are automatically permitted in cases pending in the Commercial Division. All of this expert discovery must be completed within four months, unless otherwise scheduled by the court, and prior to the filing of the note of issue and certificate of readiness. Moreover, expert disclosure provided after the note of issue is filed will be precluded at trial unless good cause is shown for that untimely production.

Rule 13 also sets forth what must be contained in an expert report. A party must produce a written report signed by the expert witness, which includes the following:

- A complete statement of all opinions the witness will express and the basis and the reasons for them;
- The data or other information considered by the witness in forming the opinion(s);
- Any exhibits that will be used to summarize or support the opinion(s);
- The witness's qualifications, including a list of all publications authored in the previous 10 years;
- A list of all other cases at which the witness testified as an expert at trial or by deposition during the previous four years; and
- A statement of the compensation to be paid to the witness for the study and testimony in the case.

This is identical to Rule 26(a)(2)(ii). Thus, litigants in the Commercial Division can no longer provide the more limited statement under CPLR 3101(d)(1), and disclose only who will testify, the subject matter "in reasonable detail" on which the expert is expected to testify, the substance of facts and opinions, and the expert's qualifications.

This rule is in its infancy. It will be interesting to see the decisions by the Commercial Division judges concerning expert discovery, especially decisions resolving motions to preclude expert testimony based on a party's failure to timely produce expert disclosure or the purported insufficiency of an expert report. Will these courts be stricter in determining what constitutes "good cause" for an untimely filing? Stay tuned.

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1 *See, e.g., Allen v Calleja*, 56 AD3d 497 [2d Dept 2008]; *Simpson v Bellew*, 161 AD2d 693 [2d Dept 1990].

By Louis Vlahos

This is part five of a five part series.

"Call it what you want, incentives are what get people to work harder."

-Nikita Khrushchev

Most of our clients are closely held, often family-owned businesses. The current owners may be the founders of the business, or they may be a generation or two removed. Sometimes, the owners have children who are active in the business and who may have manifested an ability to take over the business. In those cases, our goal is to provide for the smooth transition and succession of management and ownership of the business to those children.

No heir? Or not sure yet?

Quite often, however, the children may have no interest in the business, may not be capable of operating it effectively, or they have not yet exemplified the ability or inclination to do so.

This could put the owners in a quandary, with the only feasible option being a sale of the business at some point down the road. Of course, the owners' first priority in this instance will be to maximize the return on their investment, both for themselves and for their family. Depending upon the business, this may require the retention and cooperation of some key executive employees.

The question then, is how to incentivize and reward these key employees; how to align their interests with those of the owners; how to entice them to stay with the business, to keep growing the business, to help prepare the business for a likely sale?

There are several options to consider.

Incentive compensation choice 1: equity (or something like it)

On the one hand is "equity-based" compensation, which may take two forms.

A. Employee becomes an owner.

Under the first form, the employee may become an owner through grants of stock in the employer, bargain sales of employer stock, and non-qualified options to acquire such stock. In any of these scenarios, the stock may be voting or non-voting, it may be vested immediately or it may vest over time, and the right to exercise the option may or may not be immediately vested.

B: Employee feels like an owner

The second form does not involve the actual issuance of employer stock but, rather, seeks to mimic, to some extent, the "economics" of stock ownership. This includes phantom stock plans (on which there are many variations) and stock appreciation rights. Each of these is basically just a form of non-qualified deferred compensation, the amount of which is tied either to the value of the "shares" credited to the employee's account or to the appreciation in the value of such shares. (Where the employer is a partnership or LLC, a so-called "profits interest" may be issued, which entitles the employee to a share of future profits and future appreciation.)

The ultimate decision as to which equity-based plan is best suited for a particular business depends upon a number of factors, including the existing owner's tolerance for minority-interest shareholders, as well as the relative bargaining/negotiating positions of the employer and the key employee.

In my experience, the preference of most business owners is to avoid the actual issuance of equity (even as to family members, at least not until they have proven themselves in the business). Even with a tightly-drafted shareholders agreement, the rights afforded to a minority shareholder under state common law, and the potential for litigation – especially with an employee with whom there is no familial relationship – can make issuing equity a risky choice. Additionally, employees often do not want the obligations that often come along with ownership, e.g., personal guarantees of business loans and leases, restrictions on transfer, etc. (We will cover the issuance of stock options in a future post.

Incentive compensation choice 2: non-equity compensation

Alternatively, the incentive may take the form of a deferred compensation arrangement where the amount of the compensation is not tied by some formula to the value of the equity or to the ultimate sale price for the business. It should be noted, however, that the actual payment of the deferred compensation might be contingent upon the sale of the business. Indeed, many employers are naturally inclined to defer, and even condition, the payment of the compensation until the occurrence of a major liquidity event. Of course, because the timing of a sale cannot be predicted, such a contingent arrangement may have to account for many factors:

- Should the executive be immediately vested?
- Should he or she vest over a number of years, or only upon a sale of the business?
- Should payments be allowed upon certain events prior to a sale, including at the death or disability of the employee, or for some hardship?
- Should the deferred compensation be "secured" in some fashion?

Regardless of how these questions are answered, it is important to note that the many ways of structuring a deferred compensation agreement for the key employee of a business all share two critical elements: (a) in order to successfully defer the employee's tax liability, the arrangement must comply with certain tax principles that have been developed by the IRS and the courts over several decades, and that were modified by § 409A of the Code in 2004; and (b) this compliance must be ensured at the inception of the deferred compensation arrangement – otherwise, the tax and economic results that the parties envisioned will not be attained and someone will be very unhappy.