Chapter 4

Valuations for court purposes

The role of valuations in disputes – Compensatory damages – Share valuations – Lost opportunity – Compulsory purchase – Estate and trust cases – Divorces – Expropriation of companies – Duties of a director – The negligence of a valuer – Using valuation theory to test reasonableness of claims – Defining the entity to be valued – Methods of valuing a business entity – The market approach – The income approach (or the discounted cash flow method) – Dividend yield valuations – Special purpose valuations – Valuation of net tangible assets – Liquidation basis – Replacement cost – The choice of concepts for litigation purposes – Fair value – Economic value – Valuation combinations – CPO valuations – Some oddities explained – Market capitalisation and asset values – High multiples and capitalisation rates – Information gathering – Loss of investment opportunity – Methods of measuring the value of lost investment opportunity – The importance of assumptions – The valuer's liability for negligence – Summary

4.1 A good understanding of valuation methods is an essential weapon in court proceedings involving quantum. In the interests of brevity, we have had to be selective in our discussion of valuation in this book. We are concerned in this chapter with valuations arising from disputes rather than with those relating to, say, a transfer between two parties where, for tax reasons, a value has to be struck. Readers should refer to Appendix C for more information on the principal techniques which can be applied in valuing businesses.

THE ROLE OF VALUATIONS IN DISPUTES

4.2 There are many types of court case where a valuation is required and where a report by an expert valuer may therefore be needed. Some examples that arise in practice are discussed below.

Compensatory damages

4.3 Typical of compensatory damages is the case where the claimant had been promised an interest in a business which, for some reason, is denied to him or has failed to measure up to the worth represented by the seller. Much conjecture may be involved in such valuations; for example, where the valuer

has to decide what the business would have been worth if the action complained of had not occurred.

Share valuations

4.4 Disputes over the valuation of shares, which may also require expert evidence, can arise in management buy-outs or where a capital reconstruction takes place. The valuation of shares may also be relevant in disputes arising where a company buys back its own shares or in circumstances where minority shareholders are being treated unfairly or unjustly. The expert valuer can be called upon to provide evidence of the value of a block of shares under an order of the court in minority oppression proceedings under Companies Act 2006, s 994.

Lost opportunity

4.5 Valuation of lost opportunity has become an expanding area for expert valuers. The financial markets in Britain are being ever more closely regulated, and corporate behaviour (for example, in relation to 'concert parties' and other methods of manipulation of markets) has come under the scrutiny of the courts. It is likely that more cases will arise as a result of the current global financial crisis. If the court finds that, through foul play, someone has deprived his rival of the opportunity of acquiring a business, for example in a takeover battle, damages based on the value of the loss of net benefits which would have accrued to the latter will need to be argued.

Compulsory purchase

4.6 When land is acquired under the terms of a compulsory purchase order, the owner is entitled to receive compensation. Where the land is occupied by a business, the compensation is also available for losses affecting the trade. These may include costs of disturbance, loss of profits during the disruption, or compensation for the loss of value if the compulsory purchase order results in the business being extinguished. This latter loss is often referred to as loss of goodwill in these situations and can require expert evidence on valuations before the Lands Tribunal, which hears such cases.

Estate and trust cases

4.7 Situations arise where a shareholder is in a position to purchase stock from the estate of a deceased person or from a trust. The trust representatives have a fiduciary responsibility to be fair to all beneficiaries and not to sell out cheaply. An independent appraisal is desirable. If a dispute occurs, the usual requirement is to re-examine the independent valuation critically.

Divorces

4.8 Sometimes, one or both of the partners in a marriage are running a business which needs to be valued for the purposes of identifying the financial resources of the parties. The business may be either spouse's livelihood as well as the biggest

single asset of the married couple. Valuations of businesses in these circumstances can be clouded by distrust and secrecy. Quite often, expert testimony on their value has to be presented in court. The presentation of financial evidence in divorce cases is dealt with in Chapter 7.

Expropriation of companies

4.9 When one comes to deal with the expropriation of companies, it is very important to look at the terms laid down by whichever tribunal is charged with fixing the compensation. If the company which has been acquired has been a going concern for some time and has been producing profits, then the measure of loss is generally to determine the value of its future stream of earnings by reference to past achievements and future forecasts. If, on the other hand, the company is still in the start-up phase of its life, it will probably be essential to turn to some form of discounted cash flow, which takes account of the remaining investment that should be made before positive cash flow will result. That said, often international arbitration tribunals have tended to focus on a cost, or net assets, approach for start-up companies, on the basis that the future profits are too uncertain to estimate reliably.

Duties of a director

4.10 There has been an increasing number of cases (both civil and criminal) involving allegations that directors of companies have breached their duty to the company. It may be alleged, for example, that directors have been negligent or have acted in bad faith by securing a personal gain in buying or selling shares in the company. Evidence provided by the expert valuer on the valuation of such shares is often relevant to such allegations.

