Restructuring valuation: towards a framework of principles to mitigate multi-party valuation fights in workouts

Broekema, M.J.R.; Adriaanse, J.A.A.

Restructuring Valuation

– Towards a Framework of Principles to Mitigate Multi-Party Valuation Fights in Workouts –

Given the current market unrest and turbulent economic climate, we see an increasing focus on the need for business restructuring and debt workouts, partly fueled by the changes in legislation in the area of financial restructuring outside of insolvency proceedings. Obviously, this also affects the practice of business valuators. Simply put, the need for valuation support in restructuring cases (we coin the term "Restructuring Valuation") is growing, both out-of-court and in-court.

Dr. Marc Broekema

Partner and co-founder of BFI, an independent business valuation and investigation firm based in Amsterdam focusing on complex business valuation issues, economic damage assessments, and insolvency-related valuations and investigations. Marc is also a part-time Assistant Professor at Leiden Law School, part of Leiden University, and a member of the European Membership and Standards Recognition Board of the International Valuation Standards Council (IVSC). Furthermore, he is a lay judge at the Enterprise Chamber of the Amsterdam Court of Appeal.

Professor Jan Adriaanse

Partner and co-founder of BFI and a Full Professor of turnaround management at Leiden Law School. He is also Academic Director of the Institute of Tax Law and Economics at Leiden University. Jan is engaged in research projects in the interdisciplinary field of financial distress, turnaround management, applied psychology, and insolvency law. He is an author on these subjects and a regular speaker and lecturer at international conferences and courses, including the Global Insolvency Practice Course (GIPC) organized by INSOL International.

Contact: ebvm@eacva.de

I. Introduction

Business restructuring can be described as the holistic process of taking strategic, organizational, leadership, and financial measures to recover a company's short and long-term viability. A workout can then be described as a voluntary agreement concluded between the affected parties with a financial interest in a company in distress and regards the review of conditions pertaining to available funding. It often constitutes a reduction of nominal debts through payment of a percentage in combination with remission of (part of the) remaining debt, a so-called "haircut".

Another option is the conversion of (part of the) debt into a subordinated loan or a so-called "debt holiday", i.e., temporary relief from installment repayments and or interest obligations. A "debt-for-equity swap" is another possible option, where lenders become (part) shareholders in exchange for a certain degree of debt alleviation leading to the debt burden being relieved.[1]

In this article, we focus on common bottlenecks in such processes, specifically those of valuation fights. Research and practice show that workout negotiations are often hindered by or even fail due to disagreements on the (perceived) value of the company to be restructured. Lengthy debates and negotiation processes are not uncommon, during which the financial state of the distressed company further deteriorates, and chances of survival often disappear. Moreover, perceptions can vary in such a way that dissenting parties simply cannot bridge the value gap consensually. For example, in our first contribution to this journal, we discussed a restructuring case in which there was a (maximum) difference between the calculated valuation outcomes of two parties of EUR 171 million.[2] Obviously, these differences in opinion – often leading to multi-party valuation fights – are detrimental, if not fatal.

We first discuss research on why restructurings fail in practice. We then address the problem of so-called cognitive biases and "noise" – as potential drivers of valuation fights in workouts. Third, partly based on results from an explorative study, we present a "framework of principles to mitigate multi-party valuation fights in workouts".

II. Why restructurings fail and the role of valuations

There is a great deal of empirical evidence for why restructurings fail. We include a list of the most common failure factors:

