REPRINT

CD corporate disputes

TELL ME YOUR SECRETS: CHAPTER 11 DISCOVERY RISKS FOR INVESTOR VALUATION MATERIALS

REPRINTED FROM:
CORPORATE DISPUTES MAGAZINE
APR-JUN 2023 ISSUE

www.corporatedisputesmagazine.com

Visit the website to request
a free copy of the full e-magazine

Davis Polk

Published by Financier Worldwide Ltd
corporatedisputes@financierworldwide.com

PERSPECTIVES

TELL ME YOUR SECRETS: CHAPTER 11 DISCOVERY RISKS FOR INVESTOR VALUATION MATERIALS

BY **MARSHALL HUEBNER AND ELLIOT MOSKOWITZ**
> DAVIS POLK & WARDWELL LLP

In recent years, a number of major bankruptcy cases have featured battles over whether a party's internal valuation of a debtor is a proper subject of discovery. Distressed investors, including hedge funds, are often the target of such requests in their roles as restructuring plan sponsors, bidders or creditors taking an active role in the restructuring. These parties may have created valuations of the debtor to inform investment strategy, and such valuations may well be different from what the debtor believes and is telling the bankruptcy court its assets are worth.

A party challenging the debtor's valuation may find it useful to seek a creditor's valuation in discovery to try to undermine the debtor's valuation. In contested discovery hearings in New York, Delaware and Texas, bankruptcy courts have often, but not always, held that such material is off limits for discovery, at least where the creditor is not putting on its own valuation evidence.

In a world in which discovery is increasingly being used as a weapon in hotly contested bankruptcy cases, it is useful to review recent decisions in this area as a guide to the factors judges consider when this issue arises.

Parties seek discovery of valuation materials for a variety of strategic reasons. Such discovery requests are especially likely when the propounding party is

disputing the valuation of the debtor in the context of opposing plan confirmation. The propounding party may also seek such discovery to apply pressure in negotiations with a fund or investment firm, given that materials reflecting its internal valuation of the debtor may reveal proprietary and sensitive information. For similar reasons, the propounding party may also seek discovery or other information revelatory of funds' business strategies, such as its trading activities with respect to the debtor.

The *Washington Prime Group* Chapter 11 proceedings in the Southern District of Texas (2021) provide a recent example of how these discovery issues can arise and how a judge may consider them. There, a court-appointed committee representing equity holders sought discovery from the restructuring plan sponsor – an investment firm and distressed investor – of valuation material that the plan sponsor had kept internally and did not share with anyone outside the firm. The committee argued that its requests were necessary for its potential objection to the company's plan of reorganisation, in which the committee would argue that the debtor's marketing process was deficient and failed to attract bids that would reveal a much higher value for the enterprise. The committee suspected that the plan sponsor's internal valuations would reflect a higher valuation of the company.

Following litigation, the court ruled that the internal information and communications sought by the committee, including with respect to plan valuation, were not relevant to the confirmation hearing. The court stated that making the plan sponsor produce such information was not "proportional to the needs" of the case because the plan sponsor's perception of value – as distinct from the debtor's – was "not relevant to anything that I might do".

The court further reasoned that as a distressed debt investor, the plan sponsor was "supposed to be greedy in the world" but that its own subjective assessment of value was nonetheless irrelevant where the plan sponsor itself was not putting on its own evidence at the confirmation hearing. The court noted with approval that the plan sponsor was producing any material it shared with the debtor and that it was only withholding internal documents it had not shared outside the firm.

The *Washington Prime* court's ruling was consistent with other rulings in the Southern District of Texas and in other jurisdictions. In the Speedcast International case in the Southern District of Texas (2020), the court denied discovery of a plan sponsor's "internal communications, opinions and valuations" because the propounding party had not made any "showing of something untoward going on internally". In the Chapter 11 cases of *The Dolan Company* in the District of Delaware (2014), the court acknowledged that internal valuation materials "may be appealing" to use on cross-examination but ultimately concluded that such materials would be burdensome to produce and "of limited relevance" to the debtor's valuation.

Courts have not spoken with one voice on this issue, however. In the *Phoenix Services Topco* Chapter 11 cases in Delaware (2022), the court granted the request of an official committee of unsecured creditors to obtain in discovery internal valuation materials of a group of secured lenders. The context may have made a difference insofar as the discovery requests were propounded under Federal Rule of Bankruptcy Procedure 2004 – which contemplates broad discovery in support of potential claims – rather than in the context of plan confirmation proceedings, where the scope of issues is generally narrower.

Several takeaways emerge from such cases. First, many courts have shown sensitivity to the proprietary nature of purely internal valuation materials from funds and other investment firms and the burden of producing such materials. Parties facing such discovery demands can draw on a growing body of case law to oppose or narrow the discovery.

Second, there are circumstances in which it is more likely that internal valuation materials will be subject to discovery. If a creditor seeks to introduce its own valuation evidence at a confirmation hearing, for example, it is far more likely that the creditor

will have to produce its own valuation materials in discovery so that opposing parties can test whether the valuation evidence presented by the creditor is contradicted by the creditor's own files. Parties against whom there are credible allegations of misconduct also are more likely to be the subject of invasive discovery demands by opposing parties, as are insiders of the debtor.

Finally, if a creditor is willing to produce valuation materials shared externally with the debtor or other parties, that offer of production may satisfy the court that the creditor is sharing valuation material conceivably relevant to the proceedings while maintaining the confidentiality of proprietary data that the creditor did not share with others.

Despite the trend in the case law, creditors should understand that in a contested bankruptcy case, there is a possibility that its internal valuation material – and private communications about such material – could be the subject of discovery. As with any documents created in the information age, parties should be cautious in preparing credit memoranda, valuation documents and trading strategy materials to use language that would not be misinterpreted or taken out of context were such materials to be produced in discovery. This is particularly so if such materials are shared with other parties, such as the debtor.

When it is necessary to share valuation materials with a debtor – for example when parties are coordinating with the debtor to prepare for a contested plan confirmation hearing – it may be useful to share such materials through counsel to bolster a claim of common interest privilege which is available to parties that jointly prepare for litigation with one another.

In the event that valuation materials are required to be produced, counsel should be sure to obtain a protective order from the court to ensure that the disclosure is made to as few parties as possible (and for only intended uses) to minimise harm to the creditor. CD

Marshall Huebner
Global Co-Head of the Restructuring Group
Davis Polk
T: +1 (212) 450 4099
E: marshall.huebner@davispolk.com

Elliot Moskowitz
Partner
Davis Polk
T: +1 (212) 450 4241
E: elliot.moskowitz@davispolk.com