Joint valuation retainers:

The right process in the right circumstances

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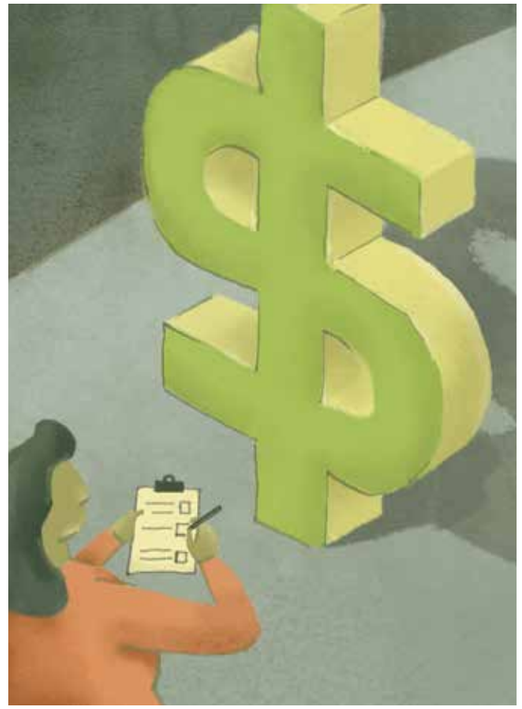
For disputes centred on the value of a business interest, the litigation paradigm is shifting from a battle of the experts (different valuators for the different litigants, each of whom often presents a different value conclusion) to a joint retainer format where one valuator or a panel of valuators is appointed to determine value in a process agreed to by the disputants, often outside the court system altogether.

The joint retainer format is unique in that the disputants make submissions to the valuator, sometimes through their own valuator, rather than to a judge. While in the litigation context it is common for counsel to instruct the valuator to assume certain things that will be proven (or not) during trial, this latitude for assumed facts, including scenario analysis, is not a common feature in a joint retainer format.

There is compelling logic for disputants to consider a joint retainer format, and it includes cost savings, timely resolution and reduced wrangling. These advantages evaporate quickly, however, if the ground rules are not set by the parties at the outset, typically in consultation with the valuator, because the entire valuation process can be derailed if a disputant (or the valuator) objects to the way the assignment is unfolding, whether justified or not, and there is no clear path to address these issues.

These bumps on the road arise because of the conflicting interests of the disputants: one disputant typically favouring a high price for the shares of a business, say, and the other a low one. The wrangling generally centres on the valuator's estimate of future cash flow and/or assessment of the risks of achieving it in the amounts and on the dates projected. (Risk is generally reflected in the valuation multiple.)

To minimize conflict, all parties should buy in to the process and the ground rules. This is not to say that the steps in the process cannot be modified during the course of the engagement, but it should be by agreement between the parties, including the valuator.



Valuation mandate

The following issues are important to consider when planning a joint retainer valuation process:

Question 1: What is being valued? Possible answers include the "en bloc" equity of the business; a particular class of equity shareholdings; a subset of a class of shares; the company's net assets; or a subset of the net assets.

Question 2: What is the mandate? The valuation mandate is the core issue. However, one or more of the parties may also seek other things, such as a forensic accounting review involving years of historical operating results. While the valuator will usually examine past financial results (for example, as part of an assessment to project future maintainable discretionary cash flow), this review is typically based on the assumption that the accounting and financial records are reliable. If malfeasance is suspected and a forensic review is to be part of the process, the terms of that review, where feasible, should be agreed to at the outset.

Question 3: What is the definition of value? Different definitions can lead to different value conclusions, all else being equal. One common definition is "*fair market* value," which Canadian jurisprudence defines as "the highest price available in an open and unrestricted market between informed and prudent parties acting at arm's length and under no compulsion to transact, expressed in terms of cash or cash equivalents." Another common definition, particularly where shareholder oppression is being asserted, is "*fair* value," which is fair market value without a discount

for minority interest positions.

Often a pre-existing shareholders' agreement between the parties sets out a value definition and perhaps even a valuation formula. The disputants must instruct the valuator whether the terms of the agreement(s) govern the process – the alternative being to discard them in favour of a new value definition and process. The disputants should consider consulting the valuator before deciding this issue. If other, non-financial, terms of the agreement(s) are in dispute and affect value, a third-party adjudicator with training in the law may be retained to decide these non-financial (essentially legal) issues.

Often enough, valuation formulas set out in such agreements are rudimentary or ambiguous. If the terms of the agreement prevail, recognize that the valuator's interpretation is undertaken from his or her perspective as an expert in financial analysis and valuation, and a lawyer's perspective may be different.

Question 4: What is the valuation date? Valuation principles hold that, with limited exceptions, the valuation will reflect only information that was known or knowable as of the valuation date. Hindsight – the use of post–valuation date information – is generally a non-starter.

