How a Damages Expert Can Stumble over the Balance Sheet
By Alexander "Sasha" Aganin

Readers of this newsletter have probably seen many cases in which a trustee or creditor of a bankrupt entity alleges that managers’ or third parties’ actions caused company’s losses during the period leading up to or following the bankruptcy filing. Superficial damages analyses confuse financing transactions with losses, instead of quantifying economic losses and analyzing their causes.

When calculating damages, an expert needs to compare economic outcomes in the actual world with a hypothetical situation that differs in only one respect: The challenged conduct is replaced by alternative actions by the defendants. See Mark A. Allen, Robert E. Hall & Victoria A. Lazear, “Reference Guide on Estimation of Economic Damages,” in Reference Manual on Scientific Evidence (3d ed. 2011). This comparison aims to charge the defendants only with losses caused by their alleged misconduct. (The law imposes a constraint that the chain of causation cannot be so long that the impact of alleged misconduct is too remote from the defendants’ actions.)

Consider a simple example: A company faces two offers at the end of an auction for the same set of assets. One comes from a third party for $100 million, the other from one of the managers for $95 million. The two are identical in terms of the probability of completion, due diligence requirements, and every other aspect besides the amount. The board authorizes a sale to the manager. If the board is found in violation of its fiduciary duties, calculating damages to the company as of the time of the transaction is relatively straightforward. The company would have ended up with $5 million more in the alternative world.

Most damages calculations are much less straightforward than this stylized example. A damages expert has to specify the alternative world carefully—not just the events that would have occurred but the impact they would have had on economic outcomes for the plaintiff. One type of event that commonly comes up in calculating damages for a bankrupt company is debt financing. The plaintiff may allege that, were it not for the defendant’s actions, the company would have avoided piling up debt. Whether or not there is a causal link between these actions and the increase in debt is often subject to disagreement between the parties. Even if this causal link exists, a damages expert generally cannot use an increase in a company’s debts as a measure of damages to the company. Indeed, the value of a company’s assets generally increases in tandem with its liabilities at the moment the company closes the transaction. It is conceivable that the company realizes a loss when it invests financing proceeds in ongoing operations or a new business. That might represent damages to the company caused by somebody’s wrongdoing, but this loss is generally not caused by taking the loan itself and is not necessarily equal to the loan proceeds. See Sabin Willett, “The Shallows of Deepening Insolvency,” 60 Bus. Law. 549 (2005) [registration required]; In re Greater Se. Cmty. Hosp. Corp., 353 B.R. 324 (Bankr. D.D.C. 2006); In re Parmalat Sec. Litig., 501 F. Supp. 2d 560 (S.D.N.Y. 2007). If an expert tells you that a loan damaged the company at the time of the borrowing transaction, you need to ask

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the expert exactly what kind of damages mechanism he or she has in mind. Is the expert assuming that the company took the loan at disadvantageous terms? Is the expert assuming that the loan covenants prevented the company from undertaking a lucrative project or made it more difficult for an outsider to acquire control of the company? Is the expert assuming that the loan presented an unfavorable tradeoff between the tax savings from interest deductions and the increased probability and cost of financial distress?

The following examples from my practice illustrate some of the common errors in damages calculations involving financing transactions. The first one arose in a deepening insolvency matter, when an expert built his damages model on an unrealistic set of assumptions about events in the alternative world. Consider the following fact pattern: The chief executive officer (CEO) of a highly leveraged software company was falsifying financials and concealing accounting irregularities from the company’s board members and auditors. The company ended up filing for bankruptcy as product demand declined amid mounting losses and debts. The company’s trustee filed a lawsuit against the auditors alleging that they should have spotted some red flags in financial statements provided to them by the company’s management. The plaintiffs’ damages expert presented a simple theory: Had the auditors reported the red flags to the board of directors, the board would have fired the CEO, cleaned up the company’s accounting systems, and hired a successful new CEO who would have reduced the company’s debts and made the company the dominant force in its part of the software market. The expert calculated damages to the company based in large part on the stock performance of the most successful competitor over several years after the company in question filed for bankruptcy. As you can imagine, damages under this alternative scenario were quite large. However, was this scenario reasonable? For starters, it was difficult to imagine that the board would have replaced the executive, who was a majority owner of the company, even if the board had learned about the red flags from the auditors. Moreover, the software market contracted, and many peer companies went out of business. Selecting the best-performing peer as a performance benchmark in the alternative world had a distinct flavor of hindsight bias.

The next example concerns a failure to account for the financial implications of debt repayment. When a company repays a loan, assets generally decline by the amount of the repayment, but so do liabilities, resulting in no damages from the repayment. An expert compared the enterprise value of the company (i.e., the sum of the values of equity and debt) before and during bankruptcy, and claimed that the difference represented damages to the company from alleged breaches of fiduciary duties by directors. The expert overlooked the fact that the company sold a major asset and used the proceeds from the sale to repay a portion of debts. This repayment mechanically reduced the sum of the values of equity and debt without harming anything and should have been subtracted from the damages calculation.

