The Correct Way to Value a Company

James Wibberley, Guildhall Chambers

Sandra Mossios, Grant Thornton

1. Share valuation arises in numerous contexts across litigation, but the most common is in unfair prejudice disputes where (usually, though not exclusively) an order is made in favour of the oppressed minority that the majority should buy them out. So well worn in the path to this remedy, it is often accepted as the likely outcome so the litigation – both pre and post issue – revolves more around the valuation of the petitioner's interest than the allegations of unfair prejudice themselves.

2. The purpose of this talk is to explore the way in which the court will approach this valuation exercise, focussing on the particular sticking point of whether to discount (and if so, how) a minority interest.

<u>The Basic Approach</u>

3. It is important at the outset to identify that there are two aspects to the valuation exercise: the legal question and the expert evidence question. It is for the court to tell the expert(s) what they are valuing, when the valuation should be conducted as of, and of any special considerations that need to be considered (e.g. return of sums wrongfully taken from the company). It is then for the expert to undertake the exercise.

4. This is not to say that the two aspects are entirely separate or that they should be undertaken in isolation. Self-evidently, it will often make sense to obtain expert evidence about what a company was worth at different dates before deciding whether to take any points on the date of valuation. Similarly, it may only be through a forensic examination of the company's finances that it will be possible to determine if the actions of the (alleged) wrongdoer have resulted in a fall in the company's fortunes. It is simply that it is for the court to determine what, when it comes to the final valuation of the share interest to be purchased, is being valued.

5. In terms of the court's approach, aim is to reach a valuation that is fair on the facts of the individual case (see *Re Bird Precision Bellows Limited* [1984] Ch 419). Although there are certain rules or presumptions that have been adopted over the years, these are not cast in stone if the facts of the case demand a different approach.

6. This point is best illustrated in relation to the date of valuation. The starting point is that the valuation should be conducted as at the date when the shares are going to be purchased. See the judgment of Nourse J in *Re London School of Economics Limited* [1985] BCLC 273 at 281.

As Nourse J made clear though, this is simply the *prima facie* position and therefore subject to the overarching requirement of fairness.

7. The factors the court will consider when looking at whether to adopt a different valuation date set out by Robert Walker LJ in *Profinance Trust SA v Gladstone* [2001] EWCA Civ 1031; [2002] 1 BCLC 141 at paragraph 61 as follows:

"The general trend of authority over the last 15 years appears to us to support that as the starting point, while recognising that there are many cases in which fairness (to one side or the other) requires the court to take another date. It would be wrong to try to enumerate all those cases but some of them can be illustrated by the authorities already referred to:

(i) Where a company has been deprived of its business, an early valuation date (and compensating adjustments) may be required in fairness to the claimant (Meyer).

(ii) Where a company has been reconstructed or its business has changed significantly, so that it has a new economic identity, an early valuation date may be required in fairness to one or both parties (OC Transport, and to a lesser degree London School of Electronics). But an improper alteration in the issued share capital, unaccompanied by any change in the business, will not necessarily have that outcome (DR Chemicals).

(iii) Where a minority shareholder has a petition on foot and there is a general fall in the market, the court may in fairness to the claimant have the shares valued at an early date, especially if it strongly disapproves of the majority shareholder's prejudicial conduct (Cumana).

(iv) But a claimant is not entitled to what the deputy judge called a one-way bet, and the court will not direct an early valuation date simply to give the claimant the most advantageous exit from the company, especially where severe prejudice has not been made out (Elgindata).

(v) All these points may be heavily influenced by the parties' conduct in making and accepting or rejecting offers either before or during the course of the proceedings (O'Neill v Phillips)."

8. For a recent example of the application of these principles, see *Pinfold v Ansell* [2017] EWHC 889 (Ch) where the petitioner (49% shareholder) successfully argued that the company should be valued as at the date of his exclusion. The justification was that since the date of the exclusion, the petitioner had been locked into a company – found to be a quasi-partnership – against his will, whilst it pursued a commercial strategy that, contrary to the basis of his membership, he had no opportunity of being involved in. Although the commercial strategy adopted had not at that point failed, there was a risk that it might, and the petitioner had not had the opportunity of influencing the underlying decision. In effect, a risk was being taken with his money that he had no control over. An important part of the reasoning was that as no reasonable offers had been

made to buy the petitioner out, it could not be said that he had, through rejecting those offers, effectively decided to run the risk to the value of his shareholding by remaining a member of the company. had the petitioner rejected reasonable offers to buy his shares, it may have resulted in a different outcome.