The negligence of a valuer

4.11 A valuation may be the subject of an action in court where a valuer himself, or a lawyer who may have drafted documents, is facing a damages claim arising from his failure to exercise reasonable skill and care. In these circumstances, the expert valuer may be called on to provide an opinion on the probity of the procedures followed and the methodology used in the valuation. At the end of this chapter, we discuss a number of court cases dealing with the issue of the valuer's liability for negligence.

Using valuation theory to test reasonableness of claims

4.12 The expert valuer must always be aware of the alternative courses of action which the claimant of damages has open to him. Valuation theory is often important here. For instance, a claim is made that a piece of plant or a factory was unable to meet its design requirements; a figure of £x is put forward as the measure of damage (lost profit). The question should be asked of the claimant: 'If you receive your claim in full, will you invest it in the improvement of the plant?' If the explicit or implicit answer is: 'No, I will use it to reduce my bank overdraft', certain adverse conclusions might be drawn about the value of the business and the economic case for the basis of the claim.

4.13 Or consider a situation where, following destruction of the item in question, a more modern or larger unit is put in its place. Again, business valuation principles can be applied – perhaps to demonstrate that the book value of the old plant was unrealistic because the plant was uneconomic, either in size or through out-of-date technology.

DEFINING THE ENTITY TO BE VALUED

4.14 Fundamental to the valuation process is the determination of whether the value of the business of a company, or the *equity* in the company, is required. The expert valuer must ensure that clear instructions are received to this effect. Valuers often use the terms 'enterprise value' to refer to the value of the business (which is akin to the value of the operational assets, including goodwill and other intangible assets), and 'equity value' to refer to the value of the shares. Putting aside specific complications (for example, pension deficits and surplus assets and liabilities), generally speaking and in its simplest form, 'equity value' equals 'enterprise value' less net debt.

4.15 Great care is needed to define exactly the entity or specific asset that is the subject of the expert's appraisal. The expert and the instructing lawyer should also agree precisely:

(a) the asset (for example, enterprise or shares) to be valued;
(b) the purpose of the task;
(c) the basis of valuation (eg fair value, market value, or economic value); and
(d) the date or dates of the valuation.

4.16 Case law or other legal principles will be of critical importance. Sometimes, values can alter greatly within a short time as a result of certain events, and it may be that those events will be deemed by the courts to have mitigated the damage. Substantial changes in the investing public's perception of the value of quoted shares in general are demonstrated by the significant decline in stock market indices around the world in the latter half of 2008. Sudden changes in a company's performance can likewise have a big impact on values. Accordingly, the relevant valuation date is key, and the valuer should seek clear instructions in this respect.

4.17 In cases of expropriation, the expert valuer needs guidance on the extent to which he should remove the influence of the prospective expropriation (or other adverse influence) from his valuation methodology.

4.18 Sometimes the expert will need to produce valuations for different times in the life of the business, since the legal guidance may be unclear as to which date is likely to be decisive in the court hearing. Normally, business values depend on an assessment of expected future cash flows; such assessments in turn depend partly on a review of the past to indicate the risk associated with the forecasting of expected future cash flows. In some situations, such as an incomplete project, no history will exist for the entity being valued. Claims in such circumstances stand or fall on the reasonableness of estimates of cash flows for several years ahead;

such appraisals can be highly speculative, and the courts may well view them with reserve. There will be other situations where the expert may be asked to establish a value as a measure for compensation by considering what has been spent on the project to date, or what the replacement cost will be, or by establishing some similar method of comparison.

METHODS OF VALUING A BUSINESS ENTITY

4.19 Since value, like beauty, is in the eye of the beholder, no absolute rules can be laid down. Nonetheless, as we have already seen, the context of the dispute is important, and the measurement of damages must be put into the legal framework which is laid down by practice in the courts, by terms of the agreement or, indeed, by statutory definition. Usually, market value – namely 'the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller, acting at arm's length' – is the measure required. The instructions will indicate whether this or some other standard of value is expected from the expert; and, if this is unclear, again, the valuer should seek guidance immediately.

4.20 The courts have recognised that valuation is not an exact science, and that different experts can, with perfect legitimacy, hold widely differing opinions as to the value of the same item. This was seen in the case of *Axa Equity & Law Home Loans Ltd v Goldsack & Freeman* [1994] 1 EGLR 175, where it was held that a valuer was not negligent in valuing an asset for more than it subsequently realised where the result was within a 'proper bracket of valuation'. In *Private Bank & Trust Co Ltd v S (UK) Ltd* (1993) 67 P&CR 166, a margin of 15% was considered to be a reasonable 'margin of error' where the property was unusual and it was thus difficult to achieve a level of precision.

4.21 The two most commonly used methods of valuing a company or an operating business are the 'market approach' and the 'income approach', otherwise known as discounted cash flow ('DCF'), which we explain below. A third method, the dividend yield basis, is usually used to value minority shareholdings.

4.22 In certain specialised industries or activities, values may be established by reference to the assets belonging to a company, not its future profits or cash flows. An example where this approach is used is property companies which are valued by reference to net assets, which may include investment properties, held at market value, and development properties, typically valued by reference to cost or DCF. That said, at the time of writing this chapter, share prices of many property companies were trading at substantial discounts (in the order of 40% to 50%) to the net assets per share, suggesting that the market does not place full value on the tangible assets when determining the value of the underlying equity. A definitive explanation for this discount has not been determined, although it may be related to minority discounts, tax impacts and the impact of leverage and associated financial leverage risks.

