

**SHARE VALUATION
AND
FAMILY LAW
A PARMENTIER ARTHUR SEMINAR
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THE SPEAKERS

Steve Lygo is a Director of Parmentier Arthur Group Plc. Prior to joining Parmentier Arthur in 1998, he worked in what was then the Shares Valuation Division of the Inland Revenue (SVD), initially as a case worker in a general valuation team. In 1995 he helped form SVD's Appeals Team, which dealt with 'problem' cases and supported the Inland Revenue Solicitor's Office in appeal hearings before the Special Commissioners. Since joining Parmentier Arthur, he has continued to specialise in unquoted share and business valuation. His work with Parmentier Arthur encompasses the provision of valuation advice in the context of tax, share schemes, litigation support and commercial situations. He has appeared as an expert witness on valuation matters in connection with family law proceedings, shareholder disputes and breach of warranty claims.

Robin Arthur is the Managing Director and founder of Parmentier Arthur Group Plc, the parent company of Parmentier Arthur Tax Services Limited and Parmentier Arthur Corporate Finance Limited. Robin worked for the Capital Taxes Office of the Inland Revenue, including the Shares Valuation Division, until leaving in 1973 for tax consultancy in the City of London. He was called to the Bar in 1976. Since 1975, when he founded Parmentier Arthur, he has specialised in the field of unquoted share valuation and related areas of taxation, supporting other professional practitioners in the fields of accountancy, law and taxation. Robin has lectured widely on share valuation matters over the past twenty years including engagements in the United States and Canada.

1. INTRODUCTION – IS A VALUATION NECESSARY?

Priority placed on valuing unquoted shares and businesses in family law cases subject to changing fashions over time.

Until *White v White* Courts generally followed the approach in *Potter v Potter* in dealing with business assets.

Focus was on the wife's reasonable requirements and the husband's ability to pay.

Might involve general consideration of the sources of the husband's income and capital plus liquidity, but detailed valuation of the business avoided if possible.

Is a valuation necessary?

Minimising costs was a significant factor in this approach.

Principles in *Potter v Potter* followed in a number of later cases, e.g. *B v B*, *P v P* and *Evans v Evans*.

Court's approach summed up by Lincoln J in *B v B*:

“Fine tuned assessments of the value of a spouse’s business are meaningless and irrelevant where the business produces the family’s income and is not to be sold” [B v B 1989 1 FLR 119 FD].

Court required a broad assessment of value rather not a precise valuation.

White v White

Situation changed following *White v White*.

New emphasis on achieving fairness in divorce settlements recognising each party's contribution party to the marriage.

House of Lords judgments in the *Miller v Miller* and *McFarlane v McFarlane* appeals reinforced the importance of fairness to both parties.

Since *White v White* expert evidence to establish the value of business assets held by the parties has become more important.

D v D and B Ltd

Possibly the pendulum has begun to swing back the other way with recent case *D v D and B Ltd* [2007] EWHC 278.

Suggests focus should not just be on valuation and liquidity for purposes of a clean break but also on alternative “commercial” solutions, possibly involving periodic payments.

Costs and proportionality

Unlikely therefore that a valuation will be needed in every case where matrimonial assets include unquoted shares or a business.

Other situations where a detailed valuation may not be desirable on cost grounds include:

- Where the business is small and the cost of obtaining a valuation is disproportionate to the amounts involved
- Where the business is a sole trader or 'one man band' reliant on the input of one of the parties and is unlikely to be sold

Costs and proportionality

- Where the value of the business can be established by other means, for example a serious offer to buy received from a third party

However, principle of fairness remains and in appropriate cases a detailed valuation may be the only means of achieving this.

2. THE VALUER'S INSTRUCTIONS

Valuer needs clear unambiguous instructions specifying the issues he is required to comment on.

Typically the valuer will be asked to address gross and net (i.e. after tax) shareholding values and liquidity (can the shares be turned into cash and, if so, how?)

Since D v D and B Ltd valuer may also be instructed to consider other issues such as the company's capacity to fund periodic income payments.

One value or a "bracket" (range of values)?

Where instructions are open to different interpretations valuer may need clarification from instructing solicitors, or possibly the Court .

Example – minority shareholding in Garston Ltd

Valuer is instructed to “prepare a report as to the market value of Hector’s interest in Garston Ltd”.

