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WHAT ARE THE GOLDEN RULES OF HOW TO RING-FENCE PRIVATE COMPANY ASSETS WHEN THE "HEAVY LIFTING" IN BUILDING IT UP PRE-DATED THE MARRIAGE?

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A INTRODUCTION

IX v IY [2018] EWHC 3053 (Fam)

The use of the phrase "Heavy lifting" was most recently coined by Williams J in ***IX v IY***. The essence of the argument is as follows, as deployed by the husband in this case:

(a) Quite separately from the question of whether the company should be regarded in its entirety as a non-marital asset, the husband submitted as an alternative that the latent value of the company at the commencement of the marriage (or marriage plus pre-marital contribution) represents a contribution solely attributable to the husband and unmatched by the wife.

(b) The husband asserted that because the "heavy lifting" had been done in the development of the company prior to 2007 (when the cohabitation commenced), the business had a very substantial value at that time.

(c) The value that the company had at that time should be identified including its springboard potential and that the resulting figure should be subject to some form of indexation to reflect how it grew in value of its own momentum and without regard to the additional contribution of the husband over the course of the marriage.

(d) The latter is a contribution to the marital assets matched by the wife's contributions in the course of the marriage.

The decision in ***IX v IY*** is considered in more detail at the conclusion. In addition, note should also be had for the recent decisions in ***Martin v Martin [2018] EWCA Civ 2866*** and ***XW v XH [2019] EWFC 76*** which shows some conflict in the approach being taken by the court. These decisions are also considered further at the conclusion.

B THE ORIGIN OF THE SPRINGBOARD CONCEPT AND THE FORMULAIC APPROACH

The concept of springboard potential dates back to the Court of Appeal's decision in ***Jones v Jones [2011] EWCA Civ 41***. The main relevant facts of the case were as follows:

(a) At the date of the marriage, the husband was the sole owner of a company which he had started approximately 10 years earlier.

(b) At the date of separation, the company was worth approximately £12 million, although during the course of the financial remedy proceedings, the husband sold the company, the husband receiving net proceeds of sale of approximately £25 million.

The Court of Appeal's decision led to the introduction of what has been described as the "formulaic approach" to dealing with pre-marital assets. In calculating the wife's award, Wilson LJ took the following approach:

1. The first step was to look at the net proceeds of sale of £25 million.

2. The second step should be to ascribe to the company a value, as at the date of the marriage, which is both realistic and apt to the context in which it is required. The starting point should be the valuation of the company upon which the accountants had agreed, namely the sum of £2 million net.

3. He went on to say that there were two reasons why the sum of £2 million requires substantial adjustment as follows:

    (a) The first is consideration of the concept of latent potential or springboard. Wilson LJ emphasised that, "we are concerned only with the value to be attributed to the springboard in place at that date [ie. the date of the marriage] not with the value to be attributed to the subsequent activity of the diver or gymnast upon it". By reference to the latent potential, Wilson LJ proposed to take the value of the company at that date as being £4 million, rather than £2 million, although acknowledged that his figure was "highly arbitrary".

    (b) The second reason for the adjustment was "the need to allow for passive economic growth in the company between the date of the marriage and the

date of sale". On the issue of passive growth, Wilson LJ went on to say as follows:

"...take a work of art or land with potential for development which a spouse has owned since prior to the marriage and which, without activity on his or her part, has substantially increased in value during it. The court would accept that the increase in its value during the marriage was as much non-matrimonial as its value at the date of the marriage: it would thereby allow for its passive growth. Passive growth is to be contrasted with growth as a result of contributions of one sort of another made during the marriage, ie, of activity, irrespective of whether such is achieved with the assistance of a springboard already in position".

4. Wilson LJ applied to the sum of £4 million an uplift representing the percentage increase in the relevant Stock Exchange index between the date of the marriage and the date of the sale, thereby lifting the figure from £4 million to £8.7 million, which in turn led to an award to the wife of £8 million, ie, £25 million, less £9 million and divided by two.

5. Finally, as a cross-check, Wilson LJ tested his award as against the approach which was argued for by the wife, namely identifying such lesser percentage than 50% of the total assets as seem fair to reflect the husband's pre-marital contribution. Wilson LJ concluded that his view of overall fairness to the parties led him to identify a bracket of between 30% and 36% and therefore the award to the wife of £8 million survived the alternative test, ie, it amounted to 32% of the assets.

C THE IMPRESSIONISTIC APPROACH

The formulaic approach introduced by the Court of Appeal in ***Jones*** represented the prevailing approach for many years and was particularly favoured by Mostyn J. As he stated in ***WM v HM [2017] EWFC 25***,

"I am firmly of the view that the correct approach to give effect to the sharing principle is to try to calculate the scale of the matrimonial property and then normally to share that equally leaving the non-matrimonial property untouched. This is logically pure, morally sound, easy to understand and limits the individual judicial caprice".

"I continue to oppose the school of thought that plucks a random percentage out of the air where the pool of assets is a mixture of matrimonial and non-matrimonial property".