4.23 The assets approach may also be useful where a company is not generating a sufficient return on its assets, such that the value of the underlying individual

assets is greater than the value that may be attributed to the business on an earnings or cash flow basis.

The market approach

4.24 The market approach takes an estimate of maintainable earnings and multiplies this earnings figure by an appropriate multiple. We explain this method in detail in Appendix C. The choice of multiple reflects, inter alia: expectations about growth; business risk (which may reflect the size of a business, the market(s) it operates in, gearing and other relevant factors); quality of earnings; and management.

The income approach (or the discounted cash flow method)

4.25 As a concept, discounted cash flow ('DCF') analysis is relatively simple. It is based on the generally accepted theory that the value of a business depends on the future expected cash flows of the business at present day values. Discounting is used to take account of the widely accepted preference for money now rather than money in the future, often referred to as the 'time value' of money, and the risks associated with the expected future cash flows. Thus, as an example, the receipt of £100 in one year's time is attributed a lower economic value than £100 received today. The difference between the two economic values is represented by the discount.

4.26 The mathematical technique used in DCF analysis is the reverse of that used for calculating compound interest, a concept more familiar to laymen and perhaps the courts. Compound interest takes a capital sum today and, by the application of an interest rate, adds interest to the sum year on year, interest being calculated on principal and accrued interest in future periods. It is possible in this way to compute what a given sum, invested today at a given rate of interest, will be worth in a given number of years' time. By contrast, as we have seen, DCF will take the sum expected in the future and discount it back to the present day.

4.27 By expressing all cash flows on a present day basis, the costs of an investment can be compared with the returns from that investment, the difference being the net present value (NPV) of the investment.

4.28 In terms of this methodology, the cash flow (not the profit) that the company or business is expected to generate each year is discounted back to a current value. A simple cash flow valuation illustrating this principle is shown below.

Year	**Cash flow receivable***	**Present value (discounted at 10% pa)**
1	100	91
2	120	99
3	140	106
Total cash flows	360	
Present value of cash flows		296

*assuming cash flow is received at the year end

DCF analysis requires the following:

(a) a forecast of expected future cash flows over a relevant period of time;
(b) the choice of an appropriate discount rate; and
(c) the estimation of the terminal residual value at the end of the time period.

DCF methodology is explained in detail in Appendix C. It is natural that, when two or more parties are seeking to come to agreement, it can be difficult to reconcile views on such matters as:

(a) economic conditions in the future;
(b) business expectations, including competition and level of demand; and
(c) the competence of management to grasp opportunities.

4.29 Whilst long-term projections are therefore based on estimates and so can lack mutual acceptance, increasingly courts are recognising that DCF is a valid tool for assessing value and, in some instances, may be the most appropriate tool. That said, it is important for the valuer to realise that the creation of a large and complex model may result in confusion and extensive discussions as to methodology and assumptions, and therefore in many cases the valuer should seek to keep the DCF as simple and straightforward as possible.

Dividend yield valuations

4.30 Valuations of minority parcels of shares in private companies can also be derived based on the capitalisation of dividends rather than maintainable earnings. This is in recognition of the fact that a minority shareholder is not in a position to direct, and often not even in a position to influence, the operations of the business, including the ability to realise capital value through sale. As a result, the value of such a shareholding is generally restricted to its right to receive dividends.

4.31 Thus, for valuations of small minority interests in unlisted companies, the dividend yield method is often used. This involves computing a capital value for the shares by applying a yield to dividends actually paid or expected, based on the yield that could be derived from a comparable listed investment. Some discount would normally be applied to reflect any restriction on transferability of the shares and the absence of a ready market for the shares.

4.32 Dividend valuations of businesses do not otherwise differ fundamentally from other cash flow valuations, of which they represent a special case.

Special purpose valuations

4.33 In some specialised industries and activities, values are established by methods which do not conform to the main routes described above, for example: estate agents, insurance brokers, medical and dental practices, accountancy practices, petrol stations, hotels, public houses and off-licence shops. Each have traditional valuation formulae or rules of thumb applied to them, often based on a simple multiple of turnover or other industry benchmark, such as value per room

in the case of hotels. The methods used for evaluating such businesses provide a useful cross-check on conventional methods, ie market or income approaches, and highlight the importance for the valuer to have a good understanding of the industry issues and industry rules of thumb and benchmarks when conducting their valuation.

VALUATION OF NET TANGIBLE ASSETS

4.34 There will be occasions when the needs of the case require a valuation of a particular trading asset or group of trading assets, as distinct from the overall business valuation. The value of an asset or group of assets will normally be based on the market value of the asset; however, such values are best determined by specialists who are fully aware of the prevailing market conditions. As it is beyond the scope of the business valuer to determine specific asset values where he has no particular expertise, we have not considered the asset basis of valuation in any detail.

4.35 Net assets may be measured in a number of different ways. There are fundamentally two alternative bases: namely, by reference to their cost or to their current 'value'.