9. The points identified in *Profinance* are only one side of the story. Contrary points will also apply. For example, if it can be shown that the wrongdoer has caused a substantial increase in the value of the business that owes nothing to the labour or capital of the oppressed minority (e.g. where an underperforming minority has been excluded and the business turned around) that too could warrant an earlier date of valuation.

10. Another possibility is *Bennett v Bennett* (unreported) 17 January 2003, where the (successful) competitive actions of the departing minority shareholder had caused a fall in the valuation of the company. This meant that an earlier valuation date was not appropriate. The minority could not have his cake (i.e. the value of the company pre-departure) and eat it (i.e. through his successful new business).

11. It is important to stress though that where the court is persuaded to adopt an earlier valuation date, it will not allow the parties to use the benefit of hindsight. Per *Shah v Shah* [2011] EWHC 1902, matters occurring after the date of valuation should generally be ignored. They are only relevant in making determinations of matters such as the accuracy of forecasts, the size of contingencies and/or the parties' intentions as at the valuation date (see for example *Re Annacott Holdings Limited* [2013] 2 BCLC 46). Usually this is something that a sensible expert will be conversant of.

<u>Basis of Valuation</u>

12. Having determined <u>when</u> the valuation is going to be undertaken, the next question is to determine <u>how</u> the company is going to be valued. As explained by Lord Millet in *CVC/Opportunity Equity Partners Limited v Demarco Almeida* [2002] BCLC 108 at paragraphs 37 and 38:

"There are essentially three possible bases on which a minority holding of shares in an unquoted company can be valued. In descending order these are: (i) as a rateable proportion of the total value of the company as a going concern without any discount for the fact that the holding in question is a minority holding; (ii) as before but with such a discount; and (iii) as a rateable proportion of the net assets of the company at their break up or liquidation value.

Which of these should be adopted as the appropriate basis of valuation depends on all the circumstances. The choice must be fair to both parties, and <u>it is difficult to see any justification</u>

<u>for adopting the break up or liquidation basis of valuation where the purchaser intends to continue to carry on the business of the company as a going concern. This would give the purchaser a windfall at the expense of the seller</u>." (Emphasis added).

13. It will normally be for the expert to determine the correct valuation basis, looking in particular at the nature of the company in question. In exceptional cases the court may express a view; e.g. where the parties had reached an agreement about the future ownership/sale of the business (much as it does when it says that where the intention is to continue trading, that should be the valuation basis). The court can of course also order that adjustments are carried out to the valuation to off-set or reverse the effect of unfairly prejudicial conduct.

14. A point often missed by lawyers is that the valuation exercise is not just determined by the valuation <u>basis</u>, but also the valuation <u>standard</u>. There is a difference between the open market value of the company to a third-party arms' length purchaser, and a fair value to a known purchaser (e.g. the majority shareholder). Consideration needs to be given to this issue both when determining the valuation standard <u>and</u> when considering the issue of discount/premium. Care needs to be taken to ensure that they are neither neglected nor double counted.

<u>Discount/Premium</u>

15. The starting point is that where the court is dealing with a quasi-partnership, it will not make a discount for the fact that the innocent party is a minority shareholder. As explained by Nourse J in *Re Bird Precision Bellows Limited* at page 430:

