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Valuation Disputes In Bankruptcy Litigation

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In contested bankruptcy cases, success in litigation — over issues such as the enterprise value of the debtor — can determine the success of the reorganization and, ultimately, who controls the company upon emergence. As there often exists the possibility of such litigation, management and the board of directors should be aware of (and plan for) certain dispute-related "facts of life," long before the company files in court. Absent such awareness, the company could inadvertently set the table for disaster in a litigated dispute.

Damaging Internal Communications

Historical business plans, drafts of forecasts and projections, internal communications between employees and ill-conceived directions to management from board members or shareholders often are used to torpedo the company's strategy in bankruptcy court. Too often, the die has been cast for success or failure in litigation, long before the company actually files a case, because of damaging internal communications that ultimately must be produced in discovery.

Under applicable bankruptcy rules, parties to a dispute in a bankruptcy case are entitled to take fairly broad discovery of matters relevant to the dispute, including obtaining documents and depositions of the people involved. A debtor in a contested bankruptcy proceeding should act on the assumption that significant disputes will arise — with lenders, unsecured creditors, shareholders or others, and that it will inevitably receive a demand that the debtor turn over "all documents" on designated subjects.

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This means that the company will have to gather and provide not just paper files, but also relevant "sent-and-received" e-mail culled from its servers; electronically stored information; and often every draft of documents its employees created or received over the months (and sometimes years) leading up to the filing of the case, and during the case itself.

The company must expect that opponents of its plan of reorganization will pore over all the e-mail traffic that surrounds the creation of the business plan and projections that form the basis for the reorganization, as well as every draft of these documents, looking for inconsistencies, unreasonable assumptions and undue pressure and influence from various constituencies. Opponents will look at communications to management from operational and financial employees of the debtor, seeking evidence that management ignored the advice of knowledgeable people "on the ground" (about both costs and anticipated revenues), artificially to reach a certain desired result. They will look at materials presented to the board of directors, and the notes taken by board members on meetings and presentations, to determine whether claims exist that the board members breached any applicable duties.

Business Plans and Projections

Opponents will scrutinize prior years' business plans and projections, searching for evidence that the company's management had a track record of unreliable projections and missed targets (which can undermine the credibility of submissions prepared by that same management).

In a dispute over the enterprise value of a debtor, the debtor should assume it will be required to produce not just the final versions of its business plan and financial projections underlying its reorganization plan, but also its internal communications about the plan, communications by, to and from its board members, and communications with shareholders, lenders, and advisers (unless subject to the attorney-client privilege) concerning these documents. The debtor will likely be required to produce at a minimum, every writing concerning:

- the creation and modification of all of its business plans in the several years before the filing;
- financial projections created in those years;
- operating budgets and forecasts established and revised in the years leading up to the bankruptcy (and all the sub-components thereof);
- outside influences on management's judgment in the process of creating business plans, budgets and projections;
- efforts on the company's behalf to raise capital or sell the company;
- materials presented to or considered by the board; and
- communications with any regulators and rating agencies (and internal communications concerning these entities).

What to Do in the Months Leading Up to Bankruptcy

Know the Details of Past Plans/Projections

Entities contemplating bankruptcy often are told that shedding unserviceable debt and other obligations will offer a "fresh start." While that is true, it is a serious mistake to view the creation of the business plans and projections that will serve as the basis of a reorganization plan as something that can be done on a "clean slate." To the contrary, in a contested proceeding, every plan, projection and forecast that management offers will be viewed in the context of such plans and forecasts in the recent past. Not only will opponents dissect whether management has been ca-

pable in the past of creating reliable plans and projections, but they will scrutinize the proffered plan for unexplained inconsistencies with past approaches.

As just one example from a recent contested valuation dispute, in the years prior to the bankruptcy filing, the debtor's management created a "base-case" and "stretch" business plan every year, and modified each as the year progressed. But in the version of business plan and projections offered in the bankruptcy (to support an optimistic valuation), management created what it called a "conservative" and "base-case," and used the "base-case" numbers in the valuation. The opponents successfully argued that management had merely changed the labels so that it could call what was really its stretch plan a "base-case," resulting in an unrealistic but higher value.

