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The legal aspects of the valuation of shares

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THE LEGAL ASPECTS OF THE VALUATION OF SHARES

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CHAPTER 1

INTRODUCTION

Valuation of shares can be divided into two broad categories: fiscal and commercial. Fiscal valuations are required to help determine tax liabilities which can arise when shares change hands on death, by way of gift or by transfer at a non arm's length price. Fiscal valuations generally take place after the event and reflect the desire of the taxpayer, usually represented by a professional adviser, to minimise his tax liability. Fiscal valuations are rarely, if ever tested in the market place by the willingness or otherwise of persons to buy or sell at the valuation amount.

Commercial valuations can be defined as all valuations of shares done other than for fiscal purposes. A commercial valuation is implicit whenever shares are bought, sold or issued in arm's length transactions. It may be an open market valuation as between a willing buyer and a willing seller or it may be a valuation as between a particular buyer and seller.

Although difference exist between fiscal and commercial valuations, the former are based on the latter and most of the work required is common to both types of share valuation.

Share valuation has been a neglected study in this country. The reasons for this are not entirely clear since share valuations are being required for an increasing number of purposes - fiscal, legal and commercial. Perhaps it is because the art of share valuation involves problems of law, economics, accountancy and commercial appraisal which go beyond the speciality of a single profession. This overlapping of disciplines makes it difficult to do justice to all the many and varied aspects of the subject.

The characteristics of value

Value is almost impossible to define precisely. According to V.L. Gole, an Australian valuer, a thing may be said to be valuable if it has real worth. Real worth may be related to emotion, sentiment, tradition, market forces, scarcity, time and prospects. This echoes Ovens' and Beach's view that value '... is a psychological concept, a function of people's desires, principles, attitudes and emotions'.

The valuation of an asset is purely subjective. There is no such thing as objective truth in the assessment of value. Value is an infinitely fluid concept changing in time and varying from place to place and individual to individual.

Value is such a fundamental concept that it cannot be defined in terms of anything more elemental but we can obtain insights into the concept of value by a knowledge of how it is measured. Time, distance and temperature, for example, are all basically undefinable but can be measured by, respectively clocks, yardsticks and thermometers. Knowledge of, and familiarity with these techniques of measurement add to our understanding of the concepts themselves. Indeed, this knowledge of the means of measurement seems fundamental, and not merely peripheral, to our understanding of the concepts. It is as if the essence of basic concepts can never be defined but can best be described and understood by setting out their characteristics.

An important characteristic of value is that it is expressible in terms of a single lump sum of money considered as payable or expendable at a particular point in time in exchange for property. People acquire property for the

future benefits which ownership will confer. The buyer of a house can occupy or let it, the purchaser of a book can read and enjoy it, the collector of antiques derives aesthetic satisfaction from his collection and the shareholder receives dividends on his shares. Thus property has to have some use, or attraction, for it to have any value.

It might be thought that objects with the highest use would have the greatest value, but very often the reverse is the case. As Adam Smith observed, water and diamonds have values inversely proportional to their utility. This perverse situation arises because demand, which is a function of use, is only one side of the value equation; supply is the other. When the supply is plentiful value tends to be low, and when a commodity is scarce its price tends to be high.

Fortunately, this inverse relationship of utility to value does not seem to hold for financial assets. Although financial assets themselves have no intrinsic use - a share or debenture certificate for example is worthless - the net monetary return of financial assets is in effect the equivalent of the utility of tangible assets. Using utility in this sense, the value of financial assets clearly rises with their utility. A debenture on which interest is payable at 10 per cent per annum will command a higher price than a debenture of similar risk paying interest at only 5 per cent per annum. The greater the expected return for a given degree of risk, the greater the value.

This direct link between utility and value makes the valuation of financial assets much less subjective than that of tangible assets. Although emotion and sentiment sometimes enter into the valuation of financial assets, most of the subjectivity arises because the exact amount of the net monetary returns to be received in the future cannot be known with certainty. An

investor on the Stock Exchange, for instance, has to form a judgement about the prospects for individual companies, the industries in which they operate and the national, and possibly international, economy. This characteristic of value, that it always looks to the future, is very significant.

The value of something cannot be stated in the abstract; all that can be stated is the value of the thing in a particular place, at a particular time, in particular circumstances. The question 'to whom?' and 'for what purpose?' must always be asked before a valuation can be carried out. This is because property has a different value to different persons and these different values can have a marked effect on price. It would be wrong, for instance, to value an industrial property on its existing use if an alternative, higher use was permitted by the planning authorities. Similarly, a minority shareholding of 10 per cent of the equity of a company would normally have a low value per share compared to the value per share of a controlling interest in the same company. But if that 10 per cent were to be sold to a holder of 45 per cent of the equity, thereby giving that person control, a much higher value per share would be expected.

Price versus value

Price and value are separate but related concepts. Confusion can arise through the misuse of these terms. Price is the monetary consideration received for the sale, or paid for the purchase, of goods and services. In a purchase/sale of goods or services there is one price but there are several values. A sells B a car for R3 000. Logically, A's car must be worth more to B than R3 000, or, more correctly, the other things that B can buy with R3 000. If this were not so, if B valued an alternative purchase more highly, he would not buy A's car but would spend his R3 000 on the alternative. Similary, from A's point of view, his car is worth less than R3 000 to him, i.e. he places a higher value on the alternative goods

costing R3 000 than he does on his car. If A was indifferent as to whether he kept his car or whether he switched into other goods or services, no transaction would take place for lack of motive. Similarly with B.

Market value

Whilst price is distinct from value, prices in general are indicative of market value. Market value must be distinguished from the opinions of value that individual market participants hold about marketable property. The central idea in the concept of market value is that of the most probable buy and sell price. The basis of market value is the assumption that if comparable property has fetched a certain price then the subject property will realise the same price, or something near to it. The validity of this assumption depends upon the continuation of the market from which the sales data were obtained or, more precisely, upon the continuation of the trends demonstrated in that market.

Market value is a significant concept of value because it implies that cash flows can be generated if desired or necessary. Price should not be very different from market value for those commodities or properties in frequent demand. Thus, the price of Anglo American shares should be a fairly close indication of their market value at any particular time. On the other hand, the market in certain types of property can be extremely narrow and it may be necessary to wait along time before a buyer or seller can be found. When depressed conditions hit certain industries (e.g. property) it may be years before a willing buyer emerges. If the seller cannot wait that long, the price has to be lowered substantially. Enever sums up the position neatly:

> 'In brief, the conditions necessary for price to equate to market value are firstly that a reasonable time is available for potential vendors and purchasers to carry out necessary valuations and negotiations; secondly

that potential partners to a transaction be fully informed of the extent of the competition; and finally there must, of course, be a sufficient demand for potential purchasers for there to be any true competition at all'.

Other types of value

Besides market value, many other types of value are encountered in valuation literature and in practice, e.g. book value, going concern value, depreciated value, liquidation or break-up value, intrinsic value, replacement value, realisable value, goodwill or organisation value, current value, residual value and salvage value. Some of these concepts are misleading and most of them are less than helpful. Book value, or net worth as it is sometimes referred to, is merely the amount at which the net assets of a company are stated in the books of account and the balance sheet. It is not value at all, but should be referred to as 'book amount' or 'balance sheet amount'.

Intrinsic value may be a valid concept for tangible assets - if you cannot sell a loaf of bread you can at least eat it - but it should have no place in the valuation of financial assets. More often than not, it is used where we do not agree with market value. Thus, when share prices are low and unusually depressed, we might be tempted to say that they are below their intrinsic value. What we really mean is that we expect the market to improve because of some factor, say an economic upturn, which the market itself has not yet recognised or acknowledged. This is a dangerous position for the valuer to take as he must accept the judgement of the market place. He may be right or wrong in his speculation about the future, but this is nothing to do with any intrinsic value in the shares.

Goodwill or organisation value is not a separate type of value but merely

the value of one particular type of asset. Replacement value means replacement cost, whilst realisable value and current value are barely distinguishable from market value.

Liquidation value and going concern value are both different types of market value. Liquidation value occurs when assets of a business are sold piecemeal and possibly for scrap; it generally is the 'floor' value. A business sold as a going concern should fetch a price in excess of its liquidation value. The amount of the excess will depend on potential use. There are exceptions to this general rule, and liquidation value may then be higher than going concern value. This could happen when a company has assets with a much higher alternative use value, e.g. it owns land zoned for residential development but uses it for industrial purposes.

Fair value

In South Africa there is another type of value - fair value. This is the term that generally appears in the pre-emption clauses of private companies' articles of association. It is common for the articles to stipulate that the auditor, or some other expert, shall determine the fair value of shares for the purchase and sale purposes. The concept of fair value is based on the desire to be equitable to both parties. The transaction is not in the open market; the buyer has not been able to look around for the lowest price, nor has the seller been able to hold out for the highest price. In effect, the articles have restricted the market in the company's shares. To be fair, therefore, the value determined under the articles must recognise what the seller gives up in value and what the buyer acquires in value through the transaction.

If, for example, a minority shareholding of 5 per cent of the equity in a company is being acquired by a shareholder who already owns 46 per cent of

the snare capital, it would be incorrect to value the 5 per cent shareholding purely as a minority holding. The value of these shares to the buyer is considerable more than this since, with 51 per cent of the shares in his name, he will have control of the company.

The fair value of these shares will be somewhere in between their value as a pure minority holding and the increase in the value of the buyer's shareholding as a result of acquiring these shares, i.e. the difference in value between a 46 per cent and 51 per cent shareholding. Just exactly where the fair value is pitched is for the valuer to decide, exercising his judgement in the light of all the circumstances. As can be imagined, this has proved a fruitful area for litigation, and the valuer must be fully conversant with the legal postion before accepting such an assignment.