4.36 When the net assets are measured by reference to their cost, the source of information is the business's balance sheet, which tends to record original prices paid for them by the company. This basis is known as 'historic cost'. As the assets are depreciated over the years, the remaining balance is called the 'book value' or the 'written-down historic cost'. It should be evident that book value is not necessarily the price that the asset would fetch if sold in the market, or what it would cost to replace. The valuer should be aware, however, of the move to 'fair value' accounting under a number of accounting standards (for example, International Financial Reporting Standards (IFRS)). Accordingly, certain assets may be recorded on the balance sheet at their current valuation rather than historic cost.

4.37 When net assets are measured by reference to their current value, it is usual to adopt one of four approaches:

(a) the price that would have to be paid at today's date to purchase an asset equivalent to the existing asset (the 'current replacement cost'). If the replacement asset in question is partly worn out, it is termed 'written-down replacement cost';
(b) the current open market value of the asset;
(c) the 'forced sale' value of the asset, ie the amount likely to be obtained if it were put on the market in circumstances where the seller either has to take the best price obtainable in a fixed period or as soon as possible; or
(d) the net present value of all expected future earnings from the asset.

4.38 Each of these values may be supplemented by the premium which a purchaser is prepared to pay, reflecting such factors as potential economies of

scale, reduction in competition, the securing of a source of supply or outlet for products. The premium is unique to the purchaser. The existence of this special value means that the purchaser is prepared to pay a consideration which is over and above the value which other purchasers are prepared to pay.

4.39 The phrase 'the going concern value' is often used; strictly, this is not a system of valuation: the phrase simply states that the valuation rests on the assumption that the company can continue to trade for the foreseeable future, for example where it has adequate funds for doing so.

4.40 The economic value of a company's assets tends to be the one which causes most discussion in legal disputes, ie the present value of the assets' expected earnings.

Liquidation basis

4.41 Typically, assets sold on a liquidation basis will realise significantly less than would be the case if the asset was sold in the normal course of trading on a going concern basis. For instance, the cost of stock and work in progress sold in these circumstances by auction will generally have to be discounted significantly in order to attract buyers. This method is likely to be appropriate for valuing controlling interests of entities facing liquidation.

Replacement cost

4.42 The replacement cost basis of valuation is based on the concept of replicating or duplicating a business from scratch. The replacement cost method can be used as a method of valuation in seeking to calculate the loss which a business would suffer if deprived of an asset. Such assets may also be valued on the net present value or the net realisable value basis.

The choice of concepts for litigation purposes

4.43 No definite rules can be laid down, and clearly the requirement of the court should be the fundamental consideration in determining the valuation approach to be adopted. Sometimes, more than one approach will be appropriate. Case law may indicate the preferred course to be followed. Time should always be taken to examine all the options available and to consult with the instructing solicitors.

4.44 As a general guide, however, although value needs to be determined in the context of each assignment, most independent valuations of shares and businesses tend to use the term as meaning 'market value':

> 'the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller, acting at arm's length.'

Such factors as compatible products, synergistic advantages, competition for the shares from other potential buyers, recent trades in the shares, as well as others pertinent to the shares being valued, will be relevant.

Fair value

4.45 The expert is sometimes asked to arrive at 'fair value' for shares. Unfortunately, 'fair value', although commonly referred to, does not have a consistent widely recognised definition. The essence of the fair value concept tends to be the desire to be equitable to both parties and it recognises that the transaction is not in the open market. The buyer has not been able to seek the lowest price, nor has the seller been able to hold out for the highest price.

4.46 However, often 'fair value' will be prescribed in a company's Articles of Association or Shareholder Agreements; in this case, it is important that the valuer gives due consideration to (and often adopts) the definitions as set out in those documents. It is important for the valuer to recognise that sometimes such documents incorrectly use the title 'fair value' when they instead prescribe an approach that reflects market value (or some other basis). Accordingly, the valuer should carefully review the documents rather than taking the terms at face value. Similarly, the new accounting standards, such as IFRS, adopt the term 'fair value', although the underlying definition is that of 'market value'. Again, the valuer needs to be cautious.

4.47 While the 'fair value' basis of valuation does not ignore the factors relevant to a market value, it considers also the relative position of vendor and purchaser in the specific transaction. So, for example, a small minority shareholding in a private company may be of relatively little worth on a market value basis, but could be worth a significant amount to an existing shareholder if, for example, it would assist them to gain control of the company. Accordingly, the fair value approach may be used to consider the respective positions of the shareholders and to identify a 'middle ground'. The 'fair value' basis is commonly used in minority oppression cases under Companies Act 2006, s 994.

Economic value

4.48 'Economic value' may also have relevance in court cases. Economic value represents the value of a business or asset to the current or a prospective owner. This represents the compensation the present owner would require in exchange for not owning the business or asset, including compensation for any indirect consequences. Alternatively, it represents the value a prospective owner would put on the opportunity to exploit the business, given his circumstances. For example, if a family business is being valued it may be determined by this route, particularly if there is no intention to sell the business in the near future.

