

How do you help clients facing a sudden reduction in company income, expenses or valuation, and what do you do if you think the reductions are manipulations?

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Family-owned company

- Limited by shares
- distinct from a business run as a sole trader as it has a separate legal personality (per section 16(2) of the Companies Act 2006).
- at least one director
- There may or be employees and contracts of employment and/or service level agreements for the directors.
- Both spouses as shareholders:
 - preferential dividend taxation rate
 - maximise the use of both parties' personal allowance to reduce their tax liability
 - salary may be paid to one or both parties.

Form E requirements

- Section 2.11 requires “Your estimate of the current value of your business interest. Explain briefly the basis upon which you have reached that figure.”
- copies of business accounts for the last two financial years for any businesses, whether run as a sole trader, a partner in a partnership, via an LLP or as a shareholder in a limited company
- any documentation which may be available on which the party preparing the financial statement has based their estimate of current value of their interest in a business, for example, a letter from an accountant or a formal valuation
- Form E emphasises that it is not necessary to obtain a formal valuation at the stage of preparing financial statements

A v A [2004] EWHC 2818

Charles J ‘...it seems to me that in ancillary relief proceedings it is important for the parties and their advisers to look at issues concerning private companies through the eyes of both: (a) persons with experience in and of matrimonial litigation; and (b) persons with experience in and of business and business litigation. For example, if this is done it may quickly become apparent: (a) that there is a wide bracket of valuation; and (b) that there may be a viable and pragmatic business solution which would avoid either or both of the uncertainties and difficulties of valuation and the raising of finance, albeit that it may not involve a clean break.’

Possible Manipulation

- **Complexity:** Financial statements are complex documents that involve numerous accounting principles, estimates and judgments.
- **Subjectivity:** Many accounting standards require subjective judgments, eg estimating the useful life of assets or determining the fair value of investments.
- **Legality:** Some techniques fall within the bounds of accounting rules but are still considered misleading.
- **Sophistication:** Company owners/accountants may have a deep understanding of accounting principles and financial markets, allowing them to exploit loopholes and obscure their actions.
- **Limited Information:** External stakeholders often have limited access to information compared to insiders within the company.

Arguments

Party who wishes to continue to run the business may argue:

- the business has no substantial value over and above the net assets;
- the asset value is unrealisable whilst the business is a going concern;
- the business should be viewed as an income stream rather than a capital asset;
- the income is under pressure due to the recession, loss of contracts, bad debts etc and is very uncertain;
- there is insufficient liquidity to enable the other party to receive a share of the capital value of the business.

Counter-arguments

- May wish to respond:
 - there is a substantial goodwill element in addition to the value of the assets;
 - as H will retain the capital value, it should be fully taken into account in any division of the assets;
 - the future prospects of the business are better than the past accounts appear to show due to new products/ new markets/ new contracts; and in consequence the business has been undervalued;
 - H can pay a lump sum by a variety of means including sale of assets, cash in the business bank account and/ or further borrowing.

Red flags

- substantial discrepancy between profits and the parties' standard of living
- unclear relationships between companies under the direction of the same spouse
- inflated liabilities
- Director's loan account issues
- undisclosed bank accounts
- offshore investments/banking and purported transfers to third parties that may be a 'sham'
- Refusal to provide up-to-date or management accounts
- Undervaluation of the business capital

Shadow Expert

- do not have an overriding duty to the court; their duties are to the parties being advised.
- can be instructed on issues of concern throughout the proceedings and not be restricted to time frames or rigid instructions applicable to experts preparing reports for disclosure.
- able to provide candid advice to instructing solicitors and can inform the tactical approach to be taken.
- Costs can be better managed because they are instructed for specific tasks.

Valuation questions

- Do the accounts show the full picture?
- What proportion of the business do the parties own? Who owns the remainder of the shares?
- Are there any documents that specify the valuation that must be adopted?
- Are the shares publicly quoted?
- Is there any indication or suspicion that the business will be sold within the foreseeable future?
- Do accounts show sizeable profits?
- How close are the parties to retirement age?
- Are there complicated structures involving trusts and holding companies?
- Suspicion of undervalue?
- How liquid is the business?

Appointing an expert

- FPR 25.5(2) requires the court to have regard in particular to the issues to which the expert evidence would relate; the questions which the court would require the expert to answer; the impact which giving permission would be likely to have on the timetable, duration and conduct of proceedings; any failure to comply with FPR 25.6 or any direction about expert evidence; and the cost of the expert evidence.
- FPR 25.6(d) states that the application should be made no later than the First Appointment. Examples of exceptions include where it is necessary to consider replies to questionnaire before deciding whether to apply, and where valuations of properties have been agreed for FDR but no settlement is reached at that point (see FPR PD 25D, para 3.10).
- Should make a formal application, unless the applicant did not have sufficient time to do so, in which case they may make an oral application ('which should be seen as the exception and reserved for genuine cases where circumstances are such that it has only become apparent shortly before the hearing that an expert opinion is necessary' – FPR PD 25D, para 3.8).