"I would expect that in a majority of cases where purchase orders are made under section 75 in relation to quasi-partnerships the vendor is unwilling in the sense that the sale has been forced upon him. Usually he will be a minority shareholder whose interests have been unfairly prejudiced by the manner in which the affairs of the company have been conducted by the majority. On the assumption that the unfair prejudice has made it no longer tolerable for him to retain his interest in the company, a sale of his shares will invariably be his only practical way out short of a winding up. In that kind of case it seems to me that it would not merely not be fair, but most unfair, that he should be bought out on the fictional basis applicable to a free election to sell his shares in accordance with the company's articles of association, or indeed on any other basis which involved a discounted price. In my judgment the correct course would be to fix the price pro rata according to the value of the shares as a whole and without any discount, as being the only fair method of compensating an unwilling vendor of the equivalent of a partnership share. Equally, if the order provided, as it did in In re Jermyn Street Turkish Baths Ltd. [1970] 1 W.L.R. 1194, for the purchase of the shares of the delinquent majority, it would not merely not be fair, but most unfair, that they should receive a price which involved an element of premium."

16. This though, is not an immutable rule. See Lord Hoffman in *O'Neill v Phillips* [1999] 2 BCLC 1 at page 16. Indeed, As Nourse J himself went on to explain at page 431 in *Re Bird*:

"… Suppose the case of a minority shareholder whose interests had been unfairly prejudiced by the conduct of the majority, but who had nevertheless so acted as to deserve his exclusion from the company …. A shareholder who deserves his exclusion has, if you like, made a constructive election to sever his connection with the company and thus to sell his shares. That means that evidence of the circumstances in which the petition came to be presented was, perhaps contrary to my expectation on 1 July, properly included, although I propose to deal with that aspect of the case as briefly as I reasonably can.

Next, I must consider the example from the second category of cases in which, broadly speaking, shares in a small private company are acquired. It is not of direct relevance for present purposes, but I mention it briefly in order finally to refute the suggestion that there is any rule of universal application to questions of this kind. In the case of the shareholder who acquires shares from another at a price which is discounted because they represent a minority it is to my mind self-evident that there cannot be any universal or even a general rule that he should be bought out under section 75 on a more favourable basis, even in a case where his predecessor has been a quasi-partner in a quasi-partnership. He might himself have acquired the shares purely for investment and played no part in the affairs of the company. In that event it might well be fair - I do not know - that he should be bought out on the same basis as he himself had bought, even though his interests had been unfairly prejudiced in the meantime. A fortiori, there could be no universal or even a general rule in a case where the company had never been a quasi-partnership in the first place."

17. Conversely, it does not follow that because a company is not a quasi-partnership, there must be a discount to the value of the shares. This is one area where the law appears to be in a state of flux.

18. The traditional approach of the courts is best demonstrated by the judgment of Arden LJ in *Strahan v Wilcock* [2006] 2 BCLC 555 where, at paragraph 17, she said that:

"Shares are generally ordered to be purchased on the basis of their valuation on a non-discounted basis where the party against whom the order is made has acted in breach of the obligation of good faith applicable to the parties' relationship by analogy with partnership law, that is to say where a 'quasi-partnership' relationship has been found to exist. It is difficult to conceive of circumstances in which a non-discounted basis of valuation would be appropriate where there was unfair prejudice for the purposes of the 1985 Act but such a relationship did not exist. However, on this appeal I need not express a final view on what those circumstances might be."

19. Similarly, in *Irvine v Irvine* [2006] EWHC 583 (Ch), Blackburne J opined that the court will only depart from the approach (in non-quasi-partnership cases) of applying a discount in *"exceptional circumstances"*. This was on the basis that in valuing a minority interest, the court is valuing just that.

20. Notwithstanding this restrictive approach though, HHJ Purle QC in *Re Sunrise Radio Limited* [2010] 1 BCLC 367 held that there was *"no inflexible rule"* and so found he was able to consider the potential availability of relief through winding up and the realization by a minority shareholder of a rateable proportion of the company's assets. In short, that where a minority would otherwise do better on a winding up, it would be hard to justify a discount. See also *Re Annacott Holdings Limited* [2013] 2 BCLC 46 where the court was mindful not to allow the wrongdoer to profit from their actions, which they might do through the application of a discount to the petitioner's shares. There, the Court of Appeal rejected the argument that valuation as a going concern was only appropriate in quasi-partnership cases, holding that such a valuation would result in a windfall to the purchaser.

