Advocate's EDGE

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CPAs & Forensic Accountants

Burden vs. benefit

Court weighs in on inaccessible ESI

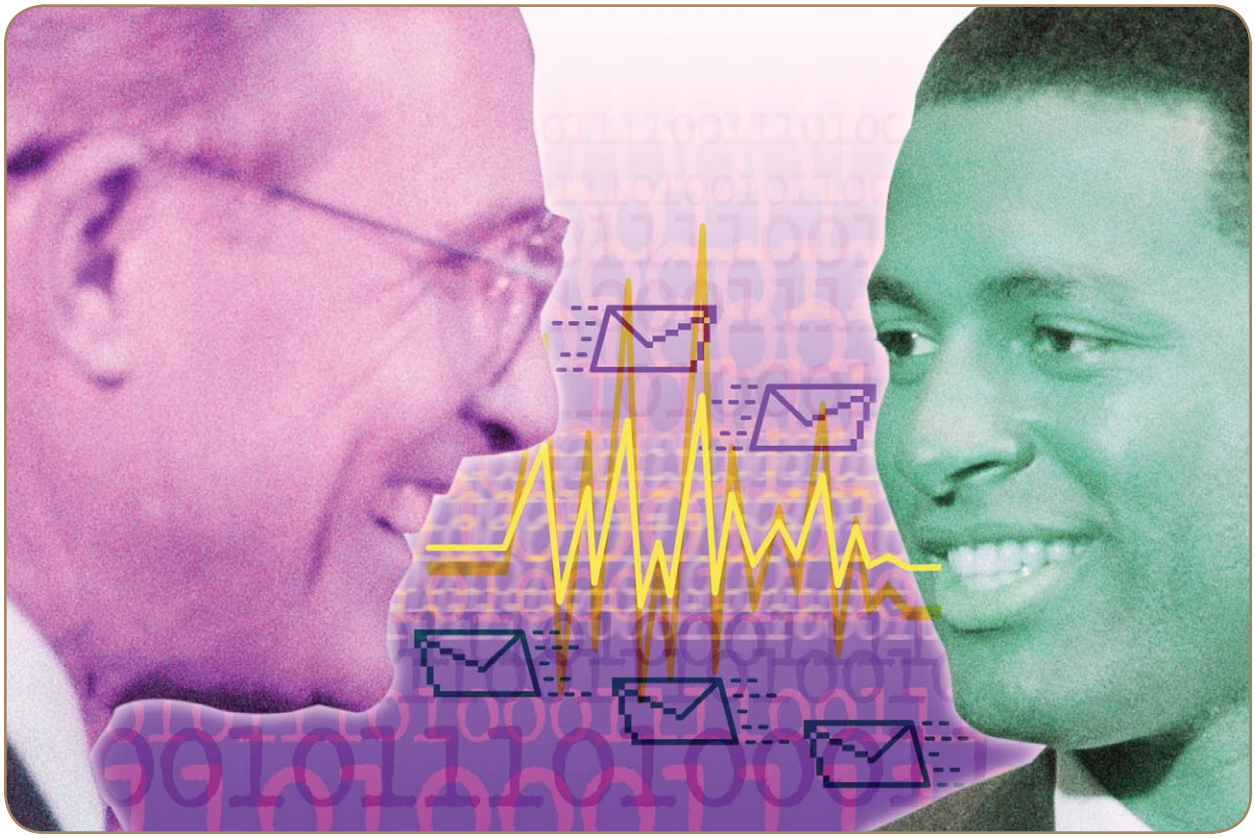
Attorneys increasingly face discovery requests for massive amounts of electronically stored information (ESI). Parties generally aren't required to produce ESI that isn't "reasonably accessible" because of undue burden or cost, but courts can nonetheless order production on a showing of good cause by the requesting party. A recent New Jersey district court opinion examines the factors relevant to the determination of whether such a showing has been made.

COST IS A FACTOR

In *Major Tours Inc. v. Colorel*, the plaintiff tour bus operators sued the New Jersey Department of Transportation (NJDOT) and others alleging that discriminatory safety inspections had been made of buses owned by African-Americans. During discovery, they requested copies of e-mail communications from the backup tapes (archived e-mails) maintained by NJDOT.