- Management and shareholders have a passive attitude towards the necessary restructuring, i.e., there is a lack of urgency to quickly take harsh measures.
- Partly because of the above, insufficient strategic, operational improvement, and cost-cutting measures are taken. Moreover, necessary business model change is neglected, commonly referred to as "management is rearranging the deck chairs on the Titanic" thus not handling the underlying problems.
- The company is unable to provide sufficient insights to key stakeholders into the actual financial situation, i.e., stakeholders are in the dark about the current and short-term cash position.
- Lack of a proper business turnaround plan. The plan should serve as a compass for company management in the turnaround process, not least in the negotiation process with lenders.
- Objective cashflow prognostications, showing a certain degree of going concern viability, are missing.
- Reliable valuations of the company are unavailable, and stakeholder negotiations are frustrated by different perceptions and multi-party fights on the value of the company. The result is an ongoing negotiation process in which parties increasingly take set positions, often fueled by their valuation advisors. Meanwhile, the company drifts into a state of bankruptcy.
- For the most part, because of the above, the company is unable to timely access bridge capital, for instance in the form of a cash injection from (new) lenders and or shareholders. Bridge capital should serve as the "oxygen" for a distressed company to explore and discuss long-term options with its key stakeholders, as well as to provide the company enough time to „fix the business".[3]

It is probably no surprise that these failure factors are in fact opposite and, consequently, supportive (like a "mirror") to the success factors of business restructurings as found in practice. Furthermore, these factors often tend to stem from the execution rather than the planning process itself. In other words, the behavior of management and key stakeholders regarding the problems is critical.

1 For an overview of financial instruments, see among others, A Toolkit for Corporate Workouts, Washington: World Bank Group, 2022.

2 Broekema/Adriaanse, Valuation Ambiguities under the European Directive on Preventive Restructuring Frameworks: Insights from the Netherlands, The European Business Valuation Magazine, vol. 1, no. 1 (2022): 4-10.

3 For an overview see Slatter/Lovett, Corporate Turnaround, Managing Companies in Distress, 1999; Adriaanse/Van der Rest (ed.), Turnaround Management and Bankruptcy, Routledge Advances in Management and Business Studies, 2017.

For the purpose of this article, it is important to stress that the chances of survival of a distressed company significantly increase when parties quickly agree on the reorganization value (i.e., assuming a renewed going concern premise) and liquidation value, as this brings clarity on the fair and economic position of all parties involved. This then opens the way for constructive and more objective (or better: less subjective) negotiations between management, lenders, creditors, and shareholders on the way forward, and on who should bear losses, and to which extent. This is often referred to in the insolvency industry as "being in or out of the money". However, although this sounds logical, practice is far more capricious, with factors like "cognitive bias" and "noise" playing a major role in restructuring valuations. We elaborate on this in the following section.

III. The problem of biases and "noise" in valuations

In recent years, the topic of "psychology in business" has been gaining popularity, both in academia and in practice. Academic research in the valuation and insolvency law domain is increasing, especially regarding decision-making processes. For example, empirical research shows that judges, bankers, valuation experts, and insolvency law experts are susceptible to many forms of cognitive biases or „fallacies" when in a situation where they are required to make rational judgments and professional decisions.[4] These professionals are not alone in this; all human beings are susceptible – no one is infallible.

Biases can be defined as patterns of irrationality i.e., humans can be affected in their judgments and decisions by factors that should if they were to behave fully rationally, not have any bearing on these judgments and decisions. A number of common biases observed in the field of restructuring valuation are:[5]

- *Engagement bias:* In experimental research by Leiden University, it was found that business valuators tend to unconsciously favor their client's interests. They adjust the perceived value of a company significantly downwards when representing a buyer, and upwards when representing a potential seller. The same information and valuation method were used; therefore, the theoretical outcomes of the experiment should have been similar. In valuation restructuring practice we observe the same phenomenon; we are rarely confronted with a valuation outcome that intuitively contradicts the economic interest of the represented party.

- *Anchoring bias:* In the same study, it was also found that business valuators are susceptible to anchoring bias, i.e., when confronted upfront with a desired result – expressed through an anchor like a value – from a client's perspective (in the specific context of this article, this could be lenders in a debt workout who desire a certain low outcome to justify a debt-for-equity swap). It unconsciously leads to an outcome in the range of that result. A control group, that did not receive any information upfront about the desired result, was significantly less likely to adjust an outcome in a certain direction.

Obviously, these biases form a breeding ground for (destructive) conflicts in a workout situation.