The impressionistic approach was exemplified in ***Charman v Charman [2007] EWCA Civ 503*** and was historically favoured by Moylan J (for example, ***C v C [2011] EWCA Civ 41***). It is now finding favour following on from the Court of Appeal's decision in ***Hart v Hart [2017] EWCA Civ 1306***.

In weighing up the case law, Moylan LJ concluded as follows in ***Hart***,
"In my view, the court is not required to adopt a formulaic approach either when determining whether the parties' wealth comprises both matrimonial and non-matrimonial property or when the court is deciding what award to make. This is not necessary in order to achieve "an acceptable degree of consistency" Lord Nicholls in ***Miller*** (paragraph 6) or to achieve a fair outcome. Indeed, I consider that the present case demonstrates the difficulties which can arise if the court strives to adopt a formulaic approach in circumstances where that is not likely to be easily achieved because of the nature of the financial history."

Moylan LJ also considered the approach taken by the Court of Appeal in ***Jones v Jones*** and noted that:

(a) It used both a mathematical and broad approach to determine the fairness of the proposed award.

(b) Both approaches arrived, effectively, at the same outcome.

(c) Both methods provide a permissible route to arriving at a fair determination.

Other particular points arising out of ***Hart*** are as follows:

1. The concept of property being either matrimonial or non-matrimonial property is a legal construct. In practice, it is not always capable of clear identification.

2. An asset can comprise both matrimonial and non-matrimonial property in the sense that it can partly be the product of marital endeavour and partly the product of a source external to the marriage. When property is a combination of the two it can be artificial to identify a sharp division because the weight to be given to each type of

contribution will not be susceptible of clear reflection in the assets' value. The exercise is therefore more of an art than a science.

3. It can therefore be artificial to attempt to draw a "sharp dividing line" between the different types of property.

4. Valuations are a matter of opinion on which experts can differ significantly and therefore an investigation can be "extremely expensive and of doubtful utility". The costs involved can quickly become disproportionate. A clear example of this is the Court of Appeal's decision in ***Versteegh v Versteegh [2018] EWCA Civ 1050*** in which a total of £2 million had been spent upon experts, yet the trial judge was unable even to make a conservative estimate as to the value of the company.

The approach adopted by the Court of Appeal in ***Hart v Hart*** has found favour in subsequent decisions. For example, King LJ in ***Versteegh v Versteegh*** and Williams J in ***IX v IY*** in which he stated, "happily, recent decisions of the Court of Appeal in the field appear to suggest a less technical, more flexible and more common-sense approach to such issues", ie, dealing with non-matrimonial assets.

D RECENT DEVELOPMENTS

The three recent cases of note addressing the issues of latent potential/springboard/growth are as follows:

- ***XW v XH [2017] EWFC 76*** – Baker J
- ***Martin v Martin [2018] EWCA Civ 2866*** – Court of Appeal (appeal from earlier decision of Mostyn J reported as ***WM v HM [2017] EWFC 25***).
- ***IX v IY [2018] EWHC 3053 (Fam)*** – Williams J

XW v XH [2017] 76

The decision of Baker J concerned a relatively short marriage of six years and 10 months. Prior to and during the marriage the husband owned shares in a company which made well known products. At the time of the marriage the shares were worth approximately £3.8 million, but when the company went public and sold in 2015, the husband received $540 million. The wife sought an equal share of the assets, whereas the husband contended that the assets were non-matrimonial and should be excluded from the sharing principle, ie that this was a needs case. In the alternative he sought a significant departure from equal sharing.

Baker J dismissed the husband's argument that the shares should be excluded from the sharing principle entirely, but the judge did accept that the nature and source of the assets affected his conclusions as to how they should be shared. A significant increase in the value of the husband's shares clearly gave rise to arguments regarding their latent potential at the date of the marriage. He summarised that there were three issues which he needed to address, arising out of the Court of Appeal's decision in ***Jones***:

1. Whether the court should adopt what he described as a "formulaic" or "broader" approach to non-matrimonial assets.

2. What allowance should be made for "passive growth" in the valuation of a non-matrimonial asset.

3. Whether the court should make any allowance for "latent potential" or a "springboard" within the company not reflected in a conventional valuation.

On the first point, Baker J considered the recent case law and found favour with the approach adopted by Moylan LJ in ***Hart v Hart***, ie, the "broader" or "impressionistic" approach.

On the issue of passive growth, Baker J noted the comments of Holman J in ***Robertson v Robertson [2016] EWHC 613 (Fam)*** in which he concluded that to apply a strict valuation of the shares at the date of the marriage seemed "so unfair to the husband on the facts...and so over-generous to the wife". He concluded that, "much greater allowance must, in fairness to the husband, be made for the history in order, to borrow words from Lord Nicholls in ***Miller***...to 'reflect the amount of work done by the husband on this business project before the marriage'".

On the issue of latent potential, Baker J concluded as follows:

1. It was not reflected in the value of the husband's shares at the start of the marriage.

2. The ultimate phenomenal success of the company was due in part to developments and decisions taken in the business during the marriage, but it was also attributable to developments and decisions taken before the marriage, "To a not inconsiderable extent, the later success was built on those earlier foundations".