The defendants sought a protective order, claiming the e-mails were inaccessible due to the cost and burden to retrieve them from about 2,500 backup tapes. Defendants estimated that harvesting the requested e-mails would cost $1.5 million. Previously, they had searched the records of 37 custodians and harvested about 152,000 e-mails from their mailboxes. A total of 135,000 documents were reviewed, with 70,000 of those containing a hit on the 100 search terms agreed to by the parties. The defendants proposed limiting e-mail discovery to these documents.

The court found that the requested data was indeed inaccessible. It observed that data stored on backup tapes typically is classified as inaccessible because it's not readily usable. The court also criticized the plaintiffs' failure to credibly rebut the defendants' cost estimate with contrary estimates or affidavits.



GOOD CAUSE ANALYSIS

In determining whether the plaintiffs showed good cause to order discovery, the court analyzed the Advisory Committee Notes to Federal Rule of Civil Procedure 26(b)(2)(B). Factors listed are the:

- Specificity of the discovery request,
- Quantity of information available from other and more easily accessed sources,
- Failure to produce relevant information that seems likely to have existed but is no longer available on more easily accessed sources,
- Likelihood of finding relevant, responsive information that can't be obtained from other, more easily accessed sources,
- Predictions as to the importance and usefulness of further information,
- Importance of the issues at stake in the litigation, and
- Parties' resources.

The court explained that these factors should be weighed by importance rather than used as a checklist for each party to tally and compare. It found that the most critical considerations in the current matter were that the defendants had already produced tens of thousands of relevant documents and that a substantial number of depositions had been and would be taken. Also, no evidence existed of intentional spoliation. Further, the requested e-mails were likely to be of marginal benefit and cumulative of documents previously produced.

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LITIGATION HOLD LETTERS MAY BE DISCOVERABLE

In an early stage of *Major Tours Inc. v. Colorel*, the court issued an order regarding the discoverability of attorneys' litigation hold letters. The order was notable because it ruled, in essence, that the defendants had waived attorney-client privilege for the letters before their attorneys had begun work on the litigation.

The hold letters were sent after the lawsuit was filed. But the court found that the duty to preserve had been triggered by a letter alleging racial profiling, sent to the New Jersey Attorney General 22 months before the filing. The letter requested a response "within two weeks in order to avoid recourse to litigation."

The court adopted the prevailing view that hold letters are discoverable when spoliation occurs. Inferring that some relevant evidence was lost, the court concluded that the plaintiffs had made a preliminary showing of spoliation and ordered the production of the hold letters.

SCALING BACK

The court concluded that the "slim likelihood" of new relevant evidence being discovered didn't outweigh the substantial burden and expense to retrieve the e-mails from the 2,500 backup tapes.

It also considered the possibility of a scaled-back alternative, with 17 tapes searched, but again found that the burden and expense outweighed the likely usefulness of harvesting the e-mails.

However, the court recognized the plaintiffs' claim that the e-mails held relevant evidence and that the plaintiffs were pursuing issues of "paramount public importance." So the court ruled that the plaintiffs and defendants should share the cost of searching the 17 tapes.

MAKE OR BREAK

The *Major Tours* case illustrates the factors likely to determine whether a court orders production of ESI when it isn't reasonably accessible. Work with an experienced forensic expert to build your own arguments for or against production in light of these factors.

Don't let line-of-credit schemes defraud your client

Companies everywhere need to make an ongoing commitment to preventing occupational fraud. But a weak economy can raise the incidence of fraud as even long-term, trusted employees become financially motivated to steal from their employers. Hard times also typically lead to more "creative" schemes. One that gets little attention, but potentially is extremely damaging, involves a company's line of credit (LOC) with lenders.

POTENTIAL GOLD MINE

Many businesses establish asset-based revolving LOCs that let them borrow funds as needed for working capital to, for example, pay vendors. The amount of credit available to a company generally is tied to its asset balances.

An LOC based on a company's accounts receivable, for example, might allow advances up to 85% of "eligible" accounts receivable. The company is required to submit a periodic calculation of its accounts receivable availability (which typically excludes invoices more than 90 days past due and receivables from affiliated businesses). With so much money involved, it's not surprising that some employees have found ways to exploit LOCs.

INFLATING NUMBERS

Employees who are closely involved in arranging for LOCs or are calculating periodic receivable availability reports have the necessary access to commit this type of fraud. Staff members can falsely inflate their companies' accounts receivable numbers, thereby raising the amount of available credit — and funds available to steal.