Hector has a 30% minority shareholding in the company and the remaining shares are owned by Boris and Clive with 35% each.

Company is very profitable but distributes only a small proportion of its profits as dividends and re-invests the rest in building the business.

Example – minority shareholding in Garston Ltd

The shareholders are all in their early 40's and not connected to each other.

There are no plans to sell the company.

The Articles of Association contain strict pre-emption provisions which require a departing shareholder to sell his shares to co-shareholders at a formula-based price well below the company's value on a trade sale.

Example – minority shareholding in Garston Ltd

Does requirement to value Hector's interest in the company limit the valuer to considering just the formula price on exit?

Is the company's 'true' value relevant even if it is not actually for sale?

Alternatively, should the "market value" of Hector's interest simply reflect the (low) value of the dividends Hector receives from the company?

Without specific guidance, the valuer would probably take all factors into account but this may not have been the intent of the Court or the interpretation of instructing solicitors.

Single joint experts

Increasingly valuer's instructions will be to act as a single joint expert (SJE) in valuing the shares.

Worthy aim of minimising costs by avoiding multiple expert reports, experts' meetings, court attendance and cross-examination.

However if only criteria for instructing SJE is cost aim of achieving fairness may be compromised if inexperienced or superficial valuation is relied on.

'Unfair' value (materially too high or too low) may result if corners have been cut and important issues glossed over.

Instructing the SJE

Ideally SJE's instructions will be agreed by both parties but this is not always possible.

If the parties cannot agree terms of reference, each side may instruct the SJE separately.

This can cause problems where the instructions differ in substance, or where the two sides interpret the same instructions differently.

Avoid this situation if possible as separate instructions likely to result in increased costs.

3. SHAREHOLDING SIZE AND MINORITY DISCOUNT

Minority and majority holdings

Size of shareholding (usually measured as proportion of voting share capital) highly relevant to share value and possibly also to valuation methodology.

Control and voting influence are the key issues.

Minority and majority holdings

In most situations, minority value will be lower than pro rata value:

- Pro rata value equates to whole company value (i.e. 100% of the share capital), reflecting the market value of the company on a trade sale
- Minority value will either reflect a “discount” from pro rata value or be calculated in a different way, for example on a dividend yield basis

Whole company value

Usually arrived at on a capitalisation of profits basis.

Accounting profit may have to be adjusted to allow for non-commercial overheads.

Balance sheet (asset value) also relevant, particularly if profit low or company loss-making, or for investment companies.

Whole company value should allow for any 'surplus cash' (i.e. amounts above company's reasonable needs) or non-business assets owned by the company (e.g. investment of 'lifestyle' properties, expensive cars, works of art) as an addition to trade sale value.

Why do pro rata and minority values differ?

Value differential recognises benefits of voting control to a majority shareholder including the right to determine:

- The company's day to day management
- Strategic issues such as business direction and focus
- Liquidity issues (return of capital) including whether a trade sale or public listing is pursued
- The composition of the company's Board and the amount of directors' remuneration
- The company's dividend policy

Why do pro rata and minority values differ?

Minority shareholder typically has limited influence at best in these areas.

Minority value also reflects a number of disadvantages inherent in an investment in a privately owned company:

- No open market for private company shares unless the company floats on the stock exchange or is sold, so the shareholder cannot simply sell his shares (“unmarketability”)
- The company’s Articles of Association probably impose restrictions on transfer (e.g. a Board veto and/or pre-emption provisions), which may require the shareholder to accept a disadvantageous sale price

Why do pro rata and minority values differ?

- The majority shareholder controls the dividend policy and may decide to retain profit in the company or extract it in some other way, e.g. directors' bonuses
- As a result the pool of potential purchasers is limited

Minority discount

Minority value often referred to as a “discounted” value, which implies a direct relationship with whole company or pro-rata value.

This is not necessarily the case as a minority value may be either:

- A ‘top town’ value, i.e. derived from whole company value but incorporating a discount to allow for lack of voting control and any other minority disadvantages such as unmarketability
- A ‘bottom up’ value reflecting either the company’s actual profits (i.e. without adjusting for excessive directors’ remuneration etc) or a valuation method that doesn’t involve placing a value on the company, e.g. dividend yield approach

Minority discount

The 'bottom up' approach is generally preferred by HMRC in tax valuation situations but may be inappropriate for family law purposes in family-owned companies, 'quasi partnerships' or if a shareholder "exit" (usually a sale, public listing or liquidation of the company) is expected.