Although value is a multi-faceted, somewhat elusive concept and valuation itself a subjective art with, in some people's view, a cosmetic content of science, it would be incorrect to conclude that the value of something is anybody's guess or that valuation is a matter of hunch or 'seat of the pants' feel. Most valuations done by experts proceed 90 per cent of their distance on well defined principles and the result can usually be stated in terms of a narrow range of values. The existence of a range of values does not mean that the value has been estimated, with the connotations of rough approximation which the word implies. Rather, value is determined or measured. This implies that the valuer has come to a decision on the value. There is nothing absolute or completely objective about the figure, and others may disagree, but the amount decided upon is still his opinion of the value.

CHAPTER 2

SUBJECT MATTER - DEFINITION OF A SHARE AND SHAREHOLDING

'Stocks or shares' are defined in the Estate Duty Act[1] as meaning, in relation to any company. 'any part of the share capital of that company including any debenture, debenture stock or any other like form of marketable security'. The definition of a 'share' as defined in the Companies Act[2] is very similar: '"Share", in relation to a company, means a share in the share capital of that company and includes stock; and, in relation to a prospectus, means the share of a company, whether a company within the meaning of this Act or not, and includes debentures and any rights or interests (by whatever name called) in a company or in or to shares of debentures.'

In the leading case of Borland's Trustee v Steel Bros & Co Ltd[3] Farwell J considered the meaning of a share:

> 'A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liablity in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with s 16 of the Companies Act 1862. The contract contained in the articles of association is one of the original incidents of the share. The share is not a sum of money settled in the way suggested but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount.'

In the estate duty cases of Re Crossman and Re Paulin[4], Lord MacMillan expressed the meaning of a share as follows:

> 'A share in a joint stock company is an entirely conventional creation; the congeries of rights and liabilities of which it consists is the

1 Section 1(1) of the Estate Duty Act 45 of 1955
2 Section 1 (1) of the Companies Act 61 of 1973
3 (1901) 1 Ch 279 at 288
4 (1936) 15 ATC 94 at 117

> creature of the Companies Act and the memorandum and articles of the particular company. Within the law the rights and liabilities appurtenant to a share may vary widely. But it cannot exist independently of the inherent attributes with which it has been created.'

In the same case the meaning of a share was also considered by Lord Russel of Killowen at 115:

> 'It is the interest of a person in the company, that interest being composed of rights and obligations which are defined by the Companies Act and by the memorandum and articles of association of the company. A sale of a share is a sale of the interest, so defined and the subject matter of the sale is effectively vested in the purchaser by the entry of his name in the register of members. It may be that owing to provisions in the articles of association the subject matter of the sale cannot be effectively vested in the purchaser, because the directors refuse to and cannot be compelled to register the purchaser as shareholder. The purchaser could then secure the benefit of the sale by the registered shareholder becoming a trustee for him of the rights with an indemnity in respect of the obligations.'

Shareholders are not, however, part owners of the undertaking. In the eyes of the law, the undertaking is somewhat different from totality of the shareholdings. In Short v Treasury Comrs[5] Evershed LJ stated:

> 'Prima facie, as it seems to us, and apart from any special words in the regulation, each shareholder is entitled to get, and to get only the value of what he possesses; for that is all that he has to sell or transfer.'

Kenny J in Attorney-General v Jameson[6] expressed it as follows:

5 (1948) 1 KB 116 at 123
6 (1904) 2 IR 644 at 669

'In considering whether that case (Borland's Trustee v Steel Bros & Co Ltd) was rightly decided, it is important to bear in mind the character of the property in question. It is not the property of the company that is subjected to restrictions on alienation. The assets of the company, its premises, stock in trade, etc, are all capable of being disposed of without limitation or fetter of any sort. No shareholder has a right to any specific portion of the company's property, and save by, and to the extent of, his voting power at a general meeting of the company, cannot curtail the free and proper disposition of it. He is entitled to a share of the company's capital and profits, the former, in the words of Farwell J, being measured by a sum of money which is taken as the standard for the ascertainment of his share of the profits. If the company disposes of its assets, or if the latter be realised in a liquidation, he has a right to a proportion of the amount received after the discharge of the company's debts and liabilities. In acquiring these rights - that is, in becoming a member of the company - he is deemed to have simultaneously entered into a contract under seal to conform to the regulations contained in the articles of association. Whatever obligations are contained in these articles, he accepts the ownership of the shares and the position of a member of the company, bound and controlled by them. He cannot divorce his money interest, whatever it may amount to, from these obligations. They are inseparable incidents attached to his rights, and the idea of a share cannot in my judgment be complete without their inclusion. This was the view taken by Farwell J, whose language was adopted by FitzGibbon LJ, in Casey v Bently (1902) 1 IR 393. He could not, nor could his personal representatives, retain the mere money interest and repudiate the contracts entered into in connection with it. The money interest and the contractual obligations form one whole, and no member could be heard to say that he had a right to retain the former and disclaim the latter.'

CHAPTER 3

THE CONCEPT OF VALUE

The meaning of the term 'value' had to be determined by the Appellate Division in Pietermaritzburg Corporation v South African Breweries Ltd[1] where the valuation of land for municipal rating purposes was in dispute. The relevant statute was silent as to how the valuation of property was to be fixed for rating purposes. The court held that in the absence of statutory direction the proper standard of value was the market value and that 'the value of an article is, as a general rule, what it will fetch'.[2] The court rejected any concept of value determined by reference to cost or its utility to the owner. De Villiers JP examined the term 'value' in the light of writings on political economy where the term 'value has two meanings - it sometimes expresses the utility of a particular object (called value in use) and sometimes the power of purchasing other goods (called value in exchange). In deciding that the value in exchange was the appropriate standard of value the judge recognized that 'value in exchange' could either be the temporary or market value of the property or its permanent or natural value to which the market value tends to return after every variation. De Villiers JP concluded that the ordinary meaning of the term 'value' is the temporary or market value.

The fundamental principles laid down in Pietermaritzburg Corporation v South African Breweries Ltd have been followed in numberous subsequent cases in South Africa.

In Katzoff v Glaser[3] the court approved Voet's test of value. Dowling J concluded that '... it will be seen that Voet cites with approval in the passage quoted from Book 18, a remark of Seneca, "that the value of anything is what it is worth" meaning thereby "what it will fetch". This has been a test of market value which has, necessarily, been widely used although it may not be the only or a conclusive test.'

1 1911 AD 501

2 The principle that the value of an article is as a genreal rule, what it will fetch, is well recognized. See for example Elstow v Rose (R 4 QR p4)

3 1948 (4) SA 630 (T) at 636

A more recent expression of the general valuation test in South Africa was that of Colman J in Novick and another v Comair Holdings Ltd and Other[4]. The court was there dealing with s 228 of the Companies Act 61 of 1973 which requires a company to obtain the approval of a general meeting of shareholders before, inter alia, disposing of the greater part of its assets. Two suggestions as to how a company's unquoted share investments should be valued were put forward:

One was that their values should be determined by reference to the underlying net assets of the relevant companies based on balance sheet figures.

The other was that the calculation should be made solely by reference to the profits earned by the relevant companies during the past year. In rejecting both these suggestions Colman J held that 'the only test which can reasonably be applied in the application of the section is the test of value. And by that I mean market value in the sense of the price which the assets under consideration would fetch in a bona fide sale between a willing buyer and a willing seller, both of whom are reasonably well informed about the transaction, and neither of whom is under extraordinary pressure to buy or to sell, as the case may be'.

In the United Kingdom most litigation regarding the valuation of shares has arisen in the context of valuation for estate duty purposes. The general method of valuation for estate duty purposes is prescribed by the Finance Act of 1894:

Section 7 (5) provides that the principal value of any property shall be estimated to be the price which, in the opinion of the Commissioners, such property would fetch if sold in the open market at the time of the death of

4 1978 (4) SA 671

the deceased. Section 44 (1) provides that the market value in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market. These two sections give rise to many arguments between professional advisers acting for taxpayers and various departments of the Board of Inland Revenue.

Various guidelines have developed over the years. These have mostly been based on the decisions in IRC v Crossman[5], Salvesen's Trustees v IRC[6] and Re Holt, Holt v IRC[7], and the whole position has been reviewed in the case of Re Lynall, Lynall v IRC[8].

In Findlay's Trustees v CIR[9] the court interpreted the section above as 'the price which might be fetched in the open market ... (on the assumption) that the transaction takes place between a willing seller and a willing purchaser'.

In the United States of America the general principle of valuation is stated as follows:

'The true value of a given commodity is the price for which that commodity would exchange hands between a willing seller and a willing buyer, neither being under any compulsion to act, and both having full knowledge of the facts involved.'

5 (1937) AC 26
6 (1930) SLT 387
7 (1958) 2 All ER 1499
8 (1971) 2 All ER 341
9 (1938) 22 ATC 437

In the Canadian case of Minister of Finance v Mann Estate[10], McIntyre J accepted the following definition: '.... the highest price available estimated in terms of money which a willing seller may obtain for the property in an open and unrestricted market from a willing, knowledgeable purchaser acting at arm's length'.

It remains to be considered what is meant by the term 'fair value'. There is no statutory definition of fair value and it does not appear to have been considered in any great detail by the courts.

In another Canadian case, Untermeyer Estate v Attorney-General of British Columbia[11], the Supreme Court pondered whether the expression 'fair' adds anything to the meaning of the words 'market value', except possibly .... 'that the market price must have some consistency and not be the effect of a transient boom or a sudden panic on the market'.