21. More recently, in *Re Blue Index Limited* [2014] EWHC 2680 (Ch), Robin Hollington QC (sitting as a deputy High Court Judge) effectively sought to turn the traditional approach on its head, commenting at paragraph 24 onwards that:

"Suppose the minority shareholder has been seriously wronged and prejudiced such as to justify relief on the oppression ground, whether it be by way of a share purchase order or, in the absence of such a remedy, a winding up order. It would be just as unfair to the wronged minority shareholder in such a case for his shares to be purchased by the oppressing majority with a discount for a minority shareholding as it would be if it were a quasi-partnership case. Take further, by way of contrast, the quasi-partnership case where shares have nevertheless clearly been acquired at a discounted price. Such a case would fall into the second category in the analysis of Nourse J, as was indeed noted by Peter Gibson J (as he then was) in Re a company (No. 005134 of 1986), ex parte Harries [1989] BCLC 383, discussed below.

In other words, I can see nothing in the fact that the case is a quasi-partnership one for that to be the determining factor as to the general applicability of a discount for a minority shareholding.

It may be objected, as it was argued unsuccessfully before the Court of Appeal in Re Bird Precision Bellows [1986] Ch. 658, that this ignores the reality that the shareholding to be purchased is a minority shareholding. But that argument was rejected. And it is in my view a fallacious one, since the whole purpose of the unfair prejudice remedy is to grant the oppressed minority a remedy which it would not otherwise have. It would substantially defeat the purpose of the new remedy if the oppressing majority were routinely rewarded by the application of a discount for a minority shareholding."

22. A more neutral approach was that adopted by Mark Anderson QC in *Booth v Booth* [2017] EWHC 457 (Ch) where, eschewing the suggestion there was a fixed starting point, he said at paragraph 139 that: *"The task is to find a fair price. That may require no discount, it may require the full discount which would be expected in an arm's length sale, or it may require something in between. As Oliver LJ observed in the passage quoted in paragraph 125 above, I have a wide discretion to fashion a remedy which will do justice between the parties."* Before continuing that:

"I have carefully considered Judge Purle QC's review of the authorities in paragraphs 290 to 305 of his judgment in Sunrise Radio (which went to the Court of Appeal on other points) and the propositions which he derives from those authorities, the following of which seem to me to be relevant in this case:

i. The discount is usually applied to reflect the simple truth summarised by Blackburne J in Irvine v Irvine (no 2) [2007] 1 BCLC 445, "A minority shareholding . . . is to be valued for what it is, a minority shareholding, unless there is some good reason to attribute to it a pro rata share of the overall value of the company. Short of a quasi-partnership or some other exceptional circumstances, there is no reason to accord to it a quality which it lacks."

ii. However valuing shares for the purposes of fashioning a remedy under section 996 is not the same as ascertaining the value they would achieve in a sale in the open market.

iii. In some cases it may be unfair to treat the petitioner as a willing seller because he may only be selling because of unfair prejudice which has left him with no alternative. That consideration may apply outside the context of a quasi-partnership.

iv. Consideration only of the value which the petitioner could achieve by selling his shares elsewhere may be unfair without considering the value of the shares to the respondent, especially if the conduct giving rise to the petition was influenced by a desire to buy the shares.

v. A relevant factor may be the amount which the petitioner would receive if the company were wound up. If the conduct complained of would justify a winding up on the "just and equitable" ground, the petitioners should not ordinarily be in a worse position by invoking section 994 than they would have been if they had petitioned to wind it up."

23. There is of course a significant interplay between the valuation basis and the question of minority discount. In broad terms, where the value of the company is in its (real) assets rather than in its trading performance/potential, that suggests an asset basis valuation and a lower (if any) discount for a minority. It therefore makes sense to obtain valuations on more than one basis. Even if the correct method is valuation as a going concern, if that, following a discount, results in

a minority receiving less than their rateable proportion of the company's assets, this provides a basis for challenging the valuation methodology and/or level of discount.