If one were to consider debt repayments as part of damages, one would find damages in a wider variety of transactions. Consider a family with only one asset, a house worth $200,000, financed by a mortgage of $190,000. If the family sells the house for the fair market value of $200,000 and uses the proceeds to repay the mortgage, the assets shrink from $200,000 to $10,000,
assuming the household does not have to pay transaction costs. However, the $190,000 decline in the value of the family’s assets cannot be claimed as damages because the transaction extinguished the $190,000 liability.

Similar logic applies when a company returns money to shareholders through a dividend payment or repurchase, as in the next example: The trustee of an investment fund argues that, in the absence of allegedly negligent advice from a third party, the fund’s board of directors would not have allowed redemptions from the fund several months before the bankruptcy filing. The plaintiff’s expert includes the redemptions as the largest component of calculated damages to the company. Does this make any sense? Imagine a mutual fund run by Fidelity or Vanguard: Its assets fluctuate daily as investors buy and sell shares. Redemptions from the fund usually return to investors what they own, and they don’t reflect losses to the fund. Because the investors’ money does not belong to the fund, it is inaccurate to include financing outflows in damages to the fund.

Returning cash to investors or creditors prior to a bankruptcy filing can become a hotly contested preference issue in subsequent litigation. Opposing parties disagree about the value exchanged in these transactions. For example, a trustee may allege that a repurchase of shares from shareholders prior to bankruptcy should be voided as a fraudulent transfer. Under the trustee’s theory, the company was already insolvent or inadequately capitalized, or became that way as a result of the share repurchase. It is important to note that the trustee needs to establish that the company did not receive adequate value as part of the repurchases. This means that shareholders received more than their shares were really worth at the time of the transactions. In other words, shareholders allegedly redeemed shares above fair market value, unlike the hypothetical mutual fund example discussed above. (Fair market value is the price at which the assets would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.) If the trustee concedes that the company was solvent after the repurchases and ends up pursuing a damages claim rather than a fraudulent transfer claim related to the repurchases, the expert should not include the full amount of redemptions as damages to the company because a part of what shareholders received (equal to the fair market value of their shares) was rightfully theirs before the redemptions.

Now let’s apply some of the concepts discussed so far to calculate damages to a company using the popular dissipation-of-assets approach. Under a naïve application of this approach, a damages expert measures the $100 difference between the fair market value of assets before and after the alleged wrongful conduct, $200 and $100 respectively. Clearly, the fair market value of assets may change for a variety of reasons unrelated to the alleged wrongdoing. One example is financing. Suppose that the company repaid $20 of debt and thereby reduced its liabilities from $150 to $130. Let’s also assume that the company did not pay dividends but repurchased equity in the amount of $30. Let’s assume for simplicity that both the creditors and the selling shareholders had sufficient information and transacted in competitive markets, so that the borrowing and the stock repurchase were done at fair market values. The naïve damages measure of $100 does not come close to an accurate estimate because it does not even capture the
economic loss correctly, much less model what would happen in the alternative scenario. The economic loss during the damages period is $50 instead of $100 because there was an outflow of funds in the interim equal to $50. The economic loss can be expressed as the change in the fair market value of assets adjusted for financing. Simply put, that’s $100 – $50. It can also be expressed as follows: ($200 – $150) – ($100 – $130) – $30 = $50. The terms in parentheses describe the extent to which the fair market value of assets exceeds the company’s liabilities before and after the alleged wrongdoing. For a solvent company, this value represents the fair market value of the company’s equity. For an insolvent company, the economic loss reflects the gap between the fair market value of assets and liabilities.

Armed with this formula for economic loss, the expert then needs to compare it in the actual world and an alternative scenario changed in only one respect—the challenged conduct is replaced by alternative actions by the defendants. Would the company raise less debt? Would it change operations and investments? Would it still make the repurchase and, if so, at what price? Would it pay a dividend instead of making the repurchase? It should be noted that a company’s trustee’s claims for damages may overlap with those of the creditors. For example, Judge Lewis Kaplan ruled that a trustee cannot claim damages on behalf of an entity in liquidation if even in the hypothetical scenario, the entity would have been liquidated, with all liquidation proceeds going to the creditors. See In re Parmalat Sec. Litig., 501 F. Supp. 2d 560 (S.D.N.Y. 2007).

The expert will need to make sure that the alternative world he or she is modeling is well grounded and not speculative. The expert will also need to make apples-to-apples comparisons of risky cash flows happening at various points of time in the actual and the but-for worlds. Because the fair market value of assets equals the present value of their expected future cash flows, a careful damages calculation based on the balance sheet data should be equivalent to a lost-profits analysis.

Calculating damages is often complex and always requires careful modeling and a good grasp of finance concepts. One of them is that a new financing transaction or a repayment of financing changes both assets and claims against those assets (for example, debt, equity). A damages expert is well advised to keep track of both sides of the balance sheet when calculating damages.

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