In terms of how Baker J took the latent potential into account, he rejected the approach of Holman J in ***Robertson*** (treating 50% of the value of the business as at the date of sale as having been created prior to the marriage) and the approach of Mostyn J in ***WM v HM*** (excluding the proportion of value in the business that was created for the marriage on a linear apportionment basis). Baker J concluded,

"As Arden LJ noted in ***Jones v Jones***, the court must try to look as far as it can at the reality of what actually happened rather than proceed on an artificial assumption of a straight-line growth from the date of foundation of the business up to the eventual sale. To insist on a linear or arithmetical approach would be to fall into the error identified by Moylan LJ in ***Hart v Hart*** of imposing 'constraints which are not needed to achieve, and which deprive the court of the flexibility required to achieve, a fair outcome'".

Baker J therefore proposed to undertake a broad evidential assessment before deciding how the wealth should be divided. His assessment was that there was a significant, though unquantifiable, latent potential in the company at the date of the marriage which was not reflected in the formal valuation. The fact there was such a latent potential in the company must therefore be taken into account when determining the extent to which there should be a departure from the sharing principle.

Other issues (which are outside the scope of this lecture) arising from the judgment include the following:

(a) The husband also sought to rely on the principle of unilateral assets which arose from Baroness Hale's speech in ***Miller; McFarlane [2006] 1 FLR 1186*** and which had recently been applied by the Court of Appeal in ***Sharp v Sharp [2017] 2 FLR 1095***. Baker J took the view that applying the principle would be discriminatory; however, the fact that the shareholding, worth approximately half a billion pounds, was generated by the husband's business activities was a fact which cannot be ignored entirely. It was a fact to be taken into account in deciding how it should be shared.

(b) This is one of a small handful of cases in which a party succeeded with their special contribution argument. Baker J concluded that, "The nature of [the husband's] contribution is such that it is very obviously inconsistent with the objective of achieving fairness for it to be ignored".

In conclusion, the "fair outcome" to the wife was a lump sum equivalent to 25% of the difference between the husband's share of the proceeds of sale of the company and the value of his shares as at the date of the marriage (with an uplift for passive growth), ie, a lump sum payment to the wife of £115 million.

Martin v Martin [2018] EWCA Civ 2866

Aside from the issue of springboard or passive growth, the Court of Appeal's decision is of particular note with regard to the following:

(a) Following the comments in ***Versteegh***; valuations of private companies can be fragile and need to be treated with caution.

(b) That assets have different levels of risk and as a matter of principle the court must take that into account when applying the sharing principle. That extends to the quality of the asset so that liquidity and illiquidity can equally be factors in their own right.

(c) Even where the court can fix a value as to private shares, that does not mean that the value of shares in a limited company has the same weight as the value of other assets.

On the issue of pre-acquired assets, the decision is principally of note as it runs contrary to the decision of Baker J in ***XW v XH***. Moylan LJ held that Mostyn J (in the first instance decision of ***WM v HM***) was entitled to adopt a straight-line approach when determining the increase in value of the shares during the course of the marriage.

IX v IY [2018] EWHC 3053 (Fam)

In considering the authorities, Williams J concluded,

"The weight of authority would support an approach which seeks to identify and to take into account any latent potential that a business asset had when it was brought into the marriage by a party. The authorities would also support an allowance for the passive growth of that latent potential during the course of a marriage. How that is to be done will depend on the facts of the individual case".

E CONCLUSIONS

1. Evidencing pre-marital contributions. In ***Hart*** Moylan LJ stated that he did not agree with the comments of Mostyn J in ***N v F [2011] EWHC 586 (Fam)*** that a party would need to prove the existence of pre-marital assets "by clear documentary evidence".

Moylan LJ was of the view that there is no reason to limit the form or scope of the evidence by which the existence of such property can be established. The normal evidential rules apply. Those rules include the court's ability to draw inferences if such are warranted.

2. Evidence backed by a narrative statement describing the "heavy lifting" undertaken prior to the marriage. Noting Mostyn J's comments in ***WM v HM***, "...and that, intrinsically, value is (at least) as much a function of time as it is of work or market forces. In argument, I asked 'how could it be said that a day's work in 1980 in creating this company was less valuable than a day's work last week?".

3. Pre-nuptial agreement.

4. Minimising inter-mingling – as Baker J noted in ***XW v XH*** – the parties had to a substantial extent kept their financial affairs completely separate during the marriage. He cited Baroness Hale in ***Miller*** in which she stated, "the nature and the source of the property and the way the couple have run their lives may be taken into account in deciding how it should be shared". In Baker J's decision, the way the couple chose to run their lives and keep their financial affairs separate was, "a matter of considerable relevance".

5. Length of the marriage - as Williams J noted in ***IX v IY***, "...the shorter the marriage in practice, the easier it may be to identify a non-marital assets and the longer the period of the marriage then the greater to which the asset has a mingled character, the harder it may be to identify it".