

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

Thursday 26 June 2008

Steve Lygo

Peter Wyatt

Parmentier Arthur Corporate Finance Ltd

90 Long Acre

Covent Garden

London

WC2E 9RZ

Tel: 020 7849 3018

Fax: 020 7849 3171

email: steve.lygo@parmentierarthur.com

7 The Waits

St Ives

Cambs

PE27 5BY

Tel: 01480 465522

Fax: 01480 461221

email: peter.wyatt@parmentierarthur.com

Law Society Accreditation Reference: BUY/PARG

CPD Points 1½

Disclaimer

These notes are not intended to be exhaustive and they should not be regarded as such. Neither do these notes offer specific advice. They are merely an outline of the subject matter.

No liability will be accepted in respect of actions taken or refrained from as a result of information given herein or given by the author during the presentation. Specific professional advice should always be obtained.

**Copyright Parmentier Arthur Group Plc:
may not be reproduced without permission.**

THE SPEAKERS

Steve Lygo is a Director of Parmentier Arthur Group Plc. Prior to joining Parmentier Arthur in 1998, Steve 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, litigation support and commercial situations, including the sale or purchase of private companies and negotiations between shareholders. He has appeared as an expert witness on valuation matters in connection with family law proceedings, shareholder disputes, professional negligence and breach of warranty claims.

Steve is listed in the Law Society's Directory of Expert Witnesses as experts in the field of valuing unquoted shares and businesses.

Peter Wyatt

After taking a law degree, Peter qualified as an accountant with Coopers & Lybrand, his final position being Senior Manager in the Toronto office. In 1979 Peter left Coopers to join Indal Ltd, a Canadian subsidiary of RTZ. Peter was appointed Vice-President Financial Controller in 1983 and VP Corporate Development in 1987 with responsibility for the group strategic plan, evaluation of capital expenditure, and the group's acquisition and divestment strategy. Following RTZ's decision to sell Indal, Peter joined Parmentier Arthur. His work with us focuses on company sales, commercial and litigation support valuations across a wide range of industry sectors, preparation of business plans and raising finance.

1. THE VALUER'S INSTRUCTIONS

Ideally clear unambiguous instructions specifying the issues valuer is asked to comment on

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

Valuer may also be asked to consider other issues such as the company's capacity to fund periodic income payments (*D v D and B Ltd*)

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

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

Example – 30% 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 (3,000 shares) in the company

- Remaining shares are owned by Boris and Clive with 35% each
- Shareholders all in their early 40’s and not connected to each other
- No plans to sell the company

Example – minority shareholding in Garston Ltd

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

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

- Average profit after tax ('PAT') for last three years
- Profit multiple ('P/E ratio') of 5
- Value of holding = pro rata value (i.e. no minority discount)

Example – 30% 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 actual value relevant even if it is not 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

Example – 30% shareholding in Garston Ltd

	Yr 1 £	Yr 2 £	Yr 3 £
Turnover	2,600,000	3,770,000	5,500,000
Gross profit	1,325,000	1,960,000	2,930,000
Admin costs	(975,000)	(1,270,000)	(1,650,000)
PBT	350,000	690,000	1,280,000
Tax	(98,000)	(193,000)	(358,000)
PAT	252,000	497,000	922,000
Dividends	30,000	60,000	90,000
Net assets	307,000	744,000	1,576,000

Example – 30% shareholding in Garston Ltd

1) Dividends

- Holding value say £270,000 - £338,000 (8% - 10% yield)
- **Formula value**
- Company value = £2,785,000 (5 x average PAT of £577,000)
- Holding value = £835,500 (30%)

3) Actual value?

- Company, say = £10,000,000 (8 x Yr 3 PBT)
- Holding value = £3,000,000, possibly subject to discount



- **INFORMATION**

Valuer aims to arrive at an objective assessment of value

- That is fair to both parties
- Without disproportionate expenditure of time and associated costs

Realistic value depends on reliable information about the Company

Valuer is interested in information likely to impact value

What information is relevant?