Don't Disregard Recommendations From Operations-Level Personnel

The company anticipating a bankruptcy filing should consider carefully what documents exist in its files from operations-level employees like plant managers and the sales force about expected costs and revenues. In particular, the company should think about what these employees would say under oath if questioned about their recommendations for business plan/budgeting purposes. In one recent dispute, an operations-level manager admitted that the company's capex budget (which was part of its business plan) had essentially been dictated to him by the CFO, who had disregarded the man's advice and judgment about what capex would really be required to maintain the companies' operations. Again, a business plan that is built on assumptions that are contrary to what operations personnel have realistically advised is unlikely to withstand scrutiny when the operations personnel are put on the witness stand.

Establish a Protocol to Avoid Appearance of Undue Influence

A company headed into bankruptcy should establish a protocol so that neither the company nor interested constituencies (like equity holders, lenders, etc.) generate discoverable documents that can be used in court to suggest that the business plan and projections were engineered to reach a desired result. While this should be self-evident, it is surprisingly not. It is common to discover e-mail communications in a debtor's files that suggest that projections were shaped to satisfy outside constituencies.

In short, the company facing a bankruptcy proceeding should assume that opponents will look beyond the sausage and get into the nitty gritty of the "sausage-making." They will compare every draft of plans and projections, compare them with past formats, pounce on changes in process, and use communications from outside constituencies to their advantage.

Maintaining Credibility Is Key

Success in a contested bankruptcy (indeed, success in any litigation) fundamentally hinges on credibility. Here, it is the credibility of both the business plan/projections in dispute and the witnesses espousing the plan. Every person who may conceivably testify in court should be reminded early and often that their credibility is at the heart of a successful plan. This includes not only management, but also board members and any testifying experts.

All of these people should assume that they will be live witnesses in court, testifying under oath, about every document they created and every decision they made concerning the plan they are supporting. They should understand that assumptions and conclusions in business plans and forecasts will be challenged by lawyers who have complete access to the drafting process and communications concerning that process. They should assume that in their live testimony in court, the lawyers will point out any inconsistencies between their live testimony and their deposition testimony by playing video of the deposition.

Before any deposition is given, if not arranged by the lawyers, these people should insist that their lawyers show them every single document concerning the issue in dispute that they might be shown in the deposition. They should take whatever time is necessary to study the documents so that there will be no surprises "under oath," and so that all possible avenues of attack can be anticipated in advance. This process seldom takes less than a full day. It is the rare witness who does well in deposition (and then in trial) without thorough preparation beforehand.

The company should thoroughly investigate any testifying expert it retains, to learn about successful challenges to that expert in other proceedings, about problems in his or her career, and about opinions he or she may have given that contradict the opinion in the case at hand. Simply asking the potential expert to disclose this information, and the customary "reference calls" to lawyers who have used the expert in the past, is sometimes not enough. Expert witnesses who "puff" their credentials, and omit their failures are not the least bit unusual. On cross-examination, a surprised or defensive expert witness whose failures are exposed can easily lose a case.

The company should insist that the expert base his or her opinions only on standard, generally accepted methodologies — and that the expert not alter the methodologies in ways that have not previously been admitted in court. A sure-fire way to complete loss of credibility is for an expert to create a methodology for the case at hand, or to alter a methodology to reach a favorable result. In a valuation dispute, it is essential that the expert be required to use all three generally accepted valuation methodologies (the discounted cash flow analysis, the comparable companies method and the comparable transactions method). The expert must then explain any weighting between the three methods. The company should assume that an expert who can be demonstrated to have skewed his results in any of these ways will face a *Daubert* challenge.

Conclusion

In short, the company should hire a well-qualified expert, have complete background checks performed before putting the expert's name in the court file, and tell the expert that he or she should play it straight, use standard and generally accepted methodologies, and account for all the known facts in the case. To do otherwise risks a disastrous result.

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