4.49 Economic value may also be more appropriate where the market value of an asset is significantly affected by prevailing external factors, such as the availability of debt finance, as at the valuation date, and where there is no intention to sell the business in the near future. Alternatively, economic value may be relevant where there is significant personal goodwill attached to a business such that the 'market value' of the business absent that individual might be very low, although the earnings generated by that business in its current form, operation and structure may be high, and therefore warrant a higher value. Sometimes, economic value

is also referred to as intrinsic value (ie the value intrinsic to the specific asset or business). Economic value is typically determined by the DCF approach, but each situation needs to be taken on its merits; and, in some circumstances, economic value may simply mean the value of an asset absent marketability discounts.

Value combinations

4.50 It is perhaps helpful to consider what concepts are to be applied when the dispute is more extreme between the parties. Take, for instance, a claim for lawful or unlawful expropriation. If the business has operated profitably, the claimant may well argue for an economic or market valuation. But he will also look at replacement value on the grounds that the underlying asset should not be taken from him 'on the cheap', in what is really a forced sale.

4.51 If his business is still in the start-up phase, the claimant may use book value as a starting point, taking the line that as a minimum he should receive back what he has spent. He will also look for compensation for the lost opportunity to make profits in the future, attributing an element of economic, or market, value to the assets.

4.52 A claimant may in certain situations be justified in looking for a valuation which includes elements of all approaches (market value, fair value, net realisable value, replacement value, and economic value). Consider, for instance, a business which has not only a profitable operation, but also a redundant office building, a large unused bank balance, and mineral deposits (or a land bank) which will take care of many years' requirements. Here, the claimant should argue for market or economic value for the profitable operation, net realisable value for the surplus office building and the cash, and replacement value for the mineral deposits (or land bank).

CPO valuations

4.53 In claims for compensation for compulsory purchase of business premises, the concept of extinguishment valuation can arise. Most businesses facing a compulsory purchase order will seek to relocate. Generally, if the cost of relocating is more than the present value of the business, the court may limit the compensation to the lower value (known as extinguishment value). However, following the decision in the Hong Kong case of *Director of Buildings and Lands v Shun Fung Ironworks Ltd* [1995] 2 AC 111, PC, the fact that the cost of relocation exceeds the present value of the business is not an absolute bar to assessing compensation by reference to the cost of relocating. It depends on how a reasonable businessman, using his own money, would behave in the circumstances. The expert valuer can assist the court here in two ways: first, he can quantify the extinguishment value; and, secondly, he can compare this with the total expected cost of relocation at the time the decision to relocate was taken. As a result, he may be able to express an opinion on the reasonableness of the company management's decision to relocate based on the financial information available to them at the time.

4.54 In a more recent case, *Optical Express (Southern) Ltd v Birmingham City Council* [2003] ADRLR 08/27, the Lands Tribunal accepted a departure from

the traditional valuation methodology used in compulsory purchase claims. This approach had valued the business using historic profits and applying a multiple of years purchase (usually in the range of two to five). The Lands Tribunal criticised this approach on the basis that the years purchase multiple had no reference to market value. Instead, it accepted the use of an EBITDA (earnings before interest, tax, depreciation and amortisation) multiple based on comparable listed companies.

4.55 We hope that the discussion of alternative valuation concepts set out above will demonstrate the subjectivity and choice which exists in this area and the importance of discussing both the basis of valuation and the appropriate methodology with instructing solicitors at the outset of the engagement. The merits of each type of valuation approach adopted by the claimant will need to be looked at critically by the defendant's experts. It is unlikely that one method alone will be sufficient for arguing the case in court.

SOME ODDITIES EXPLAINED

4.56 The following apparent oddities arise in valuations at times, puzzling lawyers and others concerned with values:

(a) How does market capitalisation relate to asset values?
(b) How do multiples relate to capitalisation rates?

Market capitalisation and asset values

4.57 Some people expect there to be a relationship between market capitalisation and asset values. Financial commentators talk about underlying asset values being X% more or Y% less than the quoted price, as though the relationship is direct. The reality is that shares are normally valued on earnings capability, not on underlying assets. A financial services company, for example, with virtually no tangible assets may have a market capitalisation of millions of pounds. The difference between the market capitalisation and net tangible assets is therefore represented by intangible assets (for example, brand or tradename, customer relationships, technology, patents and workforce) and goodwill. Alternatively, if a company can be broken up and sold off, asset values may be more important, as the intangible assets and goodwill may no longer be in existence.

4.58 Furthermore, it is fundamental for the valuer to ensure he is comparing like with like. For example, assessing the value of a business using an EBITDA multiple will generate enterprise value (ie the value pre-debt). This is because the EBITDA multiple itself is calculated based on the enterprise value of the comparable company and is a before interest (finance) measure. However, if the valuer is basing the value assessment on a price/earnings multiple, this generates the equity value (ie value post-debt). Depending on the method of calculating the cash flows , the DCF method can arrive at enterprise value or equity value, a fundamental difference if there is material debt in a company.