Another disturbing topic is the psychological concept of "noise", a phenomenon that has recently gained interest due to the work of Nobel prize winner *Daniel Kahneman*, together with fellow researchers *Oliver Sibony* and *Cas Sunstein*.[6] Noise concerns the occurrence of unwanted variability in judgments that should in fact be identical (or at least more or less equivalent) when asked to a group of experts with similar professionalism. It is therefore not about bias. The latter rather concerns a systematic deviation in a certain direction, while noise lacks systematics. However, it should be noted that noise may also occur within the phenomenon of bias. The starting point is that with an accurate decision, all decision-makers (read in this context: professional business valuators) should end up approximately in the middle of an imaginary dartboard („*bull's eye*"). Thus, they all take (roughly) the same decision based on a specific case description and equal information. Where the decisions actually go in all directions, that is noise. Incidentally, the possibility of an accurate or correct/best decision (the bull's eye) does not always play a role.

This also applies to valuations in a restructuring situation. However, this does not lessen the problem of noise. Even when no (in)correct answer is possible, a large degree of variability is undesirable, especially in a workout context where a high degree of variability leads to multi-party conflicts, uncertainty, and possibly, a drift into bankruptcy.

4 For instance, Broekema/Strohmaier/Adriaanse/Van der Rest, Are Business Valuators Biased?: A Psychological Perspective on the Causes of Valuation Disputes, Journal of Behavioral Finance, vol. 23, no. 1 (2022): 23-42.

5 Authors acknowledge that up till today, more than 150 biases have been discovered in the social sciences. For further study see, among others, Ghisellini/Chang, How Many Real Biases Are There? In: Behavioral Economics, Palgrave Macmillan, 2018.

6 Kahneman/Sibony/Sunstein, Noise. A Flaw in Human Judgment, London, 2021.

Decades ago, the American judge Marvin Frankel drew attention to major differences in perception, analysis, and decision-making by professionals, although he did not call it "noise" at the time. He commissioned a study of the judgments of fifty judges on a series of cases that were identical for each participant. He concluded, "Absence of consensus was the norm". As an illustration, the sentence for a heroin dealer ranged from one to ten years, and in a judicial case of blackmail, the sentences ranged from a $ 65,000 fine to twenty years in prison.

Other studies also show a similar, significant degree of noise in judgment and decision-making. For example, research into a thousand verdicts from juvenile courts in America showed that stricter sentences were handed down on Mondays if the local American Football team had lost the weekend before, an effect which also trickled down to the rest of the week, albeit to a lesser extent. That the mood of a judge influences a verdict has also been demonstrated in France. An analysis of six million judgments over a period of twelve years demonstrated that judges were more lenient if it was the suspect's birthday. Finally, a four-year study of 270,000 asylum applications found that an asylum application was less likely to succeed on hotter days.

In short, noise in professional judgments apparently arises from relative differences between evaluators, their personal characteristics, and arbitrary situational factors.[7] In this article, it is relevant to observe that valuation professionals are probably also vulnerable to noise. Combined with the biases, this leads to the conclusion that many valuation conflicts in corporate workouts probably arise due to at least these psychological aspects. In the next section, we discuss whether it is possible to mitigate their effects.

IV. A framework of principles to mitigate valuation fights in workouts

A review of the literature shows that, in practice, mitigating biases and noise is difficult. For example, even when decision-makers are explicitly made aware of the fact that biases may occur, they still can be trapped. However, it is worthwhile exploring ways to mitigate biases and noise, especially in cases where specific strategies and principles for practice are developed. We present a framework of principles to mitigate potential valuation fights. We first discuss the conceptual idea behind such standards. Then, we present seven specific principles for workout practice and discuss how these should be applied in the field.

7 For further information on the studies see Partridge/Eldridge, The Second Circuit sentencing study: A report to the judges of the Second Circuit. Federal Judicial Center, 1974 and Chen/Loecher, Mood and the Malleability of Moral Reasoning: The Impact of Irrelevant Factors on Judicial Decisions, 2016.