10 (1972) 5 WWR 23 (BCSC), aff'd. (1973) CTC 561 (CA)

11 (1929) SCR 84

CHAPTER 4

THE CONCEPT OF AN OPEN MARKET

A valuation may be made on the basis of various assumptions, one of these being known as the open market value, which is the price the shares would fetch if sold in the open market at the appropriate time. This basis of valuation is the one used for most fiscal purposes, with various statutory modification.

As discussed earlier, the Finance Act in the United Kingdom refers to the term 'principal value'. In Ellesmere (Earl) v Inland Revenue Commissioners[1] Sankey J stated that principal value means 'the price which the property would have fetched on the death of the deceased in the open market if it had been then sold in such a manner and subject to such conditions as might reasonably be calculated to obtain for the vendor the best price for the property ...'

In the Pietermaritzburg Corporation case[2] the Appellate Division also laid down the fundamental principle that the term 'value' means value in the open market. The concept of what is meant by an open market, has been expounded in several cases:

(a) It includes a sale by auction but is not confined to that; it would include property publicly announced in the usual way relevant to the property in question and designed to attract as much competition as possible. In Duke of Buccleuch v IRC,[3] Lord Reid put it as follows:

> 'Originally no doubt when one wanted to sell a particular item of porperty one took it to a market where buyers of that kind of property congregated. Then the owner received offers and accepted what he thought was the best offer that he was likely to get; and for some kinds of property that is still done. But this phrase must

1 (1918) 119 LT 568 at 573

2 1911 AD 501

3 (1967) 1 All ER 129

> also be applied to other kinds of property where that is impossible. In my view the phrase requires that the seller must take - or here be supposed to have taken - such steps as are reasonable to attract as much competition as possible for the particular piece of property which is to be sold. Sometimes this will be by sale by auction, sometimes otherwise. I suppose that the biggest open market is the stock exchange, where there is no auction.'

Cozens-Hardy MR defined open market in the land value duty cases of IRC v Clay and IRC v Buchanan[4] in the following terms:

> 'It would include property publicly announced in the usual way by insertion in the lists of house agents. But it does not necessarily involve the idea of a sale without reserve. I can see no ground for excluding from consideration the fact that the property is so situate that to one or more persons it presents greater attractions than to anybody else. The house or the land may immediately ajoin one or more landowners likely to offer more than the property would be worth to anybody else. This is a fact that cannot be disregarded.'

In the same case Swinfen Eady LJ stated[5]:

> 'a value, ascertained by a reference to the amount obtainable in an open market, shows an intention to include every possible purchaser. The market is to be the open market, as distinguished from an offer to a limited class only, such as the members of the family. The market is not necessarily an auction sale. The section means such amount as the land might be expected to realise if offered under conditions enabling every person desirous of purchasing to come in and make an offer, and if the proper steps were taken to advertise the property and let all likely purchasers know that the land is in the market for sale.'

4 (1914) 3 KB 466

5 Supra footnote 4 at 475

The term open market was also considered in the land value duty case of Glass v IRC[6]. Lord Johnston stated:

'I think the referee is mistaken in assuming that open market necessarily means sale by auction. A sale takes place in open market if the subject is put on the market and the best offer taken, however made.'

(b) The seller must be assumed to be acting voluntarily. In Sri Raja Vyricheria Narayana Gajapatiraju Bahadur Garu v Revenue Divisional Officer[7], compensation was paid by the government for expropriation of land. Lord Romer, concerned with the value of the land, said:
'The compensation must be determined, therefore, by reference to the price which a willing vendor might reasonably expect to obtain from a willing purchaser. The disinclination of the vendor to part with his land and the urgent necessity of the purchaser to buy must alike be disregarded. Neither must be considered as acting under compulsion. This is implied in the common saying that the value of the land is not to be estimated at its value to the purchaser. This does not mean, however that the fact that some particular purchaser might desire the land more than others is to be disregarded.'

(c) The seller must be assumed not to be in an undue haste to dispose of assets (Weber and Pretorius v Gavronsky Brothers).[8]

(d) Whether the hypothetical sale is assumed to be by auction or otherwise it must not be supposed that the owner would withdraw the property if a sufficient offer was not forthcoming - an estimate must be made of what the property would have fetched on the particular day if it had been exposed for sale. (Duke of Buccleuch and another v IRC).[9]

6 (1915) SC 449
7 (1939) 2 All ER 317
8 (1920) AD 48
9 (1967) 1 All ER 129

(e) Even though the property falling to be valued is not readily realizable it must nevertheless be valued as long as it is capable of valuation. In Gold Coast Trust Ltd v Humphrey[10], Viscount Simon commented as follows:

> 'It seems to me that it is not correct to say that an asset, such as this block of shares, cannot be valued in money for income tax purposes in the year of its receipt because it cannot, in a commercial sense, be immediately realised. That is no reason for saying that it is incapable of being valued, though, if its realisation cannot take place promptly, that may be a reason why the money figure set against it at the earlier date should be reduced in order to allow for an appropriate interval. Supposing, for example, the contract conferring the asset on the taxpayer included a stipulation that the asset should not be realised by the transferee for five years, and that, if an attempt was made to realise it before that time, the property in it should revert to the transferor. This might seriously reduce the value of the asset when received, but it is no reason for saying that, when received, it must be regarded as having no value at all.'

It is also immaterial that no one was actually in a position to sell the property. For example,

> 'shares in companies which had belonged to an enemy alien, but were at the time of his death in the control of the Public Trustee as custodian, (nevertheless) had to be valued for duty at the ordinary market price of similar securities'.[11]

10 (1948) 2 All ER 379

11 Re Aschrott, Clifton v Strauss (1927) 1 Ch. 313;
See also Inland Revenue Commissioners v Crossman, Inland Revenue Commissioners v Mann (1937) AC 26; 1936 1 All ER 762

(f) In estimating the price which would be fetched in the open market, it must be assumed that the transaction takes place between a willing seller and a willing purchaser. The willing seller - willing purchaser conception is in principle a simple one based on the thesis that a common price will be acceptable to both parties to the transaction. This concept is discussed later (see page 37).

Legal fiction

It is obvious that the open market value for fiscal purposes is a statutory fiction which ignores the impossibility of an actual sale. In the words of Lord Morris of Borth-y-Gest in the estate duty case of Duke of Buccleuch v IRC[12]:

> 'The value of any property must be estimated to be the price which, in the opinion of the commissioner, the property would fetch if sold in the open market at the time of the death of the deceased. "At the time of the death" must not be paraphrased or altered so as to read "within a reasonably short time of the death". It follows from this that the section is envisaging a hypothetical sale at the time of the death. This is quite inconsistent with the notion that the value of a piece of property is to be estimated by postulating that preparations for an actual sale would be commenced at but after the time of death and that a sale would follow after such preparation. This is now what the section, which is in effect a valuation section, envisages. The section prescribes the criterion of valuation.'

This concept of a hypothetical sale was also considered by Plowman J in the estate duty case of in Re Lynall, Lynall v IRC[13] as follows:

> 'It is common ground that the shares must be valued on the basis of a hypothetical sale .... in a hypothetical open market between a

12 (1967) 1 AC 506 at 535

13 (1971) 47 TC 375 at 377

> hypothetical willing vendor and a hypothetical willing purchaser on the hypothesis that no one is excluded from buying and that the purchaser would be registered as the holder of his shares but would then hold them subject to the articles of association of the company, including the restrictions on transfer.'

In other words, the hypothetical willing purchaser buys in the open market but should he ever need to sell, will sell in the restricted market allowed by the articles. This requirement of selling in the restricted market will usually be a depreciatory factor in a valuation.

Even the fact that an actual sale would be illegal is ignored in arriving at the open market value. This was confirmed by Eve J in the estate duty case of Re Aschrott, Clifton v Strauss[14]:

> 'At the testator's death part of the property passing under his will consisted of shares saleable in the open market. It is true that, by reason of the subsisting war, he was disqualified, and his executors after his death were disqualified, from transferring the shares, but these shares were only part of the share capital of the several companies in which he was interested, and, in order to ascertain the market price of the shares which were disposed of by his will the broker was bound, I think, to find out at what price some of the shares were being sold and dealt with on the market and to return that as being the correct valuation; it was open to the valuer to say: "The market price of shares in this particular company is so much, but, in view of the fact that the transferor of these shares is an alien enemy, the market for some of the shares (those which he would be purporting to transfer) would be nil"'.

Actual sales around the date of the valuation of the shares may be

14 (1927) 1 Ch 313 at 322

persuasive evidende in arriving at the open market value[15] but are not conclusive as the actual circumstances may differ from those which have to be hypothesised in an open market valuation[16].

Neutral identity

It has repeatedly been laid down that in applying the yardstick of the postulated sale in the open market, every possible purchaser must be taken into account. The property must be assumed to be 'offered under conditions enabling every person desirous of purchasing to come in and make an offer', proper steps being taken to advertise the property and let all likely purchasers know that the property is for sale[17].

In applying the abovementioned principle, one of the possible elements in valuation is the existence of a person or class of persons (referred to as 'special purchasers') to whom the property or shares in question is more valuable or more desirable than to the general public.

Special purchasers

In valuing shares and other property the courts have generally

(a) ignored the particular identity of the owner whose property is being valued; and

(b) have not taken into account the identity of any particular purchaser

except that the requirements of a particular purchaser might influence the price which a hypothetical neutral purchaser may be prepared to pay.