High multiples and capitalisation rates

4.59 Some people, seeing a share quoted at 25 times reported earnings, think that this implies that the shareholders are content to buy shares that will give them only a 4% net return. However, investors are more interested in the future earnings capacity of a company. If this year's earnings double, the multiple will halve to 12½ times. If profits double again, the multiple will drop to 6¼ times. Conversely, if profits halve, the multiple will double to 50 times reported earnings. Accordingly, the valuer must understand the multiple of earnings, how this was derived (for example, whether it is a historic, current or forecast multiple), and the growth prospects for a company.

4.60 Alternatively, a multiple may be high because, for example, a new business was established mid-year and therefore the reported historic profits do not represent an annualised year of earnings. In other words, the share market may have captured the likely 'value' of this new business, whereas the reported earnings do not yet reflect the impact of the new business.

INFORMATION GATHERING

4.61 As with many aspects of accounting work for litigation, a thorough approach to the way that information is gathered in preparation for valuation is essential. The court will want to be satisfied that the valuation presented to it is both reasonable and soundly based.

4.62 The following sources of information should be considered in a valuation:

(a) a site visit to the business, including meeting management;
(b) information about the business, its competitors, management (including succession issues) and prospects, obtained by interviewing those responsible for running the business;
(c) market statistics published by the stock exchange, eg share prices of comparable companies;
(d) the annual reports and audited financial statements of the company or business being valued, taking into account, where appropriate, a period of time reflecting the economic cycle of the business;
(e) government papers, industry studies and statistics;
(f) a review of literature about the business and its market environment, including brokers' reports, financial journals, trade journals and newspaper reports;
(g) a review of papers about the business's financial position and future prospects, including detailed management accounts, board minutes, business plans, and market surveys;
(h) reviews of comparable businesses or recent market transactions involving comparable businesses;
(i) examples of recent valuations of part or all of the business, such as recent employee share transactions or previous offers for the business; and
(j) the company's Articles of Association, to check whether any restrictions exist on the transferability of shares or there are any prescribed valuation methodologies, and any shareholder agreements.

4.63 The scope of the investigation will depend on the nature of the valuation and on whether the valuer has access to people and papers. Instructing solicitors will appreciate an early indication of the types of documents which ought to be seen, particularly if they need to apply for disclosure of the papers from the other side.

LOSS OF INVESTMENT OPPORTUNITY

4.64 There is a growing area of litigation in connection with lost investment opportunity, for example, loss of opportunity to do something, caused by someone else's wrongdoing. The basic rules of calculation follow those described in Chapter 2 dealing with loss of profits, but, at the risk of some repetition, the subject of lost investment opportunity deserves separate study. It is important to say that the rules are not clear in law. A number of cases have argued that damages for the loss of an opportunity should be recoverable but, to date, there has been no conclusive authority on the point. Certain cases of this type have been founded on the tort of unlawful interference or conspiracy to injure. However, it is not necessary to show that the intention to cause injury was the predominant purpose of the alleged unlawful action.

4.65 First, let us distinguish the concept of loss of profits from the concept of lost opportunity. Loss of profits is normally regarded by the courts as a form of pure economic loss (unless an element of physical damage to property or person also enters into the claim). Where such a loss is purely economic, the courts are normally reluctant to allow the recovery of damages in respect of that loss in a claim based on the tort of negligence (the notable exception to this 'reluctance' is in the case of professional negligence, where economic loss does feature in awards of damages). Accordingly, where property is damaged, any immediate economic loss which arises as a result will be recoverable as damages, but future economic loss is less likely to be recoverable, on grounds of uncertainty. In *Department of the Environment v Thomas Bates & Sons Ltd* [1991] 1 AC 499, the House of Lords held that the diminution in value of a lease due to negligent and defective building was pure economic loss and so not recoverable. The building itself, while not fit for its intended purpose, was not physically damaged, nor was it an imminent threat to health and safety. This case followed the decision in *Murphy v Brentwood District Council* [1991] 1 AC 398, HL, where it was held that the council was not liable for defects in a house in circumstances where there was no injury to persons, no risk to the health and safety of others and where there had been no damage to other property arising out of the defect. The approach taken in *Murphy v Brentwood District Council* still remains the starting point of any discussion of pure economic loss, although the law on the duty of care has evolved and is discussed in more detail in Chapter 8 of this book dealing specifically with professional negligence.

4.66 The concept of loss of opportunity caused by a wrongful act has to be viewed differently. Here, the loss complained of is the loss of the chance to earn profits in the future, rather than the loss of profits themselves. If such damages are recoverable, the claimant in respect of such a loss has to satisfy the courts, on the

balance of probabilities, that he stood a certain percentage chance of obtaining the benefits of the opportunity he claims to have lost.

4.67 A person who is wrongfully deprived of an opportunity to obtain a benefit may recover damages for the loss of an opportunity, even though it cannot be proved with certainty that the opportunity would have been taken or any benefit obtained. In *Allied Maples Group Ltd v Simmons & Simmons* [1995] 4 All ER 907, the claimant was denied the chance to negotiate a warranty protecting it against some contingent liabilities. The Court of Appeal held that the claimant was entitled to damages for losses flowing from the bad advice, even though it could not prove that it definitely would have obtained the warranty.

