



Share Valuation and Family Law

A Parmentier Arthur Seminar

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Speakers

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Share Valuation and family law

Topics to be covered:

1. What factors influence share value?
2. What information does the valuer need and does it really have an impact on value?
3. Can the company's accounts be relied on?
4. Liquidity – can private company shares be turned into cash?
5. What is a quasi partnership and is the concept relevant in family law?



1. WHAT FACTORS INFLUENCE SHARE VALUE?

Concepts

Main value drivers:

- Voting control (share value of a majority holding typically more than for a minority holding)
- Income return i.e. capacity to pay dividends (particularly relevant to minority shareholders)
- Likelihood of a capital return (usually when the company is sold or wound up, or if shares become saleable)

Where present, these factors tend to **increase value**



Minority and majority holdings

Size of shareholding is a major factor in share value

Shareholding size may also have a bearing on valuation methodology e.g.

- **Majority value** derived from pro rata value, which reflects the market value of 100% of the company's share capital 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



Why do pro rata and minority values differ?

Voting control allows majority shareholder the right to determine:

- Day to day management and 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

Minority shareholder typically has limited influence at best in these areas



Why do pro rata and minority values differ?

Minority value 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 Articles of Association often 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
- The majority shareholder may decide to retain profit in the company or extract it in some other way, e.g. directors’ bonuses, rather than pay dividends



Why do pro rata and minority values differ?

As a result the pool of potential purchasers of minority shareholdings is very limited

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

Because supply will generally exceed demand, a sale will probably be in a buyers' market which depresses price/value



Whole company value

Typically reflects a multiple of profits for profitable trading companies (e.g. x times maintainable pre-tax profit)

Accounting profit may have to be adjusted to allow for non-commercial overheads (e.g. excessive 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) as an addition to trade sale value

Whole company value

Example – Cole Ltd

Profitable engineering company achieving regular annual profit of £250,000 after paying two shareholder directors £400,000 each in salaries and bonuses

Current and deposit account balances approximately £1.2m but company only needs £200,000 working capital

Notional profit c.£750,000 if market rate salaries assumed (say, £150,000 for each director)

Company value, say,

- Six times £750,000 assumed profit = £4.5m
- Addition of £1m surplus cash gives total value of £5.5m



Minority value/discount

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

In practice minority value may be either:

- A ‘top down’ value, i.e. derived from whole company value but incorporating a discount to allow for lack of voting control and 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

Minority value/discount

Example – Ditz Ltd

Husband owns 5% of Ditz Ltd, a profitable software company which pays annual dividends of 50p (50%) on its 200,000 £1 issued shares

Maintainable profit (after tax) considered to be £350,000 (£1.75 per share)

Possible minority value:

- Yield of, say, 6% on 50% dividend = £8.33ps
- Profit multiple (price earnings ratio) of, say, 5 on £1.75 ps profit = £8.75ps



Minority value/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 where the company is run on a consensual basis for the benefit of family members
- In 'quasi partnership' situations
- Where a shareholder "exit" (usually a sale, public listing or liquidation of the company) is expected



Factors influencing level of minority discount

Discount depends on the facts of the case:

- Large minority interests tend to attract lower discounts than very small holdings
- Discounts usually lower where no single shareholder has overall control
- Lower discount likely where some dividend is being paid
- Firm 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. discount generally not 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



2. INFORMATION

Valuer's task is to arrive at an objective assessment of value:

- Value must be reasonable
- Value must be fair to both parties
- Process should avoid disproportionate expenditure of time and unnecessary costs

Realistic value depends on **accurate** information about the company and its business



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)
- Full financial statements/accounts ideally covering at least the last three annual accounting periods
- Whether the business depends on key individuals or a small number of major customers
- The role of the husband/wife in the business, their remuneration and whether other family members are employed by the company



What other information is relevant?

- The Articles of Association or partnership deed which define shareholder or partner rights in the business
- How the other shares/partnership interests are held (business partners? family members? outside investors?)
- Details of any recent arm's length transactions in the company's shares (possible evidence of market value)
- Summary of any plans to sell the company or list its shares on a public exchange (shares become saleable)



Confidential information

Some of the information may be unpublished or commercially sensitive such as:

- Management accounts, budgets, forecasts and business plans
- Details of key contracts or client relationships on which the future success of the business depends
- The remuneration (salaries, bonuses, pension contributions, benefits in kind etc) received by the main participants and their families
- Summary 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



Proportionality

Valuer's approach must be proportionate given amounts involved and the size/complexity of the business

Two sins to avoid:

- Costly and over-detailed analysis with excessive, unnecessary detail
- Inadequately supported 'broad-brush' conclusions leading possibly to unfairness if the Court has to reach decisions on inadequate information



Example – Wooden Horse Ltd

A simple example (based on a recent case) illustrates the potential impact of unpublished information on value

Wooden Horse Ltd is a small private company operating in the telecoms sector

- Owned by husband and his brother (50% each)
- Both are directors; there is also a third director who is not a family member
- Trading premises owned by directors' pension fund and company pays annual rent £60,000
- The accounts show £350,000 total directors salary costs (but not the split between directors) and “company pension costs” of £70,000



