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Mediating Valuation Disputes

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The bankruptcy courts have been continuously at the forefront of the many courts embracing mediation as a tool to resolve disputes. Unlike other commercial courts, there is an opportunity in bankruptcy to utilize mediation in a variety of contexts throughout the course of a case or a proceeding; one potential use of mediation can be to address the multitude of valuation determinations that must be made during the life of a matter. Bankruptcy professionals recognize that valuation disputes can prove to be costly and contentious, and often arise at critical time junctures in the process and with attendant time constraints. The need to address issues of valuation pervades the lifeline of a case and can appear multiple times throughout the process.

For example, first-day hearings on use of cash collateral, § 363 sales of assets, the fixing of liens and claims, applications to modify the automatic stay to reclaim collateral, and/or seeking adequate protection and confirmation of a plan all require valuation determinations. Further, these disputes often involve reliance upon experts and expert reports, and while the initial tendency might be to seek to depose experts and tee the issues up for a full evidentiary hearing before the court, counsel should consider the fact that these issues can instead be mediated and that the experts can and should play a role in that process.

There are those who would contend that valuation is a numbers issue and that there merely needs to be an acceptance or acknowledgment by the court (or the parties) that one expert's valuation is right and the other expert is wrong — that it should just be a concrete determination — but that could also be said about any of the legal issues in that one side in the end will be determined to be correct under the law. It is possible that valuation is not that cut-and-dried; if it was, you would not be finding experts contradicting one another. Putting aside the oft-joked-about term "MAI" (made as instructed), it is indeed viable that the experts simply do not agree. Whether the question is the predicate facts upon which an analysis is based, or the applied theory of valuation or the variables that each is taking into consideration, when you add to that the layers of legal argument that lawyers can also impose on the various concepts, it boils down to a variety of differing opinions.

However, mediation can be applied to resolve any dispute as long as the parties are willing to consider options and risks, evaluate their costs, and determine what makes the most sense from a business perspective. Thus, even valuation disputes can be mediated with some initial work to provide a good baseline and with the active assistance of the varying experts to sort out the information at hand.

The variety of different opinions among experts is most understandable. Let's examine two areas where experts are often utilized: opining on budgets supporting the use of cash collateral or debtor-in-possession (DIP) financing needs, and valuation to support confirmation.

Cash-collateral and DIP-financing budgets depict the operational cash flows, receipts and disbursements, and restructuring costs to administer a case. Receipts are dependent on a perspective of sales trends within the bankruptcy, whether revenue will remain stable or deteriorate, and customer-payment behavior in response to the filing. Of course, the nature of the industry, relationship with, dependency of and potential claims by customers on the debtor, as well as the effectiveness of competitor exploitation of the debtor's filing (among other factors), can all impact customers' actions. In the absence of a crystal ball, assumptions are required, and only time will tell how the future unfolds. Industry experience, intimate knowledge of customer dependency and an analysis of customer behavior in similar circumstances influence the quality of the assumptions. However, an educated guess is still a guess, and the need for liquidity during the pendency of a case can skew a budget to incorporate conservative assumptions.

Operating disbursements can fall in three categories: (1) raw material, product or service costs, and payroll variables with the level of sales; (2) relatively fixed costs such as occupancy costs, utilities, insurance and payroll easily determined with a relatively high degree of accuracy; and (3) strategic or contingency costs associated with the bankruptcy, such as critical-vendor costs, deposits, key employee incentive plans (KEIPs) and unforeseen expenses that can be material in nature and subject to much debate. Costs driving up the level of financing need might have meaningful impact on creditor constituents' recoveries, which can influence their perspective and advocacy of challenging such assumptions.

Similarly, restructuring costs, inclusive of debtors' and creditors' legal and financial advisory fees, investment banker fees, claims agent and U.S. Trustee fees, and DIP financing costs associated with a bankruptcy proceeding are high, causing many to look toward alternatives to bankruptcy. Perspectives on the course of a case might vary and are certainly unknown, leaving the estimation of

such costs a guess based on experience. At the same time, advocacy influences constituents' defense or challenge of the level of restructuring costs. So, is there a right answer?

There is a relatively small subset of generally accepted valuation techniques most often utilized to value a company among the many valuation methodologies that might be company-, industry- or situation-specific. Although the most common techniques are few — comparable company analysis, precedent transaction analysis and discounted-cash-flow (DCF) analysis — the underlying assumptions formulated by experts can vary greatly and have a material impact. Moreover, the nuances embedded in and driving the assumptions can be well hidden, requiring an in-depth understanding of the questions to impose on experts to determine the level of objectiveness or lack thereof.

