Valuations in litigation

Forensic accountants play a vital role in litigation, both as advisers to the parties to a dispute & as experts. George Sim shares his experience from the coalface

IN BRIEF

- It may be important for solicitors to consult forensic accountants for their expertise in valuation methods and their experience of the litigation process.
- Valuations may be needed in many different types of litigation ranging from commercial disputes to divorce cases.

Business valuations may be undertaken with a view to a sale of a business or for tax purposes, but they will often need to be carried out where litigation is in prospect.

Valuation can be complex: issues may arise concerning the quantity and/or quality of information available about the business and from the fact that the owner's business and personal affairs may be closely intertwined. Moreover, interests in unincorporated businesses and shares in private companies are not readily marketable and there may have been no similar transactions in the past to provide a basis for comparison.

Solicitors requiring a business valuation to be carried out will find it advantageous to instruct forensic accountants at an early stage. Forensic accountants will have a thorough knowledge of valuation methods and will be familiar with the litigation process. Instructing solicitors will need to clarify the financial issues and to define what needs to be valued. The approach to the valuation will often be related to the type of case. This article provides an overview of some areas of litigation in which valuations may be needed and gives guidance on issues which solicitors could raise with forensic accountants.

Reasons for valuations

Commercial disputes

Valuations may be needed where there is a loss of a business opportunity, eg a claimant may have been promised an interest in a business which is subsequently denied to him. Alternatively, an individual or corporate claimant may have lost the opportunity to acquire a business. Forensic accountants can assist by advising on the actual and/or potential performance of the business in the context of the market sector in which the business operates.

Other disputes may arise following the purchase of a business or of an interest in a business. A claimant may allege, for example, that there were misrepresentations by the seller, and it may therefore be necessary to establish the difference between the price paid for the business and the value which it would have had if the representations made to the purchaser had been as claimed.

Shareholder disputes

Disputes between shareholders or between shareholders and a company may arise following reconstructions of share capital or in situations where shareholders feel they have been treated unfairly or unjustly and petition the court under section 994 of the Companies Act 2006. Forensic accountants can assist by quantifying the current value of a company and can estimate the value which the business would have had if the action which is the subject of the claim had not taken place.

A valuation may be needed if the owners of a business no longer wish to carry on business together and one shareholder (or a group of shareholders) wishes to buy out the others. If agreement cannot be reached on a sale/purchase price, the Articles of Association of many companies provide for a valuation to be carried out by the auditors or by an accountant to be selected by an independent third party such as the president of the Institute of Chartered Accountants in England and Wales.

Such valuations can be large-scale exercises if the business operates through a number of companies. In one case in which we were involved, a group included several companies which had each been set up to carry out a specific housing development. It was clear that there was little point in looking at each of these companies in isolation in the context of a valuation of the group as a whole.

Divorce cases

The Matrimonial Causes Act 1973 and the Civil Partnership Act 2004 require the income, earning capacity, property and other financial resources available to both parties to the dissolution of a marriage or civil partnership to be identified. The assets of one or both parties may include an interest in a business, and they may be involved in its management. There may therefore be a need to value the business and the parties' interests in it as part of the process of identifying the resources available to both parties.

The courts have been critical of costs incurred in divorce cases on the valuation of very small businesses which represent no more than the earning capacity of their owners. If one of a couple is, for example, trading by himself with no employees, through a company in which he owns one of the two issued shares, with his wife or civil partner holding the other, there will generally be little point in valuing that company unless there are significant funds or additional income-generating capacity within the company.

If it is necessary to establish the value of a family business, solicitors may need to seek the views of forensic accountants if it has substantial assets and/or earnings potential. This will be important if the business can be said to have an existence independent of that of its owners, ie if it could be taken over by a third party as an investment. The interests of one or both of the couple in the business may in such cases account for a significant proportion of total household assets.

Loss of profits cases

A business may lose value as a result of such events as:

- production problems arising from the faulty maintenance of equipment;
- the supply of sub-standard goods, which cannot be resold or which result in production difficulties or defective output if used in manufacturing;
- professional negligence (eg if it fails to renew a lease and loses its premises); or
- action taken by public authorities (eg traffic or parking restrictions near the business's premises).

It is particularly important in this type of case to address the 'remoteness' of the loss, and a claim for the loss in value of a business (as opposed to loss of profits) may be most appropriate in cases where the business has ceased trading or has been sold.

In one case on which we advised, the proprietor of a café lodged a claim against a local authority following a closure order which had not been effected properly. The business had been operating for only a few months, and the accounting records had been destroyed. We prepared a valuation based on the goodwill element of the purchase price and the enhancement of goodwill which it could be argued would have resulted following the acquisition.

Personal injury cases

A claimant may lose his entire business as well as his income from the business as a result of an injury. Forensic accountants may need to assess the impact of an injury on the value of the business, and their instructing solicitors will need to consider whether a claim for damages under this head as well as for loss of earnings would be seen by the court as too remote.

For example, a claimant may be badly injured in an accident, with the result that he can no longer manage his or her business effectively. A claimant trading through a company may not have taken all of its profit out by way of director's fees and/or dividends. In such a case, a claim for loss of earnings would relate solely to the director's fees paid to him or her by the company. The company might nevertheless have value to a potential purchaser: eg with an earnings stream over and above a reasonable level of directors' fees. Similarly, it may be rich in assets, or it may have built up considerable goodwill. The value which these factors would add to the company might be reduced or dissipated entirely if the owner was unable to manage it effectively. Where it appears that this has occurred, forensic accountants may need to advise on the loss in value of the business in addition to the owner's loss of earnings.

In one case in which we were involved, for example, the principal shareholder of a clothing manufacturer and wholesaler who was close to retirement was severely injured in a road traffic accident. The business suffered and went into liquidation. Forensic accountants evaluated the claimant's loss of earnings and assessed losses arising from the failure of the business. The forensic accountants' report considered the projected value of the business had the claimant still been able to manage it and assisted him to obtain a satisfactory settlement.

A similar situation may arise if loans made by a claimant to a business become irrecoverable as a result of its cessation; it might then be necessary to consider the value of the loans in addition to the loss of earnings.

Summary

For all valuations, forensic accountants will have the same basic information requirements, including the business's accounts for at least three years before the date at which the valuation is to be made, its management accounts and any profit or cash flow forecasts.

It is important to note that there is no guarantee that past profitability will continue into the future, especially at the present time given that many businesses face Brexit-related uncertainties. Forensic accountants therefore need to research business conditions and consider the asset base and prospects of a business in addition to its trading history. Valuations are likely to continue to be an important aspect of litigation and forensic accountants will have an active role to play, both as advisers to the parties to a dispute or as experts. NLJ

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