This general principle was dealt with in an early case, Bradford-on-Avon Assessment Committee v White[18] where consideration had to be given to the effect on the value of a property which had a special value to a particular

15 See McNamee v IRC (1954) IR 214

16 See IRC v Marr's Trustees (1906) 44 Sc LR 647

17 Inland Revenue Commissioners v Clay, Inland Revenue Commissioners v Buchanan (1914) 3 KB 466

18 (1898) 2 QB 630

buyer. The court dealt with this as follows:

> 'I do not think that it is right to say that the competition of brewers should be wholly excluded from consideration, but the special prices which they may give, owing to personal considerations, and not on account of the value of the premises, should be excluded except so far as the possibility of such special prices being obtained raises the market value generally.'

The principle was followed in IRC v Clay, IRC v Buchanan[19]. In this case a property which adjoined a nurses home fell to be valued. It was known that the trustees of the nurses home were anxious to buy the property; and were prepared to pay £1 000 for the property which was only worth £750. It was held that £1 000 was the statutory value.

The court held that a value to be ascertained by reference to an amount realizable in an open market meant an intention to include every possible purchaser; the fact that one particular purchaser was prepared to pay more would influence the price but the value must not be fixed at the price which that purchaser in particular would pay. Cozens-Hardy MR postulated an example of a small farm in the middle of a wealthy landowner's estate. The value of that farm would not be the price which the wealthy landowner would be prepared to pay - the value would be the amount which purchasers on the open market would be prepared to pay in the knowledge that they may be able to resell it at a profit to the wealthy landowner.

Thus, although it is clear that a special purchaser has to be included as a possible purchaser, the next point to consider is what effect this would have on the price. In the words of Swiften Eady LJ:

19 (1914) 3 KB 466 CA

'It was then urged by the Solicitor General that if the probability of the special buyer purchasing, above the price, which but for his needs would have been the market price, could be taken into consideration at all, then only one further point or bid could be allowed, and it must be assumed that this special buyer would have become the purchaser upon making this one extra bid. Such an assumption would ordinarily be quite erroneous. The knowledge of the special need would affect the market price and others would join in competing for the property with a view of obtaining it at a price less than that of which the opinion would be formed that it would be worth the while of the special buyer to purchase.'

Glass v Inland Revenue Commissioners[20] on land value duty, although not a case involving shares, is also of particular interest in considering the position of a special purchaser. A farm, the agricultural value of which was £3 379, was known to be required sooner or later by Water Commissioners, and was in fact acquired by them two years after the material date for £5 000. The Court fixed the statutory value at £4 629.

'An estimate of the price obtainable for land in the open market,' said Lord Cullen, 'must proceed on the footing of people acting in the way which is in accordance with their interests.'

On the other hand, in Inland Revenue Commissioners v Crossman, Inland Revenue Commissioner v Mann (an estate duty case, the main point of which will be discussed later), it became necessary to determine the price which would be paid in the open market for shares in a private company, the transfer of which was rigorously restricted, on terms that the buyer would be registered as holder of the shares, but would hold them subject to the restrictions. There was evidence that a particular trust company was

20 1915 SC 449

prepared to pay a certain price; but a lower figure was adopted.

In the Court of first instance, Finlay J[22] had held that the open market theory could not mean that every person in the world had notionally got to be considered as in the market; and disregarded the potential bid of the trust company from a business point of view on the grounds that (on the evidence) it would have ascertained that the directors would refuse to register it and so would not have been in the market.

Various and conflicting remarks were made on the subject in the House of Lords, but careful analysis of the speeches clearly indicates that the true ratio of the decision to adopt the lower figure lay in the fact that Lord Plender (whose evidence on the valuation questions had been accepted by Finlay J) said that he had taken the trust company into account as a possible purchaser in arriving at that figure. Lord Blanesburgh said[23] 'I agree with, I believe, all your Lordships in thinking that any possible bid for the shares by a trust company was allowed for by Lord Plender in his estimate ..., accepted by the learned judge as reliable.' Lord Russell of Killowen said - 'I feel a difficulty in understanding how, if Lord Plender's figure is accepted, as it was by Finlay J any higher figure could rightly be substituted for it. As I read the learned judge's judgment Lord Plender in arriving at his figure had treated the market as open, and had excluded no one from it. The whole world was hypothetically there, making hypothetical bids'. It seems that the House of Lords regarded the acceptance by Finlay J of Lord Plender's figure as a determination of fact which they were not, in the circumstances, concerned to question.

But Lord Blanesburgh continued - 'Had that not been so' -i.e. had Lord Plender not taken the trust company into account - 'the Crown's contention on this point would have been, I think, unanswered.' And as respects Finlay

21 (1937) AC 26; (1936) 1 All ER 762, H.L; see p 410 post

22 See (1935) 1 KB 26,35

23 (1937) AC, at p 62

J.'s decision, already mentioned, Viscount Hailsham LC said - 'The learned judge says that he excluded trust companies from the possible buyers because he had evidence to satisfy him that the directors would not have consented to put them upon the register. I cannot think that this is a proper reason ...'

On the other hand, he went on - '... the extra sum which could be obtained from trust companies was not an element of the value in the open market, but rather a particular price beyond the ordinary market price which a trust company would give for reasons of its own. I do not think it would be right to appreciate the value of the shares because of this special demand for a special purpose from a particular buyer.'

It is doubtful whether Lord Blanesburgh's remarks are to be regarded as settled law; but if they are, they suggest at first sight a conflict with the earlier decisions in Clay and Glass. Lord Macmillan, in fact, in the later case of Robinson Brothers (Brewers) Ltd v Durham County Assessment[24] took the opposite point of view to Lord Blanesburgh: "The motives which actuate buyers in a market may be of all kinds, but it is not their motives but their bids that matter."

The explanation may be merely that, on the accepted evidence, the trust company, though willing, would not have needed to go beyond the figure adopted. Support for this view may be found in the judgment of Harman LJ in the Court of Appeal in Re Lynall, Lynall v IRC[25] (to be discussed later):

> 'It was the taxpayer's argument that directors must be excluded from amongst possible purchasers because they would be "special" purchasers. I do not accept this and am of opinion that this is not an ingredient in the Crossman decision. In Crossman's case it was decided that the fact

24) (1938) AC 321; (1938) 2 All ER 79 at 85
25) (1971) 47 TC 375 at 396

that a "special" purchaser, namely a trust company, would have offered a special price must be ignored, but this was because that particular purchaser had a reason special to him for so doing. So here a director who would give an enhanced price because he would thus obtain control of the company would be left out of account. But that is not to say that directors as such are to be ignored. All likely purchasers are deemed to be in the market.'

Alternatively, it may be that Lord Blanesburgh's remarks suggest that it is not legitimate to enquire into the state of mind of a particular person, where it cannot be inferred form external facts. In the Crossman case, in contrast to the Clay and Glass cases, there were no such facts.

It could also be that the second alternative is merely one facet of a broader distinction which can, if necessary, be drawn between the tw types of case. The circumstance that rendered the trust company so 'special' a purchaser in the Crossman case was its ability in fact to avoid to some degree the onus of the restrictions on transfer: its practice was to hold investments as nominee for several subsidiaries and the beneficial ownership of a shareholding could have been transferred from one subsidiary to another without the necessity for re-registration of the legal title. Some light on the point may be thrown by the earlier case of Inland Revenue v Marr's Trustees[26], which will be met again hereafter in another context and which, in fact, also involved a special purchaser (though the 'special purchaser' theory was not stressed in the judgment).

In this case, which concerned the relevance to an estate duty valuation of the price realised at an auction of cattle some time after the death, one of the 'adventitious circumstances' which led the court to reject the sale price was the presence at the sale of a bidder who had accidentally found an

26 (1906) 44 Sc L R 647

underwriter prepared (contrary to and, it was suggested, in ignorance of the normal practice) to undertake certain risks involved in the purchase without a preliminary veterinary certificate; and who was thereby enabled to offer a better price than the other bidders. The Lord Ordinary's remarks suggest that even had the sale taken place at the death, the price paid by such a purchaser would not have formed a true criterion of the open market value.

It is interesting to note that in both the Crossman and Marr's Trustees cases, the 'special price' was a result, not of any attraction to the purchaser inherent in the property itself, but of some special personal characteristic or advantage peculiar to the purchaser which, while not affecting the intrinsic worth of the property, enabled him to offer a better price for it.

To put the matter somewhat differently, the 'special price' was due not to some advantage inherent in the property but to the fact that the bidder's own position enabled him to minimise certain risks or disadvantages involved in its possession.

It is accordingly submitted that the special price which might be offered by a particular purchaser is only to be ignored as a yardstick, if at all, in the exceptional case where it is the result of some such peculiarity which (even though its operation stems from some ancillary attribute of the property, e.g. the restrictions on transfer in the Crossman case) appertains basically to the person of the purchaser. And even then the presence in the market of such a purchaser may have an indirect and modified effect on the general market level.

Support for this view may be found in the judgment (in the Court of Appeal in the Crossman case) of Lord Hanworth MR citing with approval certain

remarks of Channell J in Bradford-on-Avon Assessment Committee v White[27]: '... the competition of (particular buyers) should not be wholly excluded from consideration, but the special prices (the buyers) may give, owing to personal considerations, and not on account of the value of the premises, should be excluded except so far as the possibility of such special prices being obtained raises the market value generally'.

It is true that the actual decision in the Bradford-on-Avon case was overruled by the House of Lords in the Robinson Brothers case.