This is an important concept to keep in mind because circumstances affecting the business's risks and opportunities change over time, and these changes affect value. Also, what was known and when are possible points of contention between disputants. For instance, a failed clinical trial can adversely affect the share price of a pharmaceutical company, but only from the date that the failure becomes known. Before that date there is merely a risk of failure, which risk is reflected in the valuator's analysis on that earlier valuation date.

Question 5: Is the valuator's conclusion binding? If not, what are the follow-on steps to attain resolution? For the valuation to be binding, there should be agreement on each of these issues (among others, as applicable), and the agreement should be memorialized in a joint letter from the disputants to the valuator.

Valuation process

In our experience, the valuator must have final say on the design and execution of the valuation process for one simple reason – it is his or her conclusion that is being sought. Often the disputants will suggest steps for the process. This is fine as far as it goes; the practical ideas get implemented while the rest are set aside.

A case where we were court appointed to provide our valuation opinion illustrates this point. Our engagement letter, which was duly executed by both parties, clearly specified our mandate and also provided an overview of the valuation process. Of chief importance to us was to have unfettered access to information relevant to our analysis. According to the agreed-on process we issued an information request, which was met with open hostility by the party in control of the records. We were criticized for requesting information that the party asserted was not relevant to our analysis. We responded with detailed explanations of why the information was relevant, but our access to the information was again refused. We resigned from the engagement since it became clear we were not going to be able to execute our mandate in a timely and cost-effective manner.

This example only highlights that, once established, it is important for all parties to respect the process, which is not to say the disputants can't present their positions or provide information not specifically requested by us. To the contrary, it is important for the disputants to express their views to the valuator and to each other – particularly important in cases where one disputant (for example, a silent partner) has less access to company information.

Communication protocols

As noted, the success of a joint retainer depends fundamentally on open communication and dialogue. Any communication to the valuator should be shared among all the parties, and all parties should be privy to the information that forms the valuator's scope of review – the building blocks underpinning the valuation conclusion.

Open communication is not without its challenges, particularly when there is pre-existing acrimony between the disputants or conflicting points of view regarding aspects of the business. Properly controlled, however, the benefits of open and transparent dialogue far outweigh the risks of discord.

For example, the process may include these protocols:

1. Any disputant may request a meeting, but the valuator may choose not to grant that request. To prevent abuses of the process, the valuator should retain the right to determine the propriety of the request.
2. All conference calls and meetings should be attended by representatives from each disputant. If one party cannot attend, the call may proceed with the permission of that disputant. In all cases, the valuator's notes from the meetings will be available for review by all disputants.
3. All letters and emails from one disputant to the other disputants, or to the valuator, must be copied to all parties.
4. All disputants are entitled to copies of notes from the valuator's meetings with third parties (such as industry representatives).
5. All disputants are entitled to copies of the information that forms the valuator's scope of review.

The draft report: Review and submissions

The valuation-reporting process generally provides that a draft report is issued to all disputants for review. The review process is used to confirm that the facts presented in the report are accurate and complete, as well as to allow the disputants an opportunity to comment on particular assumptions or analyses. In the context of a joint valuation assignment, it is also important that an agreed-on review process, including timelines for comments, be pre-set to avoid unnecessary delay in completing the assignment.

For example, the process may include these steps:

1. *Blind draft issued.* This draft report contains the complete analysis except for the valuation multiple/rate of return (and thus the valuation conclusion). The logic is simple: The valuator is seeking commentary on the underpinnings of the valuation, not on the conclusion. Perhaps, cynically, it is also a worry that a disputant's review of the contents of the report may get short changed if the conclusion is in the report and the parties focus only on "the number."
2. *Blind draft review.* There should be an agreed-on period (a certain number of business days) for the disputants to review the blind draft and a requirement that they provide their comments in written form. The disputants should submit written comments simultaneously, at an agreed-on time, with copies sent to all parties.
3. *Review of other disputants' submissions.* Each disputant responds to any submitted comments in the form of a second written submission. (Submissions are again simultaneously submitted by the disputants.)
4. *The valuator's review of the submissions.* The valuator reviews the written submissions and assesses the need for any adjustments to the draft report. Often the submissions address previously identified issues, but on occasion new information is brought to light.
5. *Complete draft issued.* After taking account of any necessary changes, the valuator issues a second draft report including the value conclusion.
6. *Complete draft review.* There may also be a similar review protocol followed for the complete draft, repeating steps 2 through 4; however, the review comments should be limited to items not previously identified in the blind draft.
7. *The valuator issues the final report.*

Summary

The joint retainer format can be an efficient and cost-effective method to resolve valuation disputes. However, success requires the disputants to buy in to the process and to commit to the terms of the ground rules. Having a defined process and steps to resolve any disputes is central to managing conflicting interests.