Appointing an expert

FPR PD 25, para 3.11

- The field in which the expert evidence is required.
- Where practicable, the name of the proposed expert.
- The issues to which the expert evidence relates.
- Whether the expert evidence could be obtained from an SJE.
- The discipline, qualifications and expertise of the expert (by way of CV where possible).
- The expert's availability to undertake the work.
- The timetable for the report.
- The responsibility for instruction.
- Whether the expert evidence could properly be obtained by only one party. (*J v J* [2014]EWHC 3654 (Fam) at [46] per Mostyn J).
- Why the expert evidence proposed cannot properly be given by the expert already instructed in the proceedings.
- The likely cost of the report on an hourly or other charging basis.

Appointing an expert

Each expert should have provided ‘in good time for the court hearing’ (FPR PD 25B, para 8.1). The preliminary information should include confirmation:

- That acceptance of the proposed instructions will not involve them in any conflict of interest.
- That the work required is within their expertise.
- That they are available to do the relevant work within the suggested timescale.
- When the expert is available to give evidence, the dates and times to avoid and, where a hearing date has not been fixed, the amount of notice required to make arrangements to come to court (or to give evidence by telephone conference or video link) without undue disruption to their normal professional routines.
- The cost (including hourly or other charging rates and likely hours to be spent) of attending experts’ meetings, attending court and writing the report (to include any examinations and interviews).
- There should be a draft order (FPR PD 25D, para 3.12).

Joinder

- FPR 2019 9.26B s.1: ‘The court may direct that a person or body be added as a party to proceedings for a financial remedy if –
 - (a) it is desirable to add the new party so that the court can resolve all the matters in dispute in the proceedings; or
 - (b) there is an issue involving the new party and an existing party which is connected to the matters in dispute in the proceedings, and it is desirable to add the new party so that the court can resolve the issue.’
- *Petrodel Resources Ltd and others v Prest* [2013] UKSC 34

Questionnaire

- Financial statements/accounts going back 3 years.
- Evidence of the interest (e.g. shareholdings).
- Ledgers showing drawings/transactions on capital, current or loan accounts, probably for 2 years, but the length of time is case-dependent.
- Copies of any partnership deeds (including variations) and/or any shareholders' agreements.
- Details of the value at which assets are carried in the accounts, along with any valuations of those assets.
- Updating management accounts prior to the FDR (if the business produces them)
- **See specimen questionnaire attached**

Court's approach to valuations

- *Ditchfield v Ditchfield* [2023] EWHC 2303 (Fam)
 - The judge found that any apparent loss of income or diminution of business value at the date of trial was engineered by H.
 - First instance judge found “deliberately reduced his earnings as they appear on paper and drawn down on his capital investment in the businesses with the intention of defeating W’s claim”
 - Where the court makes findings that a party has acted to depress the performance of a business, it is open to the court to take a value informed by the totality of the evidence in the case, including to assess what the business asserts will shortly be rather than simply ‘the moment of least value chosen on a self-serving basis’.

Court's approach to valuations

- Peel J: *HO v TL* [2023] EWFC 215
 - it is for the court to determine the value, not the expert
 - valuations of private companies can be fragile and uncertain
 - the reliability of a valuation will depend on a number of factors such as:
 - whether there are applicable comparables and how 'niche' the business is
 - the appropriate basis for the valuation (eg net asset, EBITDA, discounted cash flow)
 - the extent of the parties' interests (and accordingly their level of control) and the extent of any third party interests
 - the relevance of any shareholders' agreements
 - whether there is a realistic market for sale
 - the volatility or otherwise of the figures and the reliability of forecasts, and
 - whether the assumptions underpinning the valuation are seriously in dispute

Court's approach to valuations

- the court's choices in practice are to fix the business asset with a value (which will form part of one party's share of the overall assets), order the asset to be sold or share it in specie (known as *Wells* sharing)—which option the court chooses will depend on the facts of each case
- there is a difference in quality between copper-bottomed assets and illiquid and/or risk-laden assets; when reflecting illiquidity and risk the court has three choices:
 - to incorporate a discount into the business valuation, particularly where the party retaining it has a minority holding or otherwise lacks overall control, in which case the court may simply adopt the business valuation as reflecting these matters—termed an ‘accountancy discount’
 - to allocate the other, non-business assets in such a way as to reflect illiquidity and risk as part of the court’s overall discretion—termed a ‘court discount’, or
 - to take the valuation that includes an accountancy discount and apply a further court discount

Closing thoughts

- If concerned either about complexity of business assets or about manipulation, speak to an accountant on a formal or informal basis
- Consider need for SJE or sole instruction expert right from outset so application is ready
- Remember that have all injunctive powers under s37 MCA 1973