1. The conceptual idea behind principles

The literature on the impact of principles on professional performance is mixed, with some studies reporting little evidence of a significant effect, with others demonstrating a more significant impact.[8] In particular, research in the private sector, where most business valuators operate, highlights the importance of effectively implementing principles as part of a learning process that involves instillation, reinforcement, and measurement. However, a sudden and full adherence to new principles to address biases and noise in restructuring valuation practices may be unrealistic given the autonomy of professionals in the field. Nevertheless, a framework of principles with a certain purpose (mitigating biases and noise as proposed in this article) serves as a reflection of the need to protect both the private interests of the profession – read: *credibility* – and the public. In this specific case, we refer to stakeholders in a restructuring context, with economic and legal rights that need to be respected and protected.

The extent to which the implementation and enforcement of the principles we propose will benefit the valuation profession and the restructuring field requires further study, but findings in a similar area provide a starting point. In 2000, INSOL International – a worldwide federation of professionals with over 10,500 members who specialize in turnaround and insolvency – introduced the „Statement of Principles for a Global Approach to Multi-Creditor Workouts".[9] It was drawn up by more than 150 restructuring experts and endorsed by the World Bank, the Bank of England, many international commercial banks and consultancy agencies, as well as the British Bankers' Association (with 320 banks as members; established in more than 60 countries).

The core of this statement – consisting of eight principles to be applied in restructurings and workout negotiations – soon became recognized by professional stakeholders in the restructuring field, who now regard the principles as a *best practice* for dealing with complex workout negotiations.

The main characteristics of the eight principles are summarized in table 1.

8 For an overview of the literature on (the difficulty of) debiasing strategies and principles in practice, see among others Morewedge/Yoon/Scopelliti/Symborski/Korris/Kassam, Debiasing Decisions: Improved Decisions Making With a Single Training Intervention. Policy Insights from the Behavioral and Brain Sciences, vol. 2, no. 1 (2015): 129–140.

9 For more information see www.insol.org. In 2017 a slightly revised version of the statement was introduced under the name „Statement of Principles for a Global Approach to Multi-Creditor Workouts II".

Table 1: Summary of principles of the INSOL Statement of Principles for Multi-Creditor Workouts

Principle	Characteristic
1	The relevant creditors voluntarily mark time, i.e., create an informal cooling-off period
2	None of the creditors takes any individual action on the condition that their relative positions remain intact
3	The debtor (the company in financial difficulties) does not take any actions which may jeopardize the relative (economic) positions of the creditors
4	To speed up the communication and decision-making process, creditor groups are formed (groups of secured, senior, and junior creditors for instance)
5	To be able to evaluate proposals for solutions, the debtor must grant the relevant creditors timely and full access to all relevant information
6	All proposals for workout agreements must be formulated based on prevailing legislation and the relative economic positions of the creditors
7	All information must be available and should be treated confidentially
8	When new (bridge) financing is provided during the restructuring and as part of a workout deal, it must be given priority status by all participating creditors

The fundamental objective of the INSOL principles can be defined as follows: (i) jointly creating a relatively stable situation where none of the parties take any individual action to prevent a chaotic and, for the company, potentially life-threatening “race to collect”; (ii) to create a free flow of information on which all parties within the process can take informed decisions, without worsening their relative economic positions. In other words, this informal set of principles ensures:

> “...a cooperative basis by which lenders/creditors recognize individual and collective risk at a point in time and keep that balance throughout an agreed debt recovery strategy [workout] that seeks to preserve business”.[10]

The INSOL statement underlines two aspects. First, it shows that professional practitioners can and will use principles when it is (potentially) beneficial for desired outcomes. In the case of workouts, this is a more efficient process with less risk and more benefit for all stakeholders involved. Second, a specific statement of principles to mitigate valuation fights as proposed in this article may help to spur the chances of success of a workout in which the INSOL principles are already applied. More specifically, it can help mitigate conflicts between involved parties regarding their economic positions (see principle six).

