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The New Reality: Valuation in a Volatile Market

The Capital Commitment on **April 12, 2023**

Amid rising interest rates, tightening credit markets, geopolitical concerns in Europe and Asia, stubborn inflation and continuing supply chain issues, there is a growing sense of economic uncertainty. This uncertainty will no doubt increase the frequency of valuation disputes in the year ahead. We generally see valuation disputes spring from four primary sources:

1. breach of representations and warranties in purchase agreements, which raise questions as to company value absent the breach;
2. unfair prejudice to minority investors or limited partners;
3. disagreements about price paid at exit, including earn out disputes; and
4. increased regulatory focus on exams, which may assess valuation policies and require recurring asset valuations.

Valuation disputes tend to be centered on disagreements about accounting practices, dates of assessed value, and valuation methodology.

In times of financial uncertainty or distress, economic actors may gravitate toward less conservative accounting practices, which may be in tension with historical accounting practices. Market volatility is also a breeding ground for valuation disputes based on the date on which the valuation was determined, as rapidly shifting market conditions can have significant impacts on value.

Valuation claims can also arise from differences of opinion regarding the valuation bases or methodology. While the market value of most sponsor-owned portfolio companies would involve only an objective measure of an asset's value without regard to identity of the buyer or seller, plaintiffs sometimes argue that the portfolio company or asset had synergistic value, or value that is enhanced by the presence of other assets. Typical valuation methodologies include proposed and precedent transactions, discounted cash flow analyses, comparable companies and net asset value. Increased volatility usually brings these valuation methodologies to the forefront of disputes. Importantly, complex valuation claims often involve multiple valuation methodologies with a range of resulting valuations.

We are seeing one specific subcategory of valuation disputes – earnout disputes – growing in frequency. In *Airborne Health v. Squid Soap*, 984 A.2d 126, 132 (Del. Ch. 2009), Vice Chancellor Laster presciently described earnouts as "convert[ing] today's disagreement over price into tomorrow's litigation over the outcome." Parties contemplating using an earnout provision to bridge a valuation gap should ensure their counselors focus on potential future areas of dispute such as the earnout methodology, obligations related to the supply of information necessary to fairly apply and calculate an earnout, the form of earnout consideration, and jurisdiction and resolution of potential disputes.

Asset managers can take other proactive steps to mitigate the risks valuation disputes pose. One strategy is to prioritize fair and transparent valuation policies and procedures. This should be top-of-mind during times of financial volatility. Ensuring that one's valuation policies are fair and transparent is also a helpful differentiator in the asset management market. Sophisticated limited partners often examine a firm's valuation policies and procedures as an important part of their diligence before investing in a fund.

Given the breadth and diversity of the asset management industry, valuation policies and procedures vary greatly across it. Variations include (1) the frequency at which valuations are performed, including triggering events for additional valuations; (2) whether the general partner uses an independent valuation advisor or performs the valuations in-house; and (3) whether the valuation is performed by someone with expertise in the portfolio company's industry.

The ultimate question is whether the valuation procedures used will withstand regulatory and judicial scrutiny. That is more likely to occur if sponsors develop fair and transparent valuation policies before periods of financial uncertainty and consistently communicate material developments impacting valuation to the limited partners. A history of such communications can be a powerful tool in valuation disputes.

Economic uncertainty and related market volatility create additional challenges for valuation of privately held assets. Valuation policies and procedures used to value privately held companies need to account for current economic realities. Stale valuation policies and procedures premised on outdated economic circumstances can be a source of trouble. Some general partners employ a best practice of creating a valuation policy that is consistent but flexible enough to take into account changing circumstances while also incorporating circuit breakers tied to indicia of volatility which trigger interim reviews of those valuation policies.

Given the ongoing uncertainty in the economy and the expected increase in valuation disputes in the months ahead, asset managers would be well advised to proactively review their valuation policies and procedures with an emphasis on transparency in method and communication with stakeholders.

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