29
BEDFORD ROW
CHAMBERS

Dealing with business assets on divorce

Outline

1. What to do when there's a business

2. How to approach company accounts: reviewing accounts

3. How to approach company accounts: Form E and questionnaires

4. Valuations generally

5. Legal arguments

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1. **What to do when there's a business**

1.1 You need to get a feel as to the nature of the business that you're dealing with, and whether this is the kind of case where you'll be seeking an expert valuation. You can only do that if you're well informed about business performance, its major assets and its ownership.

1.2 The business may be small and privately run, or it may have a global presence.

1.3 If you are dealing with a company, it will be required to draw up accounts to a minimum level according to its size as prescribed by the Companies Act 2006 (CA 2006).

1.4 Understanding the business at this early stage means that you need to be proficient in understanding business accounts (whether you are dealing with a company, partnership or sole trader).

1.5 Company accounts may assist in establishing:

(i) A party's true level of remuneration;
(ii) Whether a party has an interest in a company pension scheme;
(iii) Valuation – the value of the party's interest in the business;
(iv) The availability of resources which could be distributed to satisfy the ancillary relief claim of a spouse; and
(v) Whether a party's assertions as to the poor performance (and 'inevitable' winding up) of a company have any basis.

1.6 Go on to the Companies House website to see what information can be obtained.

1.7 Should be able to get:

(i) Incorporation documents (which will allow you to confirm the court's jurisdiction);
(ii) Copies of accounts for the past few years;
(iii) Annual return containing list of members (shareholders);
(iv) Statement of directors. Look out particularly for changes in shareholders and directors;
(v) Whether the company has been advertised in the gazette. If the company is being wound up and your client is a director, you might want to object - but you certainly want to know about it.

1.8 Accounts may well be abbreviated, in which case the amount of information they reveal will be limited.

1.9 If full accounts, you should be able to glean a lot of information (providing you understand them).

Year on year comparisons are incredibly useful: have there been fluctuations? Why? Is this the kind of case where you need to exercise caution because it looks as though liquidity in the company has changed significantly but for no obvious reason.

(use the quick ratio:

<u>Current assets LESS stock</u>
Creditors due within one year)

1.10 Partnership accounts (unless a LLP) and sole trader accounts will obviously be a lot less detailed.

2. How to approach company accounts: reviewing accounts

2.1 Ideally, you will undertake a review of the company accounts prior to serving questionnaires, although it may prove difficult if there is only limited information available.

2.2 Start with looking at the accounts and **comparing** the profit and loss account results for the current year with the prior year.

2.3 Are there any noticeable changes? If so, note what they are and if there is no obvious explanation, make sure that you ask a question.

2.4 Do exactly the same with the balance sheet.

2.5 Be alert to any **changes in accounting policy**. You'll need to look at the notes to the accounts. To what extent have any changes affected the results?

2.6 Have there been any **changes in the company's dividend policy?** If so, why? Question whether this is a conscious change now that there are financial remedy proceedings.

2.7 Make sure that you get to the bottom of movements on the **director's loan account**. Typically, this can be used as a 'financial resource' by the director.

2.8 Are there any **'hidden assets'**? Goodwill is going to be very hard to quantify (and if it could be quantified, it might appear on the balance sheet in any event). Query whether this is the kind of company where there might be intellectual property which has been written off through the accounts already.

2.9 **Be careful where the other spouse is a director (and a shareholder)**. Directors set the remuneration policy. Query whether there has been a conscious effort to reduce salaries, and/ or reduce dividend policy now that ancillary relief proceedings have commenced. Be particularly alert where there are a number of director/ shareholders and a number of different shares (e.g. A to E shares).

2.10 There is one kind of situation that you may well come across: where a sole-trader incorporates. The assets are bought by the new company for a sum in excess of their net value, and this excess is capitalised as goodwill. The spouse will receive part shares, but the company will owe the spouse funds via the director's loan account. This will be paid off via loan repayments. This form of remuneration allows the spouse to gain a tax advantage, in that these 'repayments' are not subject to income tax (although it is possible there will have been a capital gains tax charge on incorporation).

Indicators of financial performance

2.11 A list of 'indicators of financial performance' are attached to this document. Key indicators are 'Return on Capital Employed' (ROCE) and the 'Current Ratio'.

2.12 Where one party says that the company is under-performing and the outlook is bleak, compare the past few years results in absolute terms (ie have gross profit and operating profit gone down as a percentage), but also try to calculate ROCE and the current ratio for each year.

2.13 The first is an investor's ratio and tells you generally, how the company is performing. The second is a quick measure of liquidity. If the company is unable to meet its current liabilities with its current assets, it could end up in financial difficulties.