It was there held that, in assessing licensed premises for rating purposes, the rent which brewers would pay (with a view either to subletting or to occupation) must be taken into account. But the ruling is thought to have stemmed not so much from any fundamental disapproval of the principle enunciated by Channell J in the earlier case (and cited by Lord Hanworth in the Crossman case) as from its inapplicability to the facts under consideration: it was evidently considered that the rent in question was properly attributable to the intrinsic value of the property. Indeed the speech of Lord Macmillan seems to reinforce rather than weaken the validity of the basic principle in relation to the type of 'special purchaser' now under consideration.[28]

On the other hand, the Robinson Brothers case, coming as it did after the Crossman case, strengthens the authority of the Clay and Glass cases for the proposition that the price which a particular purchaser would pay is a yardstick of open market value where the attraction of the property for that purchaser is inherent in the property itself. And this is considered to be so even where the property is specially attractive because of some other property owned by the potential purchaser e.g. as respects shares in a private company, where the acquisition of the vendor's holding would give

27 (1898) 2 QB 630 at 639

28 See Green's Death Duties by DJ Lawday and EJ Mann 5th Edition

control to another shareholder; in the case of partnership assets, as respects a surviving partner; or in the case of professional goodwill, as respects a son who acted as the deceased's professional assistant. In such a case, the 'special price' is no more than the intrinsic value of the acquired property in the hands of the special purchaser. Once common ownership of the two 'properties' has been established, the enhanced value achieves a permanency which would be reflected in the price realised on a subsequent sale by the original purchaser. It is independent of that purchaser's personal attributes.

It remains to be mentioned that where property is to be valued, reference must be had not merely to the actual current use to which the property is being put but also to any other use (i.e. 'value' must take account of potentialities) to which it may reasonable be put and which might enhance its value.

This particular point was considered in the Indian compulsory purchase case of Raja Vyricherla Narayana Gajapatiraju v Revenue Divisional Officer, Vizagapatam[29], another post - Crossman case, by the Privy Council. It was laid down, that for the purposes of compulsory acquision, 'value' must take account of potentialities, even where the only possible purchaser of the potentialities is the acquiring authority, on the ground that otherwise the vender would not be a 'willing seller'.

The position of the special purchaser was considered as follows[30]:

> 'Proceeding therefore with the imaginary auction at which are present two classes of buyers, namely the 'poramboke buyers' (persons who are in no way interested in the land's potentialities) and the 'potentiality buyers', the former will disappear from the biddings as soon as the

29 (1939) AC 302

30 Supra footnote 29 at 315

'poramboke' value has been reached and the bidding will thereafter be confined to the 'potentiality buyers.' But at what figure will this bidding stop? As already pointed out it cannot be imagined as going on until the ultimate purchaser has been driven by the competition up to a fantastic price. For he is ex-hypothesis a willing purchaser and not one who is by circumstances forced to buy. Nor can the bidding be imagined to stop at the first advance on the'poramboke value'. For the vendor is a willing vendor and not one compelled by circumstances to sell his potentiality for anything that he can get. The arbitrator will, therefore, continue the imaginary bidding until a bid is reached which in the arbitrator's estimate, represents the true value to the vendor of the potentiality. The auction will therefore have been an entire waste of the arbitrator's imagination. If the value of the potentiality be Rs X the imaginary auction will have taken place to ascertain the value of X from the imaginary bidding, and all that can be said is that the bidding will stop at Rs X.

The truth of the matter is that the value of the potentiality must be ascertained by the arbitrator on such materials as are available to him and without indulging in feats of the imagination.

Their Lordships would not have thought it necessary to deal with this question of the imaginary auction at such length were it not for the fact that in the argument before them the respondent's counsel endeavoured to show by reference to such an auction that when there was only one possible purchaser of the potentiality the value of it to the vendor was nil - that is to say that the value of the land with the potentiality was substantially nothing in excess of its value without it ...

Upon the question of the value of the potentiality where there is only

one possible purchaser there are some authorities to which their Lordships will have to refer. But dealing with the matter apart from authority would seem that the value should be the sum which the arbitrator estimates a willing purchaser would pay and not what a purchaser would pay under compulsion. It was contended on behalf of the respondent that at an auction where there is only one possible purchaser of the potentiality the bidding will only rise above the "poramboke" value sufficiently to enable the land to be knocked down to that purchaser. But if the potentiality is of value to the vendor if there happen to be two or more possible purchasers of it, it is difficult to see why he should be willing to part with it for nothing merely because there is only one purchaser. To compel him to do so is to treat him as a vendor parting with his land under compulsion and not as a willing vendor. The fact is that the only possible purchaser of potentiality is usually quite willing to pay for it.'

In Re Aschrott, Clifton v Strauss[31] a shareholder, a German subject, was disqualified from selling shares owned by him in British companies because of the war between Germany and Britain. Upon his death during the war his executors were similarly disqualified from selling or transferring these shares. The court rejected the argument by the executors that the market price of the shares should be depreciated because the shares were held by an alien enemy. It was held that the shares had to be valued in disregard of the fact that the shareholder was incompetent to sell or transfer the shares at the valuation date.

A similar question arose in Re Samuel Thornley[32] where there was an understanding between the deceased shareholder (whose shares had to be valued) and his son that the deceased would only dispose of his shares to his son and to no-one else. The court disregarded this and proceeded to

31 (1927) 1 Ch 313

32 (1928) 7 Annotated Tax Cases 178

value the shares on the lines of a hypothetical ... who would be unencumbered by any scruples in selling his shares to an outsider.

The House of Lords in Re Lynall, Lynall v IRC[33] took the line that so long as every practical person was included in the potential purchasers, this was sufficient for the purposes of the statute. In this case, the argument revolved round the amount of information which would be available to the potential purchaser. The deceased had held approximately 67 000 shares which was a minority holding in an unquoted company. However, the directors had been advised by a firm of accountants and a firm of stockbrokers that they should seek to have the shares of the company quoted on the Stock Exchange. This advice had been given in a number of reports and had been discussed by the directors. The Revenue contended that any potential purchaser of the shares would require information from the directors as to the future possibilities of the company and that in fact they would have provided him with the information that the company might become a public company and have its shares quoted. On being asked whether they would have supplied such information, the directors of the company stated that they would have not done so. They considered that on any transfer of shares the only information which would have been provided would have been that in the published accounts. On this basis the judge in the High Court fixed the value of the shares at £3 10s 0d. per share but provided that if the information relating to the possible public issue were disclosed, the valuation should be £4 10s. 0d. per share. In the Court of Appeal in 1969 the Inland Revenue were successful in convincing the court that the valuation of the shares should be £4 10s. 0d. per share. On this basis, they contended that directors would have to disclose information of any kind requested by a potential buyer provided that information was within the knowledge of the directors. However, their views received a substantial setback in the House of Lords, who rejected the Revenue's argument unanimously. Everyone of the five Law Lords stated that the provision of such information was contrary to the statute. For a sale to take place in

33 (1971) 3 All ER 914

the open market, it must not require the hypothetical purchaser to extract information from the directors in the manner suggested. The potential buyer must be deemed to have such information as has been made public but not information which was known only to a director. In fact, Lord Pearson went on to say that in the case of a director it was not to be assumed that he had any special knowledge. Information which he had relating to the company's affairs would not affect the market value of those shares, since that information would not be available to other potential buyers in the open market and therefore the directors would be able to buy the shares at a lower price than if that knowledge were available to the public. In certain cases no doubt he would have to pay a price higher than would be the case if his own knowledge had been disclosed to the public, e.g. where the company has had a period of profitable trading and the director knows that the subsequent year's results will show a loss.

It is, however, suggested that to regard the director as excluded from the open market is incorrect. Furthermore, if two directors were both in the market then their special knowledge should come into the calculation, since each would be prepared to outbid the other director if he was anxious to obtain the shares. The main difficulty here is how far it is necessary to take into account the actual facts of the case and not deem the whole matter to be a hypothetical sale. It might seem, following the House of Lords decision, that in every case it is necessary to regard the whole matter as hypothetical with the possible exception of the number of shares involved and the nature of the company. However, it is suggested that this is not the correct view of the House of Lords decision since the value of the shares (which are an actuality) must be on the basis of the circumstances surrounding those shares.

In considering the words 'open market,' therefore, it is not to be assumed that the advisers to the potential purchaser would have any information available only to the directors and there must be a limit on the questions

which they could put to those directors. The fact that nobody would buy shares in a private company without the fullest investigation was rejected by the House of Lords as irrelevant. The Revenue had contended for this basis, but their Lordships stated that in their view this was not a sale in the open market. It was a specific sale to a specific purchaser and was consequently contrary to the terms of the statute.

It has always been considered necessary to determine the position as at the moment of death of the deceased and to reject the wisdom that might be provided by hindsight. 'It is necessary to assume the prophetic vision of a prospective purchaser at the moment of death of the deceased and firmly to reject the wisdom which might be provided by the knowledge of subsequent events.'[34] It is, however, necessary to assume that all steps have been taken up to the moment of death to place the shares in the open market. Furthermore, it must be assumed that any purchaser would be unobjectionable to the directors so that the shares could be transferred into his name. It must be assumed that the deceased or donor was a willing seller. It is suggested, however, that the views of the seller must also be considered in any case since clearly he would not sell to a hypothetical purchaser where another hypothetical purchaser would be likely to give him a higher price. The views of the hypothetical seller must not be entirely disregarded.

It must be presumed that the hypothetical purchaser will be advised by experts as to the value of the shares. But as Danckwerts J. stated in the Holt case, 'in my task I have had the assistance of a number of experts on each side who differ in their opinions in the manner in which experts normally do and the frankest of them admitted that certain of his calculations were simply guesswork, even if it was intelligent guesswork.' In this case, the Crown had originally contended for £3 per share but had finally reduced their price to 25s. per share. At the time they determined the value of the shares, for the purposes of the High Court appeal, the

34 Re Holt (1953) 1 WLR 1488 at 1492

valuation was 34s. The petitioners had argued for a value of 11s. 3d. per share but later increased this to 17s. 2d. Danckwerts J., after considering all their opinions and stating that there was no certain answer possible, valued the shares at 19s. per share. It is obvious with any substantial number of shares that the amount of duty involved varied enormously when the values were either 11s. 3d. or £3 or the final figure of 19s.