Example – Wooden Horse Ltd

Enquiries established the following:

- The non-family director receives a market rate salary; the salaries of the husband and brother are generous but not excessive
- Most of the company pension costs reflect contributions made for the husband and brother (£34,000 each)
- Both wives receive an annual ‘salary’ of £15,000 although neither works in the business (treated as staff costs in the accounts)
- The widowed mother, who never worked for the company, receives an annual ‘pension’ of £15,000 (treated as staff costs not pension)
- ‘Market rate’ rent on the trading premises would be approximately £40,000 pa



Example – Wooden Horse Ltd

The company's **value** reflects its capacity to achieve profits allowing for **commercial costs** only

Necessary to adjust accounting profits for valuation purposes to allow for:

- Generous pension contributions (say £50,000 above the 'market rate')
- High rent (£20,000 above market rate)
- 'Family payments' (£45,000 a year)

Example – Wooden Horse Ltd

	From accounts £	After adjustment £
Turnover	4,200,000	4,200,000
Gross profit	1,400,000	1,400,000
Directors' salaries & pensions	(420,000)	(370,000)
Staff costs	(565,000)	(520,000)
Rent	(60,000)	(40,000)
Other overheads	(240,000)	(240,000)
Profit before tax	115,000	230,000
Possible company value assuming, say, x 6 profit multiple	690,000	1,380,000
50% share holding assuming no discount	345,000	690,000

Profit adjustments from unpublished information suggest actual value of husband's 50% shareholding is twice the value arrived at using the published accounts

3. MANIPULATION OF ACCOUNTING INFORMATION

Audit requirements – types of accounts

TOTAL EXEMPTION - a small or medium-sized company can file unaudited, abbreviated accounts:

- A small company is defined as one with two of the following characteristics - sales of £5 million or less; balance sheet value of £2.8 million or less; and 50 or fewer employees
- A medium-sized company is defined as one with two of the following 3 characteristics - sales of £22.8 million or less; balance sheet value of £11.4 million or less; and 250 or fewer employees



Audit requirements – types of accounts

Both types of company can file abbreviated accounts:

- A small company need only file a balance sheet and notes
- A medium-sized company need only file an abbreviated profit and loss account (critically without sales data), a balance sheet and notes

In both cases accounts should be prepared in accordance with generally accepted accounting principles (“GAAP”)

Abbreviated accounts are unlikely to provide sufficient information for a valuation



Audit requirements – types of accounts

FULL ACCOUNTS must be filed for most companies not meeting small and medium-sized company criteria and must be audited

MANAGEMENT ACCOUNTS are internally prepared, usually on a monthly or quarterly basis for management purposes and unaudited

May not be prepared on the same GAAP basis as the company's annual accounts



Audit requirements – types of accounts

In non-audit situations:

- It is the responsibility of the directors to ensure that accounts are prepared in accordance with GAAP and give a true and fair view of the company's operations
- The company's accountants only have to satisfy themselves that the accounts appear to have been properly prepared
- Accountants will only enquire into obviously unusual items



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

Changes in accounting policy may impact profitability, for example

- Lowering stock and work in progress valuations will depress profits
- Treating R & D costs as an expense rather than capitalising them as an asset will lower profits
- Increasing the depreciation rate of fixed assets (e.g. plant, vehicles, office equipment, computers) intended to write them off over their useful life will lower profits



Manipulation of accounting information

Profits can be manipulated by a controlling shareholder in a number of ways:

- Accounting policies may be amended or more strictly interpreted than in past years (e.g. increasing depreciation rates from 10% p.a. to 25% p.a.)
- Trading terms with associated companies can be varied to transfer profit or possibly divert business to a second company
- Provisions for liabilities, both actual and contingent, can become more conservative (e.g. higher bad debt provisions will depress profits)



Management accounts

Treat with caution as may reflect different accounting policies compared to annual accounts

May include a provision (accrual) for discretionary costs which may never be paid (e.g. large directors' bonuses)

- Does the company have a history of such payments?
- If not, what is the justification?
- Are the amounts excessive in themselves?

Even if no manipulation has occurred, interim management accounts may only allow for accruals, changes in stock levels and bad debts on an annual basis so position 'in year' may be misleading



Valuer's role

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

Aim is to identify:

- Trends
- Departures 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



4. LIQUIDITY

Likely to be an issue in most business cases and valuer usually asked to comment

Issue: can the party owning the shares turn them into cash or raise cash against them?

Possibilities include:

- Selling the shares to another shareholder or third party
- Selling the shares to the company
- Extracting cash from the company by other means (e.g. dividends or directors' bonuses)
- Using them as security against a loan



Sell the shares to a shareholder or third party

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 are funds available?