4.68 The role of the expert valuer would be to calculate the total value of the lost opportunity. It is for the court to make such discount as is necessary to reflect the element of uncertainty present. Such an approach is illustrated in *First Interstate Bank of California v Cohen Arnold & Co* [1996] PNLR 17. The bank was given wrong information about its customer's net worth by the latter's accountants. The Court of Appeal decided that, if the accountants' assessment had been accurate, the bank would have moved to put its secured property on the market two months earlier and would therefore have had a real chance of selling the property for more than it did. The court valued that chance at 66²/₃% of the property's value two months earlier, less what was actually received.

4.69 More recently, in *University of Keele v Price Waterhouse* [2004] EWCA Civ 583, a university was wrongly advised by the defendant accountants as to the number of participating employees required for a tax-efficient scheme to be valid. It was held that the proper approach to the damages was to consider the chance that the university would have had, if it had been properly advised, to achieve the required number of participants. The court assessed the chances of success at 80%. Thus, the university was entitled to recover 80% of the moneys it had paid in tax.

4.70 In *Floyd v John Fairhurst & Co* [2004] EWCA Civ 604, a tax adviser failed to inform the claimant of the availability of roll-over relief against capital gains tax. It was accepted that the claimant had to show that he had lost the chance of taking advantage of roll-over relief and that, on the balance of probabilities, he would have done so. Both the trial judge and Court of Appeal held that the claimant had failed in this, and hence the claim failed.

It is also for the court to select, perhaps from a range of models or methods, what is most appropriate for remedying the tort or contractual defect.

Methods of measuring the value of lost investment opportunity

4.71 As we have said, one or more methods can be employed to value loss of opportunity. The key formulations are set out below:

(a) *The use of a replacement model*. We have lost the bargain, so what will it cost to find an equivalent? Such an approach might be appropriate to value, for

example, a picture, some property, an oil field, or perhaps a company which has a unique character. Sometimes, the opportunity lost is unique, such that an equivalent is very hard to find.

(b) *The valuation of the future profit potential*. Here, the need is to calculate what extra profit would have been enjoyed by the intending purchaser which was not itself fully represented in the price at which the bargain was going to be struck. This is an 'incremental profit approach' and might well be appropriate in a claim where the value to the purchaser was significantly higher than the market value, perhaps as a result of specific synergies to be realised from linking the new acquisition to its existing business.

(c) *The break-up value*. Normally, this will not be appropriate for going concerns, but it should always be considered as a partial alternative. For instance, where there is a high element of cash or spare land and buildings, or some valuable product brands which could be disposed of without injuring the rest of the business, the break-up value should be brought into the equation.

(d) *The original investment value or written-down historic value*. This may well be a valid approach where there has been an expropriation of a company.

(e) *The inflation adjusted book value of the assets*. This is really a variation of (d), and simply allows for the loss in monetary value which has occurred since the original investment was made. It is particularly relevant when the country in which the company operates has suffered from high monetary inflation.

4.72 Perhaps the most difficult approach is method (b), namely, valuing the future profit potential. There is a need to estimate what would have been the outcome had there been a complete success in terms of, say, an acquisition of a business or company. We have already discussed the two principal routes for putting a value on future earnings: the discounted cash flow technique, and the market approach.

4.73 There is a simpler approach to valuation of profits, and that is to add them all up between the date when the tort or contractual breach occurred and the date of the judgment. If this is done, together with interest, it often produces a figure which a court will be prepared to accept as a reasonable and conservative estimate of lost opportunity. It is deficient, in that it excludes any future losses arising after the court hearing. But it should not be overlooked that judges generally take the view that the damage will not be suffered for an infinite period; there will be other bargains about, and it will be up to the claimant to mitigate his loss by seeking those other bargains.

THE IMPORTANCE OF ASSUMPTIONS

4.74 When an expert prepares his valuations for court purposes, he should give special thought to the appropriateness of the assumptions underlying his work. It is surprising how often it bears fruit to ask the other side's valuer, in cross-examination, what his assumptions were when preparing the valuation. It is a truism that valuations are no better than the assumptions on which they are based; however, for valuations for court purposes, one should add a further limitation: valuations based on verifiable assumptions (for example, economic or market data) will be preferred to those based on theoretical or speculative ones.

4.75 The decision in *Anangel Atlas Compania Naviera SA v Ishikawajima-Harima Heavy Industries Co Ltd (No 2)* [1990] 2 Lloyd's Rep 526 shows the importance of being able to justify the assumptions involved in financial models.

4.76 The case concerned damages arising from a breach of a 'most favoured customer' clause. The claimants not only claimed the difference in price between the final cash price of ships sold to them and those sold to another party which was given better terms, but they also claimed loss suffered due to differential credit terms on which finance was provided to the buyers. In order to do this, Anangel's expert employed a concept of 'net finance benefit', which he defined as the net loan cash flow discounted at the opportunity cost of the funds. This represented the return that the purchasers of a vessel would be able to obtain by investing in their own business funds made available as a result of the credit terms.