Whether it is satisfactory to put a taxpayer's estate at the sort of risk resulting from such method of valuation is a matter for tax advisers to argue.

Apart from accounts which have been completed prior to the date of death or disposal, the company's memorandum and articles of association and the information which a potential purchaser could find out relating to the industry in which the company exists, what other information is relevant? It is suggested that every particular case must be taken on its own facts and it is necessary to look not only to the existing shareholders as potential purchasers but also to outsiders. In so far as there are actual persons involved in the open market, the views of those persons are probably relevant in the argument. But if there is only one person who possesses any specialised knowledge, that specialised knowledge must be rejected, since it cannot be publicly held. If two people have that knowledge, then it seems not unreasonable to include them in the hypothetical purchasers who by reason of their knowledge might be prepared to bid against each other. An intriguing thought is whether reports in the local newspapers regarding the firm's activities would be regarded as being publicly available and could therefore affect the price which a hypothetical purchaser might pay. Obviously, the information in directors' minutes would not be available to the purchaser and must therefore be disregarded.

Special sellers

However, the question of the special purchaser has its converse side. Quite

apart from any statutory injunction, it would clearly not be right in estimating the open market value of property to take into account any special value which for reasons personal to the deceased alone was attached to the property while it was in his hands and which did not follow the property into the hands of the purchaser. It may be that the existence of such a value (whether a mere sentimental attachment to the property or some other concrete advantage) would in fact have made the deceased an unwilling seller at the postulated 'fair price'. But the term 'open market' requires the assumption of a willing seller; and the question is not what the property was worth to the deceased, but what would be a fair price for the property which would pass from vendor to purchaser by reason of the hypothetical sale.

THE WILLING BUYER - WILLING SELLER CONCEPT

In estimating the price which would be fetched in the open market, it must be assumed that the transaction takes place between a willing seller and a willing purchaser[34]. However, there are some aspects of this concept which should be clarified, particularly in respect of valuation for estate duty purposes. Under these circumstances, what has to be ascertained is the real value as at date of death, and this is not necessarily the same as market value, which could be more or less.

Willing buyer

In the estate duty case of The Trustees of Johan Thomas Salvesen v IRC[35] Lord Fleming considered the characteristics of the buyer as follows:

> 'A person who was being invited to acquire a third of the shares in a private company which imposed stringent conditions on the right of transfer would certainly wish to ascertain the value at which the assets had been entered in the last balance sheet. As a prudent person he would

34 Findlay's Trustees v IRC (1938) 22 ATC 437

35 (1913) 9 ATC 43 at 50

of course keep in view that he was purchasing the shares in October 1926 and that the balance sheet shows the affairs of the company as at June 1926, and he would make inquiry as to the alterations in its financial position which had taken place between these two dates.'

The courts have repeatedly held that in applying the willing buyer/willing seller test, the buyer must be assumed:

(a) to be a person of reasonable prudence; and

(b) to have had access to accounts and other information which would be likely to be available to him and to have informed himself of all relevant facts so far as known at the valuation date.

In Holt & others v IRC[36] the accounts for the previous year were not finally completed at the date of death of the deceased. Danckwerts J said that it was fair to assume that information as to the approximate results of the year's trading would have been ascertained by a prospective purchaser. This must be compared to the decision in Lynall & another v IRC[37] where, as discussed before, the question was whether it could be assumed that a prospective purchaser would have available to him certain confidential information about the possible public flotation of the company which was in the hands of the directors. The comments of Danckwerts J in Holt's case were argued in support of this proposition. The House of Lords held that confidential information could not be assumed to be available to a prospective purchaser and that the seller of shares in a company, even if he is a director, must be assumed to be an honest man who would not make an improper disclosure of confidential information.

Lord Donovan in the Lynall case felt that it would not be right to treat as confidential accounts of the company already prepared and awaiting presentation to the shareholders. It is therefore still an open question as to what extent financial results for a preceding year must be assumed to be known to a prospective purchaser where at the valuation date financial statements have either not yet been drawn up or have been drawn up but have

36 (1953) 32 ATC 402

37 (1971) 3 All ER 914

not yet been to shareholders.

Lord Fleming in the estate duty case of Findlay's Trustees v IRC[38] stated:

> 'In estimating the price which might be fetched in the open market for the goodwill of the business it must be assumed that the transaction takes place between a willing seller and a willing purchaser; and that the purchaser is a person of reasonable prudence, who has informed himself with regard to all the relevant facts such as the history of the business, its present position, its future prospects and the general conditions of the industry; and also that he has access to the accounts of the business for a number of years.'

It should be mentioned that the hypothetical willing buyer may be drawn from any likely source. In the Australian case of Jekyll v Commissioner of Stamp Duties (Queensland),[39] a valuation was required of a parcel of one per cent preference shares of £1 each, with no voting rights. Although the low income made these shares unattractive to outsiders, Dixon C.J. considered that the ordinary shareholders would have a strong interest in acquiring them to exclude strangers from an ultimate substantial share in the company's assets. He stated that the other class of shareholders 'cannot be excluded from the body of persons whence the hypothetical purchaser is to be drawn'.

Willing seller

In the land value duty cases of IRC v Clay, IRC v Buchanan[40] 'willing seller' was defined by Swinfen Eady LJ as follows:

> 'A sale by a willing seller is distinguished from a sale which is made by

38 (1938) 2 ATC 437 at 440

39 (1962) 106 CLR 353

40 (1914) 3 KB 466 at 476

> reason of compulsory powers, where the vendor frequently obtains an addition to the price by reason of being under compulsion to sell. It does not mean a sale by a person willing to sell his property without reserve for any price he can obtain. Mrs Buchanan was a willing seller when she accepted £1 000. The fact that she was persuaded or induced to agree voluntarily to sell at that price did not make her any the less a willing seller. There was no evidence of any compulsion; there was friendly bargaining, some discussion, some haggling about price, and then an agreement come to. This is the normal course of most private contract sales. She was nonetheless a willing seller because she had not previously put the property into the hands of an agent for sale. She was willing to sell at a price, she was offered a price less than the maximum which the intending purchasers were willing to give, and she took it.'

It is also true that the so called willing vendor is a person who must sell: 'he cannot simply call of the sale if he does not like the price, but there must be on the other side a willing purchaser, so that the conditions of the sale must be such as to induce in him a willing frame of mind.'[41]

Thus, what should be remembered by valuers is that both the hypothetical buyer and the hypothetical seller should be willing, but neither should be anxious. It is not sufficient to rely only upon a buyer's maximum price, not only upon a seller's minimum price. The valuer must consider both buyer and seller and endeavour to determine whether their ideas should meet.

In more than one of his Australian High Court judgments, Williams J. has criticized the tendency of witnesses to assume that what a willing purchaser of shares (with a choice of alternative investments) would have paid, was synonymous with what a willing vendor could reasonably expect to obtain. His dictum in McCathie's case[42] was that the test of market value 'though valuable and persuasive, is by no means final or conclusive, and it should not be used so as to depress the value of property by exaggerating

41 Lord Guest in Re Winter (Sutherlands Trustees) v IRC (1961) 40 ATC 361 at 369

42 McCathie v Federal Commissioner of Taxation (1944) 69 CLR 1

temporary disadvantages to which it is subject at the date of valuation, and failing to give proper weight to its more permanent advantages.'

In aligning this statement with the concept of the willing buyer and willing seller, he reasoned in the following way:

> 'It is true that in order to arrive at the value of shares at the date of death the courts have often applied the same test as that which they have applied in the assessment of compensation upon the compulsory purchase of property, which is to ascertain the price which a reasonably willing vendor should be agreeable to accept and which a reasonably willing purchaser should be agreeable to pay for the property in its actual condition at the time of expropriation with all its existing advantages and with all its possibilities. But at the date of death no expropriation in fact takes place. The executors have the executor's year to realize the property and the Court of Equity can always sanction a postponement if the executors consider that it is inadvisable to sell during that year and require protection against the creditors. So far as the beneficiaries are concerned there may be a power of postponement in the will, and if there is not there is a statutory power ... The shares may not require to be sold at all in the due course of administration. The Court has to ascertain the real value of the shares at the date of death and the market value is not always the same as the real value.'

This test of real value was acknowledged by Gibbs J in Gregory v Federal Commissioner of Taxation.[43]

Thus the executors need not suffer the disability of a forced sale if the marketable value is less than what they consider to be the real value.

One of the other factors which may cause divergence between market value and real value is that the former is not always based upon a full knowledge of

43 (1971) 123 CLR 547

the facts by both parties. Real value is presumed to be calculated with a knowledge of all relevant data, and on the assumption that the hypothetical buyer and seller each have the same knowledge.

The Accountants' Handbook (USA) indicates a similar general approach in America, where 'to appraise a security means essentially to determine a fair market value'. Fair market value is defined as 'the price which would be arrived at under the conditions obtaining as a result of negotiations between a willing and informed buyer and a willing and informed seller. This conception excludes forced sale or liquidation value.'

In summing up, the willing buyer - willing seller concept is in principle a simple one based on the thesis that a common price will be acceptable to both parties to the transaction. In practice it gives rise to frequent difficulties, especially in the case of property of a highly speculative nature. In many such cases it may seem at first sight that a purchaser would be prepared to give little or nothing for the asset. On the other hand it may be argued that the vendor would not be willing to part for a song with an asset which could turn out to be of considerable value; and that he would rather take his chance by declining to sell at all. Similar considerations can also arise in a modified degree in the case of shares in a family company, where the apparent worth to the deceased (as a member of the family) may seem at first sight to exceed the price which a purchaser outside the family would be prepared to pay.