2.14 Benchmark?

3. <u>How to approach company accounts: Form E and questionnaires</u>

<u>What to do if you're representing the spouse with company interests</u>

3.1 Hopefully your client can provide you with information on the company and his interest. If not, Companies House should be the first port of call (see below).

3.2 Filling in Form E:

(i) Box 2.3 – bank accounts

Required to list any account in which you have an interest.
Not the company bank account here.

(ii) Box 2.10 – capital gains tax

Required to put in details of any capital gains tax due on disposal of real property or personal assets.

It is highly likely that in relation to any shareholding/ sale of business assets it will not be possible to quantify the capital gains tax due at this time, but make sure you flag it up as a liability.

(iii) Box 2.11 – Details of all your business interests. Complete one page for each business you have an interest in.

Very rarely filled in completely. Has there been a material change in the company's circumstances? If so, should it be included here?

<u>Should you obtain an expert report at this stage?</u>

If funds permit, it could be a useful way of ensuring that you introduce your expert e. It could also make it more difficult for the other side to argue for the appointment of an expert.

Give instructions in neutral terms.

Useful - but if perceived as 'stealing a march', you may come in for criticism.

J v J [2014] EWHC 3654 (Fam) and *S v S* [2014] EWHC 4732 (Fam) - the court criticised the husband for appending an expert report in respect of the value of his shares where a report was exhibited to Form E without leave of the court.

Alternative - put a valuation in Form, explain that based on valuation, and send a copy to the other side?

(iv) Box 2.12 – Directorships

Required to list any directorships you hold or have held in the last 12 months.

Make sure that you complete this – it may be worth doing a director's search.

(v) Box 2.14 – Other assets

(vi) Boxes 2.15 & 2.16 – Income from employment and income from self-employment or partnership

Make sure that these boxes tie in with whatever it says in the accounts, and tax returns.

(vii) Box 2.17 – Income from investments

Make sure this ties in with accounts and tax returns.

<u>What to do if you're representing the spouse without company interests</u>

3.3 The first step is to find out what you can about the company. See above.

<u>Asking for information in the questionnaire</u>

3.4 Consider asking for:

(i) Statutory accounts for past three years (if you have not already been able to obtain them);
(ii) Details of movements on the director's loan account for the past three years;
(iii) Management accounts showing the company's financial performance over the past 12 months,
(iv) VAT returns for the past 2 years;
(v) Business/ project forecasts;
(vi) Business plans;
(vii) Company tax returns;
(viii) Documents setting out remuneration policy in relation to key personnel;
(ix) Constitutional documents.

3.7 May want a shadow accountant's assistance at this stage.

4. Valuations generally

4.1. Valuation is an art not a science, *(see H v H [2008] 2 FLR 2092)* and a means of assisting the court in reaching a fair decision. Particularly privately owned companies:

> *"Valuations of shares in private companies were among the most fragile valuations that could be obtained, being the product of an individual's subjective assessment"*

4.2. There is no magic formula to deciding whether to have a valuation.

4.3. <u>Is it necessary?</u>

More likely to be unnecessary:

4.4. If you agree share transfers apportioning the shares between the parties, or agree a percentage lump sum on a deferred basis when the company is sold or floated - *S v S 1 & 2*.

4.5. If a business is just an income stream *(V v V)*.

4.6. Sole-trader? Not usually necessary. However, need to consider the nature of the business, whether there is intellectual property, for example.

4.7. Small minority shareholding - illiquid and significant discount.

More likely to be necessary:

4.8. If the parties own a substantial part of the business.

4.9. If a complex structure.

4.10. If the parties are close to retirement? Is the business likely to be wound up/ sold?

4.11. If there is an undervalue of assets e.g. land or property. In those circumstances, you may merely look to have a valuation of the assets.

4.12. To ascertain the company's liquidity.

4.13. To try to get to the bottom of a difference between the parties' standard of living and the assets as per the accounts.

4.14. **<u>Valuations have limitations</u>**

4.15. Valuations can only be a snap shot, even if it's a poor one. Should other spouse be able to argue that the current snap shot of the company value is unfair to her claim? Not according to *Murano v Murano[2010] EWCA Civ 119.* See also *S v S (No. 2) [2010] 1 FLR 993*.

4.16. Sometimes, it may not be possible to value a company with any degree of accuracy. The safest option, therefore, would be for the parties to each retain shares <u>*P v P* [2010] 1 FLR 1126</u>. In that case, the SJE valued the shares at £730,000. After judgment (in which the DJ awarded H the shares and W a lump sum equal to half the value of the shares) the company offered to purchase the shares from H for £2.8m. The DJ refused to vary the quantum of the lump sum. On appeal, with two fresh forensic valuations, the court determined that it could not accurately value the shares, and it would be unfair to leave the opportunity in H's hands alone, and so the shares were shared between the parties.