To conclude, the general lack of formal regulations (“hard law”) in the field of business valuation means that the use of informal principles (“soft law”) might counteract the effects of bias and noise among valuators in the context of workouts. This approach seems well suited to the nature of the valuation profession, and the underlying idea is supported through the widespread adoption of soft principles and standards by other professional organizations, such as federations of corporate professionals (accountants, lawyers, brokers, bankers) and organized professionals such as surgeons or archivists. Principles may also serve as practical guides for ethical behavior, beliefs, and evaluations, as formal rules are commonly too restrictive for that purpose.

2. Exploring a framework of principles

In this section, we present the framework of principles to mitigate multi-party valuation fights in workouts [hereafter: the framework]. We first introduce the methodology followed by a detailed substantiation of each step of the framework.

a) Methodology

The framework has been inspired by previous research into the use of principles and the application of principles used in different professions.[11] We used this as a starting point and tailored it to the specific context of workout situations.

b) The seven principles framework

The overarching objective of the seven principles is to help increase the chances of survival of distressed companies. The principles should be seen as mutually supporting (co-dependent) and together they form an entity – the framework.

Principle 1: Valuation biases, noise, and workout conflicts awareness training

Part of business valuators’ education should be mandatory training to create awareness around biases, de-biasing strategies, and noise, especially in the context of workouts. The underlying aim of this training program is to enable business valuators to experience the (negative) effects of their own biases, what noise is, and how biases are formed by others. Participation in this awareness training program will contribute to preventing unconscious decision-making processes in the context of business valuation and workouts.

10 See World Bank Group, op. cit. (footnote 1): 31.

11 Among others see Wessels/Boon, Soft law instruments in restructuring and insolvency law: exploring its rise and impact, TvOB, no. 2 (2019): 53-64.

Moreover, valuators should train themselves in the specific field of corporate turnaround and financial restructuring to understand the (basic) concepts: (i) cause of decline analysis, (ii) strategic analysis and risk assessment in distressed situations, (iii) turnaround planning, (iv) insolvency legislation, and (v) stakeholder dynamics in restructuring. Although this may sound obvious, it is our experience that not all valuators understand the specific complexity and challenges of companies in distress. For example, the "hold-out" problem with creditors or the uncertainty surrounding commercial opportunities of distressed companies when financial problems become public can result in going-concern scenarios "overnight" becoming insolvency scenarios. Furthermore, company management – the prime provider of input information for the valuation process – might be too optimistic or have other reasons to claim and substantiate (perceived) going concern value.

Simply put, the valuation of a distressed company is often far more complex than the valuation of a successful, fast-growing, or mature company. To conclude, valuators' being aware of and understanding "distress dynamics" is crucial to mitigate conflicts in practice.

Principle 2: Debiasing and noise-reducing information processing protocol

Biases and noise often result from exposure to irrelevant and or prejudiced information. To reduce this risk of bias and noise, such information should be withheld from a business valuator. To protect the executive business valuator from being exposed to potentially predetermining information, a second person (i.e., the lead valuator) conducts the intake with the client and filters out the irrelevant information.

As discussed, engagement bias leads to business valuators unconsciously favoring their clients' wishes, while from a purely theoretical perspective, it should not matter to valuators whether they work for, in the case of workouts, the company, its shareholders or (a syndicate of) lenders. By building in a "filter" to separate irrelevant information, for instance, prejudiced, unsubstantiated opinions about the market, the company itself, and/or its strategic outlook, from relevant, substantiated, objectified information, deviations are (theoretically) mitigated. As a result, conflicts among parties regarding value outcomes decrease.

Principle 3: Avoiding knowledge of the client's value perception

When business valuators are asked to value a business or a business interest in a workout situation, they should avoid having any knowledge of the client's value perception towards the valuation object, either through the client or through the client's representative. This principle specifically addresses the phenomenon of anchor bias.

Financial distress concerns a situation in which the stakes are high, the more because the parties involved (e.g., lenders, shareholders) realize that their investments are likely to (partially) vaporize. This can initiate the "race to collect", where parties try to get as large a "piece of the pie" as possible. Clearly, while involved in intense restructuring negotiations, these parties will regularly pressurize the hired valuator to devise a favorable outcome for them, given the specific situation and legal or economic position.