Factors influencing level of discount

Discount depends on the facts of the case. For example:

- Large minority interests tend to attract lower discounts than very small holdings
- Discounts tend to be lower where no single shareholder has overall control
- Where the shareholding holds the balance of power between opposing camps the discount may be small or non-existent
- Definite plans to liquidate, sell or float the company likely to justify lower discounts than if there was no 'exit route' in prospect
- Where the company is on the point of being sold the discount may be nominal

Discounts in majority situations?

Majority holdings representing 75% or more of the voting share capital likely to be valued at pro rata value, i.e. a discount will generally not be appropriate.

Some discount (perhaps 5% - 10% depending on the facts) may be justified for smaller majority holdings (50.01% - 74.99%) which do not provide unfettered control (75% or more needed) for Companies Act purposes.

4. INFORMATION

Valuer aims to arrive at an objective assessment of value which is fair to both parties without disproportionate expenditure of time and associated costs.

Realistic value depends on reliable information about the company.

What information is relevant?

Valuer is interested in information likely to impact value

Initial focus probably on the following:

- The business (what it does, how it makes money, who its customers are, what its prospects are)
- The financial statements/accounts of the company or business ideally covering at least the last three complete accounting periods
- The Articles of Association (for a company) or partnership deed (for a partnership) which define the parties' rights in the business

What information is relevant?

- How the other shares/partnership interests are held (business partners? family members? outside investors?)
- Whether the success of the business is dependent on the continued involvement of one of the parties
- Whether there have been recent arm's length transactions in the company's shares

Proportionality

Proportionality kept in mind but these issues may have to be considered even in 'smaller' cases to reach a broadly realistic value.

Much of the information will not be disclosed in the company's accounts (particularly if modified accounts are filed with Companies House).

If so, information will have to be obtained from the company or the party involved in the business (the 'insider').

Where the sums involved are substantial and/or the business is complex, valuer may require a considerable amount of additional information to arrive at a justifiable conclusion.

Confidential information

Could involve access to unpublished or commercially sensitive information such as:

- Management accounts, budgets, forecasts and business plans
- Summary of key contracts or client relationships on which the future success of the business depends
- Details of the remuneration (salaries, bonuses, pension contributions, benefits in kind etc) received by the main participants and their families
- Details of any offers or expressions of interest from potential purchasers of the business or discussions with brokers concerning a public listing
- Details of any recent transactions in the company's shares

Issues to address

Some of the issues the valuer may need to consider are:

- Has the pattern of the business changed significantly since the last financial statements were prepared? (For example the company may have gained or lost an important customer contract so that historic profits are not a guide to future prospects or value)
- Is the remuneration taken by the directors significantly more (or less) than the market rate for the industry or sector? If so, the profits shown in the annual accounts may not indicate true value
- Do the company overheads include other non-commercial costs, which a purchaser of 100% of the company would not incur?

Example – Bramcote Ltd

A simple example (based on a recent case) illustrates the potential impact these issues can have on value.

Bramcote Ltd is a small private company operating in the telecoms sector.

- Bramcote is owned by husband and his brother, each with 50%, and they are the only directors
- Trading premises owned by company pension fund. Company pays annual rent £60,000 but ‘market rate’ is £40,000

Example – Bramcote Ltd

- Directors salaries (£88,000 each) and benefits (£8,000 each) broadly in line with market rates for the sector but annual pension contributions (£34,000 each) are on the high side
- Neither wife works in the business but each paid an annual ‘salary’ of £15,000
- The widowed mother, who never worked in the company, receives an annual ‘pension’ of £15,000 from the company

Example – Bramcote Ltd

Necessary to adjust company's profits for valuation purposes to allow for:

- Generous pension contributions (perhaps £50,000 more than the 'market rate')
- High rent (£20,000 above market rate)
- 'Family payments' (£45,000 a year and included as staff costs for accounting purposes)

Example – Bramcote Ltd

	From accounts £	After adjustment £
Turnover	2,400,000	2,400,000
Gross profit	840,000	840,000
Directors' salaries & pensions	(260,000)	(210,000)
Staff costs	(325,000)	(280,000)
Rent	(60,000)	(40,000)
Other overheads	(140,000)	(140,000)
Profit before tax	55,000	170,000
Possible company value assuming, say, six years purchase	330,000	1,020,000
50% share assuming no discount	165,000	510,000

Profit adjustments indicate 'true' value of husband's 50% shareholding is over three times the value the accounting profit suggested.