4.77 The judge rejected the concept of 'net finance benefit', accepting the defendants' submissions that, if such a claim was reasonable under the agreement, it ought to be capable of being calculated by competent accountants rather than a team of high-powered accountants. Also, it should not be necessary to use data to which they, the defendants, could not reasonably have access, nor should it involve the use of assumptions. The judge also questioned the assumptions that the past rates of return were a guide to the future, and that rates of return on equity were a better measure than, for example, bank deposit rates.

4.78 The message from this case was that the court would subject both valuation techniques and assumptions to careful scrutiny. In particular, it was a warning to an expert whose methodology for calculating loss is too theoretical.

The valuer's liability for negligence

4.79 In undertaking a valuation, a valuer implicitly warrants to his instructing client that he has a reasonable degree of skill and knowledge, and that he will exercise reasonable skill and care in preparing the valuation report which is sought. A serious failure to exercise reasonable skill and care may leave the valuer liable to a claim for damages for losses occurring pursuant to a breach of contract. There may also be an extended duty of care to third parties in certain circumstances, by operation of the law arising in tort.

4.80 The collapse of property prices in the early 1990s led to an explosion of cases alleging negligence against valuers, which in turn led to a major legal debate as to whether the negligent valuer could be held responsible not only for the extent of the negligent overvaluation but also for the subsequent losses caused by the fall in the value of the property because of the collapse in property market prices generally. The debate culminated in the House of Lords decision in *South Australia Asset Management Corpn v York Montague Ltd* [1997] AC 191. The court held that, in deciding the correct measure of damage in negligent valuation cases, it is first necessary to establish the scope of the valuer's duty. There is a distinction to be made between a duty to provide information to enable someone else to decide on a course of action and a duty to advise someone what course of action he should take. In an 'information only' case, the valuer is responsible

for the foreseeable consequences of the information being wrong, ie the claimant would pay or lend too much for the property. Thus, the measure of damage is 'capped' at the difference between the negligent valuation and the true valuation at the original date of valuation.

4.81 In an 'advice' case, the valuer is under a duty to take reasonable care to consider all the potential consequences of his client following the advice given, and will be liable for the foreseeable loss which was a consequence of that advice being followed. Here, the damage would also include the subsequent loss caused by the market collapse in property prices.

4.82 'Advice' cases can also give rise to additional complications over mitigation because, in a falling market, any delay in selling will increase the potential damages. Failing to wait for an upturn in the market could have similar consequences. As usual, where questions of mitigation are concerned, the court would consider whether the claimant acted reasonably, given its predicament. The expert valuer may have a role here in providing background financial analysis to assist counsel in presenting their case on mitigation.

4.83 The House of Lords noted that there could be exceptions to the principles of damage in 'information only' cases. They cited, by way of example, a person providing information fraudulently, where, by reason of the fraud, he may become liable for the whole risk of loss.

4.84 The House of Lords decision in *South Australia* produced a result which makes commercial sense. The likely consequences of a property investing company being informed that a property has a lower true value would be for it to invest less in that property or not invest in it at all. The funds thereby made available would probably have been invested in other properties and thus remained exposed to a general market collapse, ie they would probably have suffered the recessional loss in any event.

4.85 A lender's damages can be reduced by a finding of contributory negligence in relevant cases. In *Platform Home Loans v Oyston Shipways Ltd* [2000] 2 AC 190, a lender's contributory negligence for failing to obtain the borrower's answer to a key question was assessed at 20% and, significantly, the percentage was applied to the whole of its loss, not just the 'capped' loss based on the principles set out in *South Australia*.

4.86 Interestingly, whereas in *South Australia* the valuers were held liable only for the loss resulting from the over-valuation and not for the much greater loss from the property market collapse, in *Aneco Reinsurance Underwriting v Johnson & Higgins* [2002] 1 Lloyd's Rep. 157, HL, where brokers had failed to effect valid insurance, they were held liable not just for the loss resulting from their failure to insure properly but for the greater loss resulting from their client having no reinsurance at all. This was because the House of Lords found that the brokers had undertaken a duty to advise the company as to what course of action to take.

4.87 It is likely that valuers and accountants will once again be in the firing line as a result of the current financial and property crisis. To what extent these

expected claims materialise, and to what extent they are reduced for contributory negligence, ie for the claimant's negligent lending practices, remains to be seen.

SUMMARY

4.88 Out of necessity, this chapter has merely touched upon the areas of most common concern to expert valuers. There are several excellent books on valuation, some of which we list in our bibliography. Valuation is a forward-looking exercise. No set of circumstances is precisely the same as the one which preceded it. Prices can be volatile and influenced by mood as well as reason, and so one cannot always achieve exactitude.

4.89 In all cases, the expert engaged to prepare a valuation should ensure that his opinion is:

(a) independent;
(b) based on the best available information in circumstances where there is admissible evidence to prove all of the necessary underlying factual assumptions in court;
(c) verifiable to the greatest possible extent;
(d) formulated on the basis of the relevant legal principles (as communicated to the valuer by the legal advisers);
(e) formulated using the most appropriate methodology; and
(f) presented to the court in a logical and coherent manner.