Initial focus probably on the following:

- The business (what it does, how it makes money, who its customers are, what its prospects are)
- Its financial statements/accounts ideally covering at least the last three complete accounting periods
- Its Articles of Association (if 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

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 reasonable value

Confidential information

Some of the information likely to be unpublished or commercially sensitive 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

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

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

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

Incomplete information may impact the valuer's conclusion, particularly if the primary motive for non-disclosure was to exclude 'valuation sensitive' information

3. SHAREHOLDING SIZE AND MINORITY DISCOUNT

Minority and majority holdings

Size of shareholding is a major factor in share value

Control and voting influence are the key issues

Shareholding size may also have a bearing on valuation methodology with different approaches often used to value majority and minority holdings

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 may either reflect a “discount” from pro rata value or be calculated in a different way, for example on a dividend yield basis

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
- 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 holding shares 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 sell at a disadvantageous 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

In practice usually limited to existing shareholders, family members, Directors and other employees

Whole company value

Usually arrived at on a multiple of profits basis for trading companies

Accounting profit may have to be adjusted to allow for non-commercial overheads (e.g. high directors' salaries)

Balance sheet (asset value) also relevant, particularly if company is loss-making or if activities are investment holding (property or quoted securities)

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

Example – Bramcote Ltd

A simple example (based on a recent case) illustrates the potential impact non-commercial overheads 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 directors' pension fund and Company pays annual rent £60,000
- 'Market rate' rent 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 high
- 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 above 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 holding assuming no discount	165,000	510,000

Profit adjustments indicate actual value of husband's 50% shareholding may be over three times the value suggested by the accounts

Minority discount

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

In practice 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

May be inappropriate for family law purposes, particularly

- In family-owned companies
- In 'quasi partnership' situations
- Where 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:

- 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 (5% or less)

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

Majority holdings of 50.01% - 74.99% do not provide unfettered control for Companies Act purposes (75% or more needed)

Discount of 5% - 10% may be justified in these cases depending on circumstances

4. CHANGES IN ACCOUNTING POLICY

Valuer will analyse a company's results (statutory and management accounts) in detail for a number of years

Aim is to identify:

- Trends
- Deviations from historical patterns
- Unusual items of expenditure or income

Unusual items or deviations from trend, especially if they result in lower profitability, may indicate an attempt to manipulate earnings

Manipulation of accounting information

Profits are susceptible to manipulation by a controlling shareholder in a number of ways:

- Accounting policies may be amended or more strictly interpreted than in past years
- Trading terms with associated companies can be varied
- Provisions for liabilities, both actual and contingent, can become more conservative

Important to note that management accounts often only account for accruals, changes in stock levels and bad debts on an annual basis so position 'in year' may be misleading even if no manipulation has occurred

Audit requirements

Note that a company does not require a statutory audit if its annual sales are below £5 million and its balance sheet total is £2.8 million or less

In non-audit situations:

- It is the responsibility of the directors (often in reality the controlling shareholder) to ensure that the company's accounts are prepared in accordance with generally accepted accounting principles and give a true and fair view of its operations
- The company's accountants have merely to satisfy themselves that the accounts appear to have been properly prepared although in many cases some enquiry into obviously unusual items will take place

Changes in accounting policies

A company should follow consistent accounting policies from year to year but these are capable of a broad range of interpretation

Areas most susceptible to manipulation include:

- Stock and work in progress valuations
- Capitalisation of costs
- Depreciation

Changes in accounting policies

Lowering **stock and work in progress valuations** will depress profits

This may be achieved in a number of ways:

- Shortening the period in which stock is deemed to be “obsolete”
- Eliminating an element of overhead in its valuation
- Taking a more conservative view of profit recognition in long-term contracts

Changes in accounting policies

Costs which have been formerly capitalised may be expensed

Examples can include:

- Deferred development expenses
- Raising the general level at which costs are eligible for inclusion as a “fixed asset”
- Expensing IT costs formerly written off over an extended period

Changes in accounting policies

Depreciation rates can be increased to give a faster write-off of associated assets

These actions may well fall within accepted accounting practice but their timing may be suspicious and will probably show as a deviation in trend

Trading terms with associated companies

Controlling shareholder of a company may manipulate trading terms with associated businesses to depress its own profitability and transfer profits

Manipulation of profit

An example from a recent case:

The Respondent was a majority shareholder in a company which imported plastic replacement windows from a low-cost Eastern European country of which he was once a national

Analysis showed that the gross profit margins earned by the company were well below those earned by its UK competitors and that material costs appeared unusually high

While the transfer of company profits to the supplier of the windows through excessive purchase costs could not be proven, the questioning of this and other issues by the valuer lead to an out-of-court settlement

Provisions for liabilities

In some cases provisions for liabilities may be capable of precise calculation e.g. accruals for:

- Utility bills
- Rent
- Commissions
- PAYE and NI
- Equipment rentals

Provisions for liabilities

Others may rely upon estimate and/or assessment of risk, e.g.