A thief, for example, might create a fictitious invoice for $170,000. When that invoice is assigned to the lender as collateral, the lender issues $144,500 in credit (assuming the amount of credit is limited to 85% of eligible receivables). The employee then diverts the funds through a fictitious vendor.

As the fake invoice nears 90 days past due — making it ineligible for the availability calculation — the employee circulates cash through the lender via another fictitious invoice. By assigning a new invoice for $200,000, the employee gains access to $170,000 (85% of $200,000), and directs it to a shell company to remit payment for the first fake invoice.

When the payment has been deposited with the lender, it reduces the company's accounts receivable and loan balance by $170,000. And the extra $30,000 in accounts receivable ($200,000 less $170,000) creates an additional $25,500 of available credit.

THE INVESTIGATION

Forensic experts use several methods to detect complicated LOC schemes. They can scrutinize customer and vendor lists and investigate those that aren't well known in the industry. Experts will ask suspicious vendors to provide proof that they actually sell goods or services to other companies. And then they follow up by investigating what alleged customers have received in exchange for their payments. Experts also will examine invoices, checks and receipts.

Computer analysis plays a role, too. Experts run reports to determine if unfamiliar customers or vendors account for a significant or increasing number or percentage of transactions. Sale and purchase data also can be mined for matches among vendor, customer and employee addresses.

Employees can falsely inflate accounts receivable numbers, thereby raising the amount of available credit — and funds available to steal.

DAMAGE CONTROL

Fraud schemes this complex generally run for months or even years before they're detected. This gives employees time to do a lot of financial damage. So if your client is at risk for LOC fraud or suspects it has already occurred, ask a fraud expert to investigate and help the business put policies in place to prevent future losses.

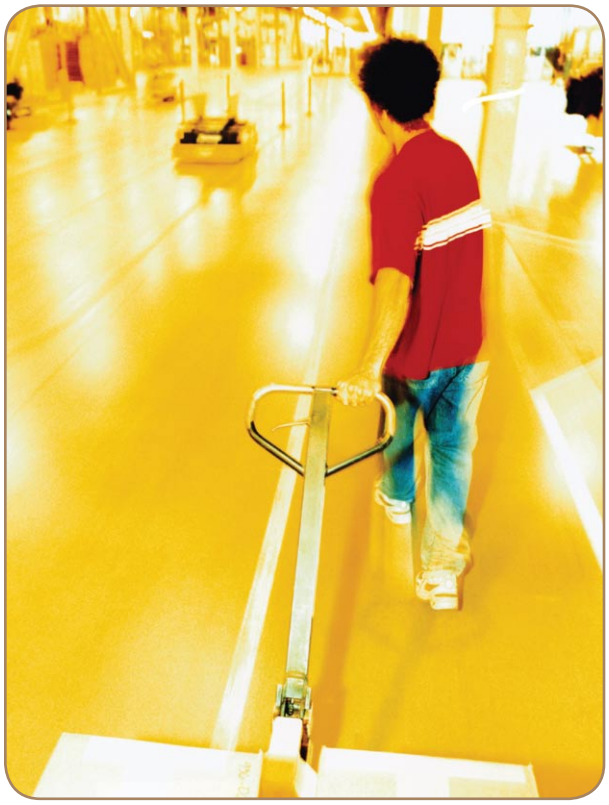
Valuation expertise is critical when a company is liquidating

Whether your client is a financially distressed business or a business buyer that's considering acquiring a company in bankruptcy, you'll need the assistance of a valuation expert. An experienced valuator can help owners make informed decisions about their troubled company's future and maximize liquidation proceeds. And valuators can provide buyers with an accurate picture of the value of bankrupt businesses and their assets.

LIQUIDATION VALUE

Recent economic turmoil means that some companies are liquidating assets to generate cash flow or even turning to bankruptcy. Although valuators typically calculate a company's value as a going concern, certain financial trends such as recurring net losses, declining sales and severely reduced liquidity may suggest that the business would be more valuable if it were liquidated.

The *International Glossary of Business Valuation Terms* lists two types of liquidation value. In an orderly liquidation, assets are sold piecemeal over a reasonable period of time to maximize proceeds. Alternatively, forced liquidation value assumes assets will be sold as quickly as possible, possibly via auction. Timing, bankruptcy laws and judicial mandates all help a valuator determine the appropriate premise of value.