Changes in accounting policy

Company's accounts also susceptible to manipulation and disguise by controlling shareholder by changing historic accounting policies, e.g.

- Increasing depreciation provisions on business assets (such as property, vehicles, equipment etc)
- Bringing forward extraordinary costs or provisions relating to future periods
- Accruing for, say, directors bonuses which may not ultimately be paid but which could reduce the level of profitability shown in interim (management) accounts
- Arbitrary changes in the level of inter-company charges where the company is part of a group

Changes in accounting policy

The effect of these changes, which may be legitimate in themselves, could be to depress current profit so the company appears to be less profitable than in the past.

Change in accruals policy (effectively providing for a deferred liability) could also reduce balance sheet value.

Obtaining information

Persistence may be needed where insider's full co-operation not forthcoming.

Insider's responses will sometimes raise new issues and partial answers may require clarification.

Process of gathering information can become drawn out and time-consuming as a result.

May impact valuer's ability to complete his report within the time allowed by the Court, particularly if one side engages in delaying tactics.

Obtaining information

If the 'insider' is unwilling to provide information, ultimately it may be necessary to obtain an order from the Court.

Valuer should ensure only essential information pursued and all parties must be aware why the information is needed.

Assuming the application is opposed, the Court may compromise and order disclosure of some of the information only.

Potentially significant impact on the valuer's conclusion, particularly if the primary motive for opposing the application was to exclude 'valuation sensitive' information.

Obtaining information

Complication where the 'insider' is a director and aware of unpublished information relevant to the valuation but not the controlling shareholder.

Board of directors may decide disclosure of management or confidential information is not in the company's interests.

Valuer can provide a confidentiality undertaking but this may not be sufficient to persuade the Board to co-operate.

Doubtful that the Court would order the company to comply and the expert's opinion of value may have to be qualified.

5. QUASI PARTNERSHIPS AND FAMILY OWNED COMPANIES

Historically value differential between minority and majority holdings has been acknowledged by the Courts.

In family law cases may not apply to:

- Family owned companies
- So-called 'quasi partnership' companies

Family owned companies

Where one party has a minority interest in a company controlled by their family, Court may conclude the company is operated on a consensual basis for the benefit of all family members.

If so, there may be little or no discount for minority status.

May be the right approach if it reflects the reality of the situation.

See *A v A* [2004] All ER (D) 329 where the Court took a different view.

Quasi partnership companies

In *G v G* [2002] 2 FLR 1143 the Court did not allow any discount in valuing the husband's 19% holding on the grounds that:

- The company was a 'quasi partnership', and
- The husband's shareholding would only be sold in conjunction with those of the other founders

G v G has been followed in a number of subsequent cases and seen by some as marking the end of "minority discounts" in family law situations.

What is a quasi partnership?

Concept originates in case law concerning the oppression of minorities under what is now s459 Companies Act 1985.

Broadly defines a situation where:

- A company embodies the personal relationship and mutual confidence of its founders
- There is an understanding that they will participate in the conduct of the business and be remunerated accordingly
- Restrictions on the transfer of shares prevent a shareholder from withdrawing his stake and going elsewhere (see *O'Neill and another v Phillips and another* [1999] 2 BCLC 1)

What is a quasi partnership?

Case law mostly relates to situations where a minority shareholder claims unfair exclusion from the running of the company following a break-down of their relationship with the other shareholders.

Where Court concludes that a 'quasi partnership' existed and the actions of the majority have unfairly prejudiced the interests of the minority, Court may order the minority bought out at an undiscounted price.

Allows excluded shareholder to extract capital without financial penalty under pre-emption provisions in the Articles of Association etc.

What is a quasi partnership?

Purchase price not necessarily synonymous with market value but reflects the wide discretion the Court has in determining what is fair (see *Re Bird Precision Bellows Ltd* [1986] Ch 658).

Note that both conditions ('quasi partnership' and unfair prejudice) must exist, e.g. *Phoenix Offices Supplies Ltd and others v Larvin* [2002] EWCA Civ 1740.