- Current litigation
- Warranty provisions (where the company's product has a guarantee period)
- Discount sales vouchers (which may or may not be presented)
- Bad debt provisions
- Directors' bonuses

These provisions are the most susceptible to manipulation

Current litigation

Provision against a negative outcome may or may not be appropriate

Although the likelihood of a materially negative outcome may have been assessed as low, a “conservative” view may result in a provision in the accounts

In this case, the valuer could discount any negative impact on profits as non-recurring with no impact on the ongoing profitability of the company, unless litigation is a regular occurrence

Warranty and sales voucher provisions

Increased provisions for warranty exposure and discount vouchers outstanding cannot be dismissed as “one-off” occurrences

Valuer should review the history of actual expense and assess the current provisions in this light

Any deemed over-provision should be added back to profits

Bad debt provisions

A bad debt provision can be:

- Specific (based on actual debts)
- General (based upon a percentage of sales)
- A combination of the two

Bad debt provisions

The age of the debt is the principal way to assess collectability, the older the debt (beyond the company's terms), the less likely settlement

The company may have a practice of providing in full for all debts say, six months beyond payment date or assess on a case by case basis

General provisions should be based on actual experience, similar to warranty provisions

Directors' bonuses

Management accounts may include a provision for directors' bonuses which may or may not be paid:

- Does the company have a history of such payments?
- If not, what is the justification?
- If so, do they conform to historical patterns?

5. QUASI PARTNERSHIPS AND FAMILY OWNED COMPANIES

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

In family law situations this value differential may not apply in the case of:

- 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 did not take this 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 s994 Companies Act 2006

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 require a departing shareholder to sell at an unfair price (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 was not excluded and chose to retire

G v G

Company founded in 1980s by husband and two fellow shareholder/directors and had grown significantly over the years

Shares became 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 (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 this is the same situation faced by most minority shareholders in private companies and reflects illiquid nature of unquoted shares

Turning vice into virtue?

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 accept a disadvantageous price if he had to sell his shares before the others

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?

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
- Family members not certain to buy shares at pro rata (i.e. undiscounted) price

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*

1. LIQUIDITY

Valuer will usually be asked to comment on “liquidity”

Can the party owning the shares turn them into cash or raise cash against them?

Possibilities include:

- Selling the shares
- Extracting cash from the company by other means (e.g. dividends or directors’ bonuses)
- Using them as security against a loan

Sell the shares

May be feasible if other shareholders have the cash and are willing to buy

Possible that in a family owned company family members may be more willing to help out but funding still an issue

Potential difficulties with transfer provisions and/or rights under a shareholders' agreement which might impose restrictions on share sales

Sale in the open market unlikely to be possible

Sell the shares

If the Company has surplus cash a share buy-back may be possible

Company must also have sufficient reserves to make the buy back

Tax rules are complex and differentiate between

- “revenue buy-back” – excess over par value taxed as a dividend (maximum 25% income tax)
- “capital buy-back” – taxed as a capital gain at 10% or 18%

To qualify for “capital buy-back” shares must have been held for at least five years and the buy-back must benefit the business in some way

Dividends and bonuses

Dividends must be paid to all shareholders (or all shareholders holding same share class) unless some sign a waiver

Maximum income tax on dividends 25% for higher rate taxpayer

Minority shareholder probably not in a position to insist on a dividend

Situation may be different if no overall control or in family company

Directors bonuses may be an alternative means of extracting available cash from the company

Shares as loan security

Often suggested as a possible way of raising cash to fund clean break settlement

If borrower defaulted and lender took shares lender would become a minority shareholder:

- Probably unable to sell shares at all or possibly only at a disadvantageous price
- Income dependant on controlling shareholder who determines dividend policy

Highly unlikely that a bank or reputable financial institution would lend on the security of a minority interest in an unquoted company for these reasons