Liquidation value often serves as a "floor" for business value. It also can help owners decide whether to file for Federal Bankruptcy Code Chapter 7 (liquidation) or Chapter 11 (reorganization), and it helps stakeholders evaluate the viability of spin-offs and mergers, out-of-court loan workouts, management buyouts, and reorganization plans.

Valuators can also help buyers of distressed businesses determine their targets' strategic value — or value based on the specific buyer's investment requirements and expectations. For example, a buyer may be willing to pay more than liquidation value for a company that provides synergies and economies of scale.

CRUNCHING THE NUMBERS

Valuators engaged to appraise a troubled company start with its balance sheet. The book values of liabilities generally are accurate, but assets may require adjustments to estimate recoverability and current market values. Valuators also consider the existence of unrecorded items, such as patents, trademarks, customer lists, IRS claims, warranties and pending lawsuits.

If a company decides to liquidate, the valuator must factor in liquidation expenses, such as lease obligations, severance pay and professional fees. Typically, money is set aside in an escrow account for these incidentals before the company distributes liquidation proceeds to creditors and investors.

SERVING MANY ROLES

Liquidation analyses are just the tip of the iceberg. Valuators can advise distressed businesses on such issues as negotiating debt restructuring with creditors and coordinating bankruptcy filings. They can provide fairness opinions for management buyouts and third-party acquisitions and help implement reorganization plans.

When creditors file fraudulent conveyance lawsuits, valuators can help determine the facts by performing a solvency analysis. The valuator's subsequent solvency opinion determines whether the allegedly fraudulent transfer has left the company unable to service its debt obligations or continue normal business operations.

Valuators also might work with, or serve as, court-appointed receivers and turnaround consultants.

Recurring net losses, declining sales and severely reduced liquidity may suggest that a business would be more valuable if it were liquidated.

EXPERIENCE COUNTS

Even when a company has lost most or all of its value, the stakes are high for owners and other stakeholders. So be sure you hire a valuator who's experienced in distressed company engagements and familiar with bankruptcy laws. In addition to financial expertise, your valuator needs the strong presentation skills necessary for persuasive court testimony and negotiations with investors, creditors and other concerned parties.

Is your appraiser vulnerable to attack?

Attorneys who rely on professional appraisers should know about some revisions made by the Appraisal Foundation to its 2010-11 Uniform Standards of Professional Appraisal Practice (USPAP) — generally considered the performance and ethical standards for U.S. real property appraisers. Experts who breach the rules may be vulnerable to attack by opposing counsel.

FULL DISCLOSURE

Under the revised USPAP, appraisers subject to its standards now must disclose to their clients — and in the subsequent report certifications — any current or prospective interest in the subject property or parties involved. Appraisers also must disclose any services performed regarding the subject property within the three-year period immediately preceding acceptance of the current assignment. Such services include not only appraisals, but also property management, leasing, brokerage, auction or investment advisory services.

Such disclosure must be made before accepting the assignment or when the interest or service is discovered in the course of the assignment. Note, however, that an appraiser may have agreed with a client to keep the mere occurrence of a prior assignment confidential. If an appraiser has agreed not to disclose that he or she has appraised a property, the appraiser must decline all assignments regarding that property for three years.

The ethics rule also requires appraisers to disclose whether they've paid a fee or commission, or given something of value, in connection with procuring an assignment. When an interest in the property or parties exists and the appraiser makes such a payment, it can sully the expert in the eyes of a jury or judge.

BE OR BECOME COMPETENT

The latest USPAP also rewrites the competency rule for appraisers. The rule generally requires an appraiser to:

- Be competent to perform the assignment,
- Acquire the necessary competency, or
- Decline or withdraw from the assignment.

Competency may apply to factors such as an appraiser's familiarity with a specific type of property or asset, specific laws and regulations, or an analytical method. If an appraiser determines, before accepting an assignment, that he or she isn't competent, the appraiser must disclose the lack of knowledge or experience to the client before accepting.

The appraiser must then take all necessary steps to acquire competency through, for example, personal study, association with an appraiser reasonably believed to have the necessary knowledge or experience, or retention of other experts with the requisite abilities. It's critical that the appraiser's report describe both the lack of knowledge or experience and the steps taken to complete the assignment competently.

ON THE ATTACK

The updated USPAP can expose an appraiser to questions regarding bias, credibility and adherence to professional standards. Therefore, you need to probe both your own experts and the opposing experts for any ethical or competency weaknesses.