As an example, shareholders will probably want to avoid a debt-for-equity swap as with that they (fully or partly) lose economic and or voting rights. With that in mind, the so-called reorganization value of the company should be as high as possible as then shareholders will be "in the money", in a theoretical liquidation scenario. The consequence is that lenders cannot, in principle, force shareholders to give up shareholder rights because, in a pure theoretical bankruptcy scenario, all lenders should and will be satisfied. Thus, shareholders have an incentive, as clients, to pressurize business valuators to propose an outcome that proves otherwise. If not, they might put pressure on the business valuator to adjust the outcome with "suggestions", for example, alternative insights on the company and its market or the cost of capital.

We earlier introduced the phenomenon of engagement bias, so in the scenario sketched above, this increases the risk of business valuators (unconsciously) being manipulated. Alternatively, this may also occur when lenders are the valuators' clients, with a preference for a low outcome, for example, to merely make a debt-for-equity swap happen. To conclude, the business valuator should avoid interference from the client as much as possible while executing the valuation process, in particular about the preferred outcome for the workout deal to be negotiated.

Principle 4: Signaling subjectivity and performing a debiasing and noise-reducing exercise with a colleague

When business valuators are engaged through a client or another professional such as an insolvency lawyer to support a client's interests, they should be aware of any subjective party information that might influence their perceptions regarding the valuation object. At the initial stages of the engagement, the business valuator must check which elements might affect the perception of the valuation case using a practical "valuation biases and noise checklist". When finalizing the valuation work, valuators then compare their work with the initially listed elements together with at least one colleague who was not engaged in the project and amend the valuation assumptions if necessary.

Principle 5: Criteria setting on quality of valuation to align mutual expectations

When business valuators are requested to conduct a valuation in a workout situation, the executive business valuator discusses (principle 2) the (non-technical) client evaluation criteria before conducting the valuation. In case of doubt regarding mutual expectations, the executive business valuator takes the initiative to discuss this with the business valuator. The topics of "potential valuation biases and noise" must form part of the discussion with the client.

Principle 6: Four-eyes principle

Business valuators should, through confidential conversation, discuss their valuation assumptions and valuation outcomes with at least one colleague, the Four-eyes principle. Preferably, the discussions should include several peers before releasing the final valuation report. The topic of "potential valuation biases and noise" should explicitly be discussed and documented among engaged peers.

Principle 7: Mirroring to assess the "other party" perspective

Business valuators should always consider an alternative valuation scenario – in addition to their initial valuation outcome – from the perspective, position, and potential criticism of their client's counterpart(s). The initial valuation outcome should then be reconsidered and amended if necessary. In a workout situation, this means that at least one or two additional perspectives should be considered, for example from the lenders' and or shareholders' point of view if the business valuator represents company management, and vice versa.

V. Conclusion

In this article, we introduce a framework of principles to mitigate valuation conflicts in workouts. The framework has been designed to serve as a discussion starter for the professional business valuation field. The urgency to discuss the role of business valuations in financial restructurings is especially relevant because of the increasing turbulence in the European business climate. Simply put, "the restructuring season is starting" and the business valuation community should be critical of its role in the restructuring field. Lessons need to be learned, and practices should be improved to ensure the profession is considered fully credible in the eyes of the other parties at the workout table, including insolvency practitioners, lenders, creditors, and board members.

It is evident that the debate on how valuation fights can be mitigated in workouts should also take place among the sector organizations active in or relevant to the international restructuring practice e.g., the European Association of Certified Valuators and Analysts (EACVA), the International Valuation Standards Council (IVSC), valuation professional organizations (VPOs), INSOL International and INSOL Europe. The international academic community can also make an active contribution to establishing mitigation principles. Meanwhile, individual business valuators can apply the principles proposed in this article, or critically review the current use of self-developed principles and quality procedures in this regard. ◆