A comparable company valuation is the easiest to perform. However, it does require that comparable companies have publicly traded securities so that the value of the comparable companies can be estimated properly. However, no two companies are perfectly alike, and as such, their valuations should not be identical. Finding a decent sample of comparables, if any, can be challenging. Thus, the selection of companies used as comparables must be carefully examined, or there is a risk of comparing apples to oranges. If a stock is thinly traded or only a relatively small percentage of stock is traded, the price might not reflect the fundamental value of the company.

A precedent transaction valuation is also relatively easy to perform, but it requires the specifics of a prior acquisition/divestiture deal to be known. For the transaction specifics to be known, publicly traded instruments are a must, and relatively few transactions might have occurred in some industries. Valuation multiples found in prior transactions typically include control premium and synergy assumptions, which often are transaction-specific and not public knowledge. Moreover, precedent transaction valuations are easily influenced by temporary market conditions, which fluctuate over time, and the current market environment might not be comparable. Thus, the size and quality of the transaction set utilized for valuation purposes can skew the results and needs to be analyzed by an expert.

A DCF analysis is one of the most reliable and often-used analytical tools to determine a company's value. It derives the fair market value of the common stock as the present value of its expected future free cash flows, typically calculated as operating cash flow less capital expenditures and changes in working capital. While the DCF analysis model arguably provides the best estimate of a stock's intrinsic value, it also relies on many forward-looking assumptions that experts can select to bias a value and need to consider carefully.

A DCF analysis is not heavily influenced by temporary market conditions, but it is very sensitive to modeling assumptions, particularly future performance forecasts, growth rates, profit margins, discount rates and terminal-value assumptions. As outer years of a projection model are forecasted, uncertainty and likely variations increase; erroneous assumptions in the first couple of years of a model can amplify variances in operating cash-flow projections in later years. Capital expenditures are largely discretionary, and investment assumptions can be elevated or depressed, especially in the outer years, to increase or decrease free cash flow.

Perhaps the most contentious assumptions in a DCF analysis model are the discount-rate and growth-rate assumptions. Depending on the desired valuation range, growth rates and profit margins can be overly optimistic or conservative. Discount rates are subject to the calculation methodology utilized (*e.g.*, weighted average cost of capital) and dependent on beta and risk-free interest rate assumptions. Terminal value, or the value of the enterprise after the cash-flow-projection period, along with the multiple utilized to determine terminal value, can wildly swing a DCF present-value calculation.

The benefits of mediating these disputes include minimizing legal costs (and expert fees), expediting at times the information and resolution of the dispute in the context of the process. Time can be money and independently has its own value in the process. There are two ways to approach this process: (1) Have a regular mediator serve to mediate the dispute by relying upon each of the parties' experts; or (2) have an expert in valuation serve as mediator (or co-mediator alongside a "regular" mediator) to handle the process. There are times when the valuation expert could be the mediator, provided that they independently possess the skill set to facilitate and conduct a mediation, but that is not often the case. In the instance of co-mediation, one can achieve the best of both worlds by hiring a top-notch valuation expert to work with an equally skilled mediator.

Utilizing an expert as the mediator or co-mediator requires the expert to not only hear the parties' various contentions, but to utilize his/her own knowledge and expertise to help the parties wade through and hopefully identify the strengths and weaknesses therein, so as to help facilitate a resolution. The expert must bring and maintain an impartial view of the dispute prior to and during the course of the mediation, have strong analytical skills and the ability to quickly perform complex calculations under a number of different scenarios, and have the ability to present findings in a succinct manner, as well as have the ability to adapt during the course of a mediation to new evidence or new arguments presented and to quickly adjust calculations in order to assist the parties and, if appropriate, the other non-expert mediator. Specialized industry expertise might also be warranted or beneficial.

One could ask, if each side has their own expert, why would we want to also have an expert serving as, or assisting, the neutral? Well, it depends on the nature of the dispute and its related complexity. As highlighted in some prior articles written for the *ABI Journal*, there can be a need to rely on some level of expertise (such as in the electronic-discovery arena) in a highly technical or complicated valuation dispute, and an expert in that area can bring value to the table. This value can be found in their easily grasping and understanding the various valuation methods and issues related to the use of one method versus another, and in being able to more easily test and assist the parties in evaluating the various risks, strengths and weaknesses in their arguments. Given that there is a legal backdrop for all of these, the need to have the non-expert mediator involved is very important. **abi**

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