24. It is also important to remember that the fact of a discount is not an all or nothing. Per *Richards v Lundy* [2000] 1 BCLC 376:

"…There may be cases in which neither a pro rata valuation [i.e. share of realisable assets] *nor a minority shareholding valuation is fair, and I do not accept the submission that it would be 'palm tree' justice to find a middle course – or if it would be, then the width of the statutory discretion justifies it. There is perhaps an analogy with an award of damages under Lord Cairns Act, where the unconscionable conduct of the plaintiff may be a factor in the amount awarded…"*

25. A similar approach was taken by Fancourt J in *in Re Edwardian Group Ltd, Estera Trust (Jersey) Ltd and anr v Singh and ors* [2018] EWHC 1715 (Ch); [2019] 1 BCLC 171. After noting that the authorities *"do not speak with one voice on the correct approach to valuation where a share purchase order is made in relation to a non-quasi-partnership company"* Fancourt J acknowledged that any basis of valuation must be fair in all the circumstances. He concluded that the question was not a simple choice between a pro rata share of the Company's overall value and the market value of the shares. Between those *"two extremes"* there are, he said, various possibilities for specifying a basis of valuation that results in a fair price as between the minority shareholders and the respondents against whom relief is granted. In the event he considered that a fair basis would be the price that would be likely to be agreed between commercially-minded but reasonable persons in the actual positions of the parties in notional arms-length negotiations, having regard to any marriage value that would be released on such s sale and purchase.

26. When it comes to setting the discount, this will be a matter for expert evidence. The key thresholds for discounts are (obviously) less than 50% and (often missed) less than 25%, below which the minority is unable to block special resolutions and therefore cannot exercise what is often known as 'negative control'. Voting provisions within the Articles of Association may also create thresholds in particular cases. What is appropriate in terms of discount will also be industry, sector and (sometimes) company specific depending on whether the value of the company is in its assets and established/sustainable profitability, or control and the potential for future profitability.

27. The flipside of discounts for minority shareholdings is the premium that acquiring a minority that allows a majority to increase their shareholding, possibly above 75% (therefore preventing any special resolutions they table from being blocked) or to 100% This links back to the comments above about the difference between fair value and market value and the present flux between the different approaches to minority discounts. In all cases, the same legal principles apply. It is about achieving fairness in the circumstances.

Adjustments

28. It is trite law that that the court can order adjustments to reverse the effect of any unfair prejudice. The court's job is to identify the unfair prejudice. Making the appropriate adjustment will then be a matter for the experts. See *Re London School of Electronics Limited* [1985] BCLC 273. It is important to bear in mind that, in appropriate cases, reversing the effect of unfair prejudice may change the appropriate valuation basis (or basis that is most advantageous to one's client).

29. A particular risk in small companies is 'key person' risk/value; the fact that smaller companies are often dependent on the charisma and/or connections of a single individual or group of individuals. Unless the 'key person' is tied into the company with a long contract, valuations of small companies will often take the risk of departure into account when determining the company's value on an earnings basis.

30. 'Key person' risk is relevant for two reasons in the unfair prejudice context. Firstly, because it will likely be built into any valuation assumption (e.g. the multiplier to be applied to the EBITDA) and the valuation of any valuations of comparable companies. For obvious reasons, it will usually be inappropriate to factor 'key person' risk into the valuation where the buying party is the 'key person'; see *Re Scitec Group Limited* [2012] EWHC 661. It is not therefore appropriate to use – either directly or via valuations of comparable companies – a valuation methodology that accounts for the risk of the purchaser departing.

31. Secondly, the 'key person' may be, or have been, the minority. In such cases, it is again difficult to see why the risk should be included in the valuation if it is the act of unfair prejudice that has resulted in the departure. This links back to the question of valuation date discussed above. Where the departure of the minority is a significant factor affecting valuation, it will mitigate towards an earlier date (with the valuer valuing prospectively at that date rather than retrospectively with the benefit of hindsight).

32. In all cases though it is important to ascertain where the company's value comes from. Is it fixed assets and long-term contracts, or is it the industry and ingenuity of specific individuals? If the latter, how is that affected by the unfair prejudice and how has the expert addressed that in their report?

JAMES WIBBERLEY
SANDRA MOSSIOS
October 2019