Could it be argued that the price must be that which the purchaser is prepared to pay? It is submitted that this argument is fallacious. A sale would be equally out of the question if the price were too low for the vendor. There is no justification for favouring one party rather than the other: indeed, quite apart from the specific references in the authorities to willing vendor and willing purchaser, the whole conception of an open market implies freedom of choice by all concerned. And it is abundantly

clear from the decided cases that the statutory basis involves an equal degree of willingness on both sides. The crux of the matter in a given case is - 'What is a fair price under all the circumstances?' If at the outset it seems that the views of vendor and purchaser might differ on this question, it must be assumed that there will be reasonable negotiations on equal terms continuing until a settlement is reached.

Time of hypothetical sale

The Estate Duty Act provides that the value of

(1) quoted shares not sold in the course of liquidation of the estate[44]; and

(2) unquoted shares[45]

to be included in the estate is the fair market value thereof as at the date of death of the deceased.

In the estate duty case of Duke of Buccleuch[46], Lord Reid said that it

> 'must mean the price which the property would have fetched if sold at the time of death. I agree with the argument of the respondents that "at the time of death" points to a definite time - the day on which the death occurred: it does not mean within a reasonable time after the death.'

Later on he continued[47]

> 'But here what must be envisaged is a sale in the open market on a particular day. So there is not room for supposing that the owner would do, as many prudent owners do - withdraw the property if he does not get a sufficient offer and wait until a time when he can get a better offer. The commissioners must estimate what the property would probably have fetched on that particular day if it had been exposed for sale, no doubt after such advance publicity as would have been reasonable.'

44 Section 5 (1)(g)

45 Section 5(1)(f) bis

46 (1967) AC 506 at 524

47 Supra footnote 46 at 525

Although it is clear that the property must be valued at the time of death, the question arises as to how much reliance can be placed on prior and subsequent sales in arriving at the fair market value.

Prior sales

It is possible that previous arm's length sales may have been affected which may be taken into account in a subsequent valuation. In practice, however, the number of cases tend to be few and far between.

Nevertheless, in the Irish estate duty case of McNamee v IRC[49], Thomas McNamee at the time of his death owned 175 ordinary shares out of 50 000 ordinary shares in issue in the Convoy Woollen Company Limited.

Mr McNulty, the solicitor of the company, gave evidence as follows:

> 'I purchased 150 of these shares in 1946 at £150. Registration no 248. The parties were at arm's length. The dividend was 10%. Registration no 261. That was a sale at arm's length. Weir to Carless, May 1949; J R Weir to IB Carless, 777 ordinary shares for £971. 5s.0d. Registration no 266, 19 March 1951, Raphoe Electric Light Co, John Moffat, 100 ordinary shares of £125. They were at arm's length. 19 September 1951, the McNamee sale was registered. In January 1951, the MacNamee sale was negotiated by me. It was not registered until the September following, registration no 269. It was the best price I could get. Mr Kilpatrick had recently been appointed a director. He wanted shares. He knew of the sale of Carless and he offered the same price. I am certain he couldn't have got them at that price. This sale at £1. 10s. 0d. was at arm's length. It was a completely commercial transaction. I am solicitor to the company and I know a fair amount about its affairs. In ordinary cases I would consult the secretary as to the sale. That didn't happen in this case. I knew Mr Kilpatrick wanted the shres. We had a bit of a haggle. I pushed him to £1. 10s.0d. I couldn't get any more at

49 (1954) IR 214

all. The most I could get was the £1. 10s. 0d. I did not hawk them around. It was a sale to the most probable purchaser. The directors knew the shares were for sale. I got the highest price in the history of the company.'

In his judgment, Maguire J stated:

'Accepting Mr McNulty's evidence as to the bona fides of the sale of these shares to Mr Kilpatrick and granting that this price of £1. 10s. is the highest ever paid for these shares in the history of the company, I still must bear in mind that this was not a sale in any real or any imaginary open market. I must make allowances for the sale in an imaginary open market. It is here I find evidence of Mr Shott and Mr Butler of great value. I have given anxious thought and consideration to this, perhaps in some ways the most difficult part of my task. I am satisfied that not more than £1. 12s. 6d, certainly not more than that, might have been obtained in the open market, an imaginary open market, for this lot of 175 shares. Accordingly I fix and determine the value of these shares at £1. 12s. 6d each.'

Subsequent Sales

Although it appears that a previous arm's length may be taken into account in a subsequent valuation (McNamee's case), the interesting question arises as to whether a subsequent sale after the date of valuation, give grounds to re-open and amend the earlier valuations.

One of the leading estate duty cases on this point, althought not dealing with shares, is that of IRC v Marr's Trustees[50]. A herd of cattle, belonging to Mr Marr who died on 7 June 1904, were valued on 20 June 1904 at £9 031 by Mr H Ritchie. The herd wsas subsequently sold at an auction sale on 11 October 1904 for £17 722.

50 (1906) 44 SLT 647

The Commissioner argued that the price fetched in the open market, when the herd was exposed for sale within four months after the deceased's death, afforded a reasonable and proper criterion of value of this portion of the deceased's estate. They further argued that the amount actually realised formed and fell to be treated as an important asset of the estate, allowance being made for such outlay as was incurred by the defenders, as executors, in the keep and care of the herd. The balance, after making this allowance, represented truly the value of the herd at the deceased's death.

Lord Johnston drew a distinction between property which was subject to considerable fluctuation in value and that, such as a house, where a valuation was apparently considerably easier. The judgment is useful in highlighting the different factors which may be applicable at the date of valuation and not at the subsequent sale.

> 'In the case of house property, at any rate, there is a natural time of the year which is regarded as the proper property market, and unless a house has some special attractions it can hardly be said that there is an open market say, in the month of August, should that be the time of the deceased's death. Though the house may not be actually saleable then, yet values change so gradually, that there is no difficulty in a skilled valuator putting a proper value upon the house even in August with his knowledge of past markets and present prospects. There will be no substantial change in the intrinsic value of the house between August, when it may have to be valued and the following February, when it may have to be sold for entry at the ensuing May.
>
> But when one comes to deal with a subject of a fluctuating value, the fluctuation depending upon natural increment or rather on the excess or otherwise of natural increment over natural decrement, a different question arises. Such a subject is a herd of cattle. It is in the definite ascertainable condition at the date of the deceased's death.

But in the lapse of months important changes take place. At the date of the death a cow may be two or three weeks from calving. In the course of three or four months the risks of calving and the risks to the life of the young calf are over. The cow in calf is one thing, the cow and her calf on its feet and three or four months old is a totally different thing. Again a calf a few weeks old at the date of the death and a calf some months old at a date posterior to the death are also very different things. The calf is over the troubles of its early weeks and every month is developing more of its quality. Similarly a cow may have been put to the bull shortly before the death and in the course of three or four months may prove either to be barren or to be in calf. Again losses by death occur from time to time, and cattle which may be perfectly healthy at the date of the death of the owner may either singly or as a herd be afflicted with disease rendering them valueless at the end of three or four months. It is, I think, therefore obvious that to call for a valuation (and no valuation can be better than actual exposure to sale by auction) at a date three or four months posterior to the date of death would not give the true value of the herd at the date which the statute itself fixes viz, the date of the death.

Now if what I have already said would be true of an ordinary herd of cattle it is true to a greatly enhanced degree in the case of a herd of prize cattle, whose risks and whose variations in individual value are extreme in degree when compared with those of an ordinary herd. Moreover, if what I have said above is true generally there could not be two periods in the year better suited to display the difference in values than the dates with which we are concerned, viz 7 June and 11 October. In June the herd is in a transition state. The majority of the calfs have been recently dropped, some of the cows are uncalfed and the herd has had none of the benefits of a summer's grass. By October the conditions of the herd is set for the season, the cattle have, in agricultural phrase, got the bloom on them, and there can be no question

that in the interests of the estate the trustees acted prudently in taking the risk of carrying the herd through the summer and selling it in October, rather than selling it at once, and they also acted prudently in not taking the risk of carrying it through the winter and selling it in February which is the other chief market month for prize cattle, and when if everything had gone well the herd would have been of still greater intrinsic value, though I doubt whether it would have met as good a market.

Even if I had not considered the special circumstances to be immediately adverted to, I should have no hesitation in stating that the herd must be valued at the date of the death, though it might have been imprudent to bring it to the hammer until three or four months later, and that the Commissioners of Inland Revenue were not entitled to have a valuation as in October, when the best market may be anticipated, or a valuation based on the results of actual sale at that period.'

It would appear that the price realised in the subsequent auction was itself exceptional and this was a further reason for rejecting any attempt to drop back from the subsequent sale price to arrive at the value in June. As Lord Johnston stated:

'I think that the sale which actually did take place in October was accompanied by certain adventitious circumstances which, though they rebounded very much to the advantage of the estate, render the sale price obtained a misleading criterion of the true market value of the herd at the date of the death, or indeed at any other date.

Also, in the estate duty case of Re Holt[51], Danckwerts J stated:

I rule out of consideration the knowledge provided by the passage of time since March 11 1948, that the company's dividend on ordinary shares has

51 (1953) 32 ATC 402 at 410

> not been increased from 5% and that the company has been able to avoid a public issue of ordinary shares by launching an exceedingly successful issue of new preference shares in September 1950.'

It appears, therefore, that events subsequent to the valuation date have to be ignored. However, it is submitted that information arising after the date of valuation may nevertheless help to shed light on the position at that date.