Sale in open market unlikely to be possible

- Potential difficulties with transfer provisions and/or rights under a shareholders' agreement which might impose restrictions on share sales
- Demand from third parties probably limited as a result



Sell the shares to the company

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

Company must also have sufficient reserves (i.e. undistributed profits) to make a buy back

Tax rules are complex and differentiate between

- “revenue buy-back” – excess over nominal value of shares taxed as a dividend
- “capital buy-back” – presently taxed as a capital gain at 10% or 18% but this may change

To qualify for “capital buy-back” shares must have been held for at least five years, the buy-back must benefit the business and shareholding must be substantially reduced



Dividends and bonuses

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

Minority shareholder 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 depends on attitude of controlling shareholder who decides 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

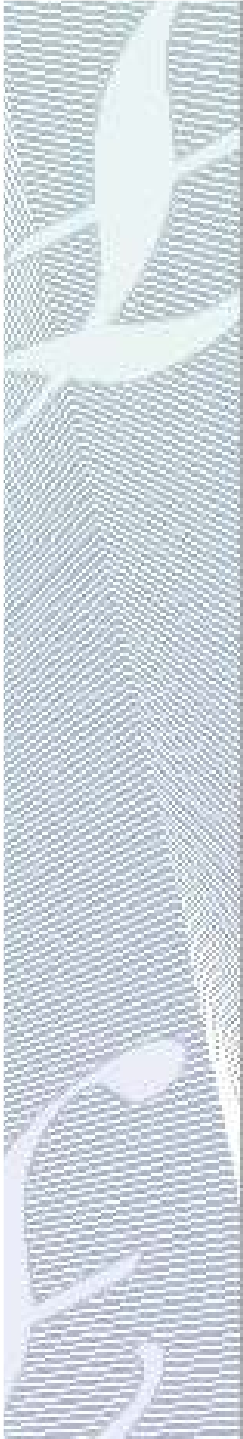


5. QUASI PARTNERSHIPS AND FAMILY LAW

What is a quasi partnership?

Concept originates in case law concerning the oppression of minorities under what is now s994 Companies Act 2006. Broadly applies 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?

Example – Greatest Capes Ltd:

- Tom, Dick and Harry are former employees of KaPow Plc and have known each other for 15 years
- In 2001 they left KaPow to form Greatest Capes Ltd, an on-line fancy dress hire company, owning 33.3% each
- Tom, Dick and Harry remortgaged their houses to finance the company and worked together to build a very successful business
- The Articles of Association stipulate that a shareholder must sell their shares if they cease to work for the company at “the market value of the shareholding as determined by the auditors of the company for the time being”



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 the relationship between 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 imposed by pre-emption provisions in the Articles of Association etc



What is a quasi partnership?

Example – Greatest Capes Ltd:

- In 2009, an old disagreement between Tom and Harry over business direction came to a head. Dick sided with Harry and they decided Tom should be dismissed
- Tom was sacked and told to sell his shares to Dick and Harry in accordance with the Articles of Association
- The auditors valued the company at £6m and applied a 65% discount in valuing Tom's shares as a minority interest

What is a quasi partnership?

Example – Greatest Capes Ltd:

- Tom was required to sell his shares for £700,000 but claimed £2m (£6m x 33.3%)
- Tom sought legal advice following his dismissal and eventually succeeded in an action under s.994
- The Court ordered Dick and Harry to pay £2m for Tom's shares on the grounds that Greatest Capes was a quasi partnership and Tom had been unfairly excluded without a reasonable offer for his shares



What is a quasi partnership?

Market value of Tom's 33.3% interest may have been £700,000 - £1m

Purchase price reflects the wide discretion the Court has in determining what is fair (see *Re Bird Precision Bellows Ltd [1986] Ch 658*)

Both conditions ('quasi partnership' and unfair prejudice) must exist for this treatment to apply

E.g. in *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 and had not been excluded



Are quasi partnerships relevant in family law?

In *G v G* [2002] 2 FLR 1143 the Court did not allow a discount in deciding the value of 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 marked the crossover of the quasi partnership concept from corporate law into family law



G v G – basic facts

Company founded in 1980s by husband and two fellow shareholder/directors (originally 33.3% each)

Shares gradually became more widely held, e.g. by trusts on behalf of adult offspring of founders and by five new directors

Three founder directors in their late 50s/early 60s when case heard, holding 57% between them (19% each)

Founders thinking about eventual retirement but timing not decided and no 'exit strategy' yet in place



G v G – the husband's situation

Husband had not been forced out of the company and relations between founders were amicable

Other shareholders under no obligation to buy if the husband wished to sell his shares

Husband could not simply 'extract his capital and go his own way' if he decided to sell

In practice husband would probably have to accept a disadvantageous (discounted) price if he needed to sell shares (e.g. to raise cash to fund a settlement)



G v G – valuer's analysis

Undiscounted value would apply if husband owned 100% of the company, with total control and freedom to pursue a sale whenever he wished

Value should reflect the husband's situation:

- 1) Holds 19% minority interest not 100% (-)
- 2) Part of the Main Board with significant influence over the company's affairs (+)
- 3) Shareholders intend to sell company within 5 years (+)
- 4) No market for husband's shares in the meantime (-)



G v G – valuer's analysis

Liquidity/unmarketability issues cannot be ignored

Discount of 50% - 70% might be justified because of 1) and 4)

However much lower discount appropriate due to 2) and 3), say 20%

Is it right to treat shares as more valuable in a family law context than they would be in a real sale situation?

Good law or bad law?