4.17 **<u>Selecting a valuer</u>**

4.18 Primary considerations: cost and expertise.

4.19 If it's a specialist area - obviously require a valuer with specialist expertise.

4.20 Also need to think outside the box. A valuer from a well-known firm will have the reputation of the firm behind them, but they make not carry out all of the work. Think ahead - how good will they be in evidence?

Legal arguments

5.1 Pre –marital, post marital or non-marital acquest

Growth in a company before or after marriage. Why should a spouse outside of the company share in the growth?

5.2 Pre-marital growth

Where one party has owned or built the company long before the marriage does that justify departure from sharing? See *Jones v Jones* [2011] EWCA Civ 41 and *Robertson v Robertson* [2016] EWHC 613 (Fam).

See also *H v H [2008] 2 FLR 2092* Moylan J found that the fact that Husband had worked in his family restaurant business for 30 years was a factor that had to be taken into account. However, it was not possible to or appropriate to split the assets into non-marital and marital. The business could not be sold, there was insufficient capital to afford a clean break. Wife received 67% of the non-business assets and joint lives periodical payments.

5.3 Post marital growth

Depended upon the efforts and contributions made jointly during the marriage? Not in *S v S (No.1) [2007] 1 FLR 2120 and S v S (No. 2) [2010] 1 FLR 993.* W did not share in the growth even though she argued that H had enjoyed the use of her share of the company since separation, without which he could not have achieved that level of growth.

The company had become a different animal since the breakdown of the marriage, W retained all the copper bottomed assets, H retained only risk laden assets and H would have to work extremely hard not to lose the company, and even more work to make a success of it.

See *N v N [2001] 2 FLR 69 (Coleridge J)* where W received 40% of the assets to reflect the significant growth in the company post separation.

5.4 Springboard effect

The efforts of the spouse during the marriage to the company can be seen as providing the “Spring board effect” as explained in *Jones v Jones.*

5.5 Goose that laid the golden egg

A cautious approach necessary to avoid slaughtering the proverbial golden goose, see *D v D & B Ltd [2007] 2 FLR 653i.* Ongoing periodical payments would compensate for lack of share in the company

5.6 Valuations too unreliable – divide shares

This is the only remedy where there is likely to be (a) significant variation in the valuation evidence, (b) liquidity issues and (c) no outside buyer. If setting out to receive shares, can avoid cost and uncertainly of accountancy evidence from outset. *See P v P [2010] 2 FLR 1126 (Moylan J)*

5.7 Deferred capital claims

Worried that the director spouse may try and shift the company business into a new company leaving Wife with valueless shares? Leave open her lump sum claims until compliance by the husband /company in sharing ultimate sale proceeds when company is bought out. Could include recital to express limited nature of lump sum claim, ie: to protect share value and ensure parity with Husband in any eventual disposal of his shares.

Appendix I – Indicators of financial performance

1. **<u>Return on capital employed</u>**

   ROCE = profit after tax/ capital employed x 100%.

   Capital employed = fixed assets plus investments plus working capital (current assets less current liabilities). Use market values if possible.

   <u>SOLVENCY</u>

2. **<u>Current (or quick) ratio</u>**

   Current ratio = current assets/ current liabilities (2:1)

   Quick ratio = current assets less stock/ current liabilities (1:1)

   <u>WORKING CAPITAL CYCLE</u>

3. **<u>Trade debtor days</u>**

   Trade debtor days = Trade debtors/ turnover X 365

   (Tells you how long it takes on average for debtors to pay up – the lower the better)

4. **<u>Trade creditor days</u>**

   Trade creditor days = Trade creditors/ purchases x 365

   (Tells you how long it takes on average to pay creditors – the higher the better, but it's important not to push creditors too far, otherwise they might call in debts).

5. **<u>Stock days</u>**

   Stock days = Finished stock/ purchases x 365

   (Tells you how much 'working capital' is tied up in stock. The lower the better, because a company wants to realise its stock in sales).

GEARING

6. **Debt: Equity**

   Debt compromises debentures, long term loans, preference shares and long term overdrafts. Equity comprises ordinary shares, share premiums, reserves and minority interests.

   Generally, 1:1 is healthy – but it depends on the type of business.

   The higher the gearing, the greater the risk of return for shareholders.

7. **Interest cover**

   Interest cover = operating profit/ interest payable.

   It is a key measure for lenders.

8. **Price/ earnings ratio and earnings per share**

   The price/ earnings ratio shows you how long it would take to earn back the investment.

   Earnings per share: Dividends/ No of shares.

   'Earnings' is usually profit after tax and preference dividends and before extraordinary items.