Court of Appeal accepted the company was a 'quasi partnership' but did not order buyout at undiscounted price as minority shareholder chose to retire.

G v G

Main company founded in 1980s by husband and two fellow shareholder/directors and had grown significantly over the years. Second company founded recently, considerable potential but not yet profitable.

Shares now more widely held, some by trusts on behalf of adult offspring of founders and others by non-founder directors.

Three founder directors held 57% between them at time of trial (19% each).

No dispute between the founders and other shareholders under no obligation to buy if the husband wished to sell his shares.

G v G

Husband could not simply 'extract his capital and go his own way'.

Husband likely to receive 'best price' if shares held until the company was sold.

However same situation faced by most minority shareholders in private companies and reflects illiquid nature of unquoted shares.

Virtue or vice?

Value can go down as well as up!

G v G

Court made no allowance for the fact that the husband could not dictate if or when the company would be sold or the possibility that the founder shareholders might disagree over timing.

Husband could be forced to sell at a disadvantageous price if he had to realise his investment before the others wanted to.

Same value per share would have applied if husband owned 100% of the company in his own right, with total control over company's affairs and freedom to pursue a sale whenever he wished.

Husband effectively treated as owning a more valuable asset than he held in reality.

G v G

Not widely recognised but two companies/shareholdings in *G v G*

Smaller company set up as a 'quasi partnership' with shareholders in main company plus others.

Court accepted 75% discount for minority interest in smaller company.

A v A

Does later case of *A v A [2004] EWHC 2818 FAM* represent a departure from *G v G*?

A v A involved shares in a family owned company rather than a 'quasi partnership' but issues similar.

Wife's holding 25.4% in family company, X Ltd, which paid substantial dividends. Wife also employed in the company.

Valuers agreed her shares would fetch around £5m if the company were sold but disagreed on present value.

A v A

Judge clearly familiar with many of the issues faced by the valuer of shares in a private company, e.g.

- Effect of pre-emption provisions
- Impact on value of delay in realising an investment
- Effect of remuneration of family directors on profit
- Propensity of family members to buy shares

A v A

Characterised as “a business approach” to valuation.

Court considered value in a number of scenarios distinguishing:

- Likely company sale price (i.e. £5m)
- Value of the holding on an income producing basis (around £2.8m)
- Price other family members might pay for the shares (around £2m)

A v A

Not clear how different values were balanced in the final judgment as husband did not claim lump sum payment based on an equal division of total value of all matrimonial assets.

Shares treated as providing income stream for wife for child maintenance.

Court seemingly recognised that unless the company were actually sold, division of assets on the basis of whole company sale price might not be fair.

“Business” or “commercial” approach subsequently followed in *D v D and B Ltd*.

6. THE VALUER'S REPORT

Valuer's report must be:

- Objective
- Proportionate to the amounts involved
- Prepared in accordance with Part 35 of the Civil Procedure Rules

Detailed and comprehensive report may be appropriate in 'big money' cases where private company shares form a significant component of total matrimonial assets



The valuer's report

Time and expense of a detailed report unlikely to be justified in smaller cases.

These issues should have been discussed with the legal advisers at the outset and an approach agreed.

Other issues

It may be appropriate for report to address ancillary issues to assist the Court, even if not expressly included in valuer's instructions. For example:

- The consequences of liquidating a company
- The capacity of the company to buy in a spouse's shares through a purchase of own shares
- The income stream the company is capable of providing in the future

The bracket

The valuer's instructions may have required him to provide a range of possible values ("the bracket") to allow for a number of different scenarios, such as those identified in *A v A*:

- Value on a sale of the company
- Value on the basis of pre-emption rights in the Articles of Association
- Value on an income providing basis
- Value by reference to a sale to other shareholders

If so, the differing values should be clearly distinguished in the valuer's report to ensure there is no confusion.

Issues the valuer cannot resolve

Issues of fact which the valuer cannot determine are best addressed by providing alternate values leaving it to the Court to decide on the correct approach.

Examples include situations where it is claimed:

- The company is a 'quasi partnership' (whether this is so and if valuation on a pro-rata basis is appropriate)
- The 'insider' is a key man and is likely to leave the company (whether or not valuation should be on the assumption that the 'insider' will leave the company)