In the estate duty case of The Trustees of Johan Thomas Salvesen v IRC[52] Lord Fleming stated:

> 'I quite recognise that the problem I have to deal with must be solved in the light of the information available at or about the time of the testator's death. I think that, however, does not debar me completely from making any reference to the balance sheet at 31 July 1927 which includes a period of nearly three months prior to the testator's death (24 October 1926).'

In the cases of Re Bradberry National Bank Ltd v Bradberry, and in Re Fry, Tasker v Gulliford[53], although not dealing with the valuation of shares, Uthwatt, J stated:

> 'It was held by the Court of Appeal that although the moment at which the damages in a case ... are to be fixed is the moment of death, that did not mean that the court was to shut its eyes to subsequent happenings and that the court could, in assessing damages, inform its mind of circumstances which had arisen since the cause of action accrued and which threw light on the realities of the case.'

And later he proceeds:

52 (1930) 9 ATC 43 at 51
53 (1943) 1 Ch 35 at 44

'A principle is to be drawn from these authorities, namely, that where facts are available they are to be preferred to prophecies.'

The use of hindsight has also been an issue in two important Canadian tax cases heard before the Federal Court of Appeal in recent years, each dealing with publicly traded securities. One is the decision of National System of Baking of Alberta Limited v The Queen[54] and the other is The Queen v Littler.[55] Both cases involved a formal takeover within months of the valuation date at a price two to three times in excess of the quoted trading price.

In National System of Baking (at the Trial Division level), Mahoney J stated:

'I expressly rejected the validity of hindsight as probative of fair market value at a given date and took nothing that occurred after Valuation Day into account.'

In Littler, the use of hindsight is contrasted with the availability of facts existing at the vauation date. Two out of the three justices in this case were of the view that the fair market value of the subject shares was the eventual takeover price, not the stock market price on the valuation date, such view being without the benefit of hindsight. The Court of Appeal confirmed the decision of Decary J of the Federal Court - Trial Division. Dubinsky DJ (dissenting) stated:

'... With deference, therefore, to the contrary view of the learned trial Judge, the Minister had every reason to attribute to the value of a share in Lowney's a figure of $68,22 quite apart from what eventually took place in May, 1968 ... As far as the Minister's decision is concerned, it was not, in my opinion, a case of hindsight at all.

54 (1978) CTC 30; 78 DTC 6018

55 (1978) CTC 235; 78 DTC 6179

It was based on substantial facts existing prior to the transaction challenged herein'

This again indirectly raises the aspect of informed parties in the concept of fair market value, viz the willing buyer - willing seller principle.

CHAPTER 5

MAJORITY AND MINORITY SHAREHOLDINGS

Introduction

Considered at large, control must signify a power vesting in some person or group to direct the business and affairs of a company. This power may have a legal foundation as, for instance, where it is exercised by means of a majority holding of the company's issued voting share capital, or by a contractual right. Control may also exist in fact in a number of informal ways as, for example, where the economic or other circumstances in which a company is placed allow control to be exercised by someone holding only a minority of shares, or perhaps none at all. De facto control is an even more elusive concept than legal control, but while it may be as effective as any form of legal control, it may always be overridden by legal control. Control of either variety is no less real because it is infrequently exercised, as it is always available to the controller whenever he chooses to use it.

Corporate control is control over the company as a whole, and only indirectly over its assets, decisions and activities, because the ownership of a share is not a proportionate ownership of the corporate property.

Subject to the specific and general restraints on the freedom of a controlling shareholder, control (or a controlling interest) is for most purposes said to exist when the shareholder holds shares which, taken together, carry 50 per cent plus one of the total votes which may be cast on an ordinary resolution at a shareholders' meeting. A shareholder with such voting power will generally be able to elect all the directors (including himself) and, through them, to govern the company's business. A shareholding insufficient to accomplish this is described as a minority interest. If the shareholder has enough voting power to pass a special resolution, he will also be able to determine another range of matters which require such a majority. If the shareholder owns 100 per cent of the voting

of the voting shares he may have absolute control.

It appears that in most countries, there is no statutory definition of 'control' and the meaning must be found in the principles developed in case law. Most of the case law has arisen under income tax legislation, and it is these cases which are discussed below.

Legal Control

United Kingdom jurisprudence has uniformly held that control means control by legal means and, more, that legal control springs from the constitution of the company itself. The basic rule was laid down by Rowlatt, J. in BW Noble Ltd v IRC[1]:

> 'It seems to me that "controlling interest" is a phrase that has a certain well known meaning; it means the man whose shareholding in the Company is such that he is the shareholder who is more powerful than all the other shareholders put together in General Meeting.'

Although it is clear that legal control turns on ownership of voting shares, it is necessary to go further and examine the matters on which those shares may be voted. In the Canadian case of Buckerfield's Ltd et al v MNR[2] the Court spoke of a majority of the votes in the election of the board of directors. The power to elect directors is probably the most important criterion with which to assess the importance of voting power because, in the usual situation, directors are also given broad authority to manage the company. If this is so, the vesting of some specific and limited management authority elsewhere may not impair the control. But the Court in Donald Applicators Ltd et al v MNR[3] said that the reasoning in the Buckerfield's case would apply only when the directors had the usual powers of directors.

In the Donald Applicators case a company had issued 2 Class A and 490 Class B shares. Both classes carried full voting rights except that the class B

1 (1926) 12 TC 911 at 926

2 (1965) 1 Ex CR 299; (1964) CTC 504; 64 DTC 5301

3 (1969) CTC 98; 69 DTC 5122; aff'd (1971) CTC 402; 71 DTC 5202

shares had no right to vote in an election of directors. The court refused to accept the argument that the class A shares controlled the company because they had the exclusive right to elect directors. Instead, the court looked at the realities, noting the the directors could issue no shares without the consent of all shareholders and that the class B shareholders could at any time amend the company's consitution to strip the directors of all powers and vest in the shareholders the entire authority to manage the company.

Similarly, two directors holding two-thirds of the voting shares did not have control of a corporation when the corporation's constitution provided that shareholders' resolutions had to be unanimous and that a quorum at both shareholders' and directors' meetings was three because the third shareholder-director could frustrate any matter proposed by the other two.[4]

It is interesting to note that the judge in the Donald Applicators case expressly declined to take account of the de facto control possesed by the class B shareholders, and he also said that the fact that the directors performed no important functions and deferred entirely to the manager appointed by the class B shareholders did not in itself establish that control did not rest with the class A shares.

In Oakfield Developments (Toronto) Ltd v MNR[5] the Supreme Court of Canada held that a corporation was controlled by its common shareholders (even though 50 per cent of the total votes was vested in a class of voting preferred shares), because the preferred shares had only a restricted (albeit prior) right to dividends and to shares in assets upon liquidation, and liquidation could be effected by a 50 per cent vote of all shareholders.

As discussed earlier, control may also vest in a shareholder or shareholders through a casting vote, intermediate companies, trustees and nominees,

4 Fairgreen Investments Ltd v MNR (1972) CTC 2446; 72 DTC 1374

5 (1971) SCR 1032; (1971) CTC 283; 71 DTC 5175

voting agreements, powers of attorney, group control, etc. For the purposes of this paper, it is not deemed necessary to deal with these at length.

It remains, however to briefly discuss the incident of ownership of control.

Property in Control

It has been customary to assume that any value attaching to a controlling block of shares over and above the value of the shares themselves is an incident of the ownership of the block. The control premium which the owner of a controlling block of shares might be able to command on a sale is that shareholder's property, and he is not accountable to the corporation or to the other shareholders for any part of it. As Lord Uthwatt expressed it:[6]

> '... if some one shareholder held a number of shares sufficient to carry control of the company, it might well be that the value proper to be attributed to his holding under the regulation was greater than the sum of the values that would be attributable to the shares comprised in that holding if they were split between various persons. The reason is that he has something to sell - control - which the others considered separately have not. The contention of the appellants, if accepted, would, as the Court of Appeal point out, deny him the real value of his holding.'

Nevertheless, many argue that 'control' should properly be regarded as a corporate asset and that all shareholders should enjoy rateably the proceeds of its sale.[7] The American case of Perlman v Feldman,[8] while it did not explicitly adopt the 'corporate asset' theory, did conclude that the

6 Short v Treasury Commissioners (1948) AC 534; (1948) 2 All ER 509 at 513 (All ER)

7 See Gower, Modern Company Law 3rd ed p546, 578; Andrews, 'The stockholders right to equal opportunity in the sale of shares', (1965) 78 Harv LR 505

8 219 F 2d 173; cert denied 349 US 952 (1955)

9 The case was remanded for a determination of the value - of the selling price of $20 share, $14,67 was determined to be the fair market value at the date of sale, so that the control premium was $5,33 per share.

minority shareholders were entitled to share in the premium received by the seller of a block of shares (37% of the total) which carried effective control.[9] The circumstances in Perlman v Feldman were unusual in that the company whose shares were sold was a steel producer at a time (during the Korean War) when supplies of steel were scarce and producers were exercising restraint on prices. The purchaser was a steel user, and the premium price paid for the shares was an indirect payment for a supply of steel. Thus, the court characterized the sale of shares as, in part, a sale of the company's product. Looked at in this way, the minority shareholders were really sharing in a profit resulting from a high demand for the product of their corporation, and the controlling shareholder, as a fiduciary, could not appropriate that profit to himself.

Fiduciary obligations were also imposed upon controlling shareholders in Jones v Ahanson[10] and Rosenfeld v Black[11]. However, many other decisions in the United States have not adopted the rationale of Rosenfeld v Black.

In South Africa there has not yet been a case in which a seller of control has been required to account to other shareholders for a premium obtained, whether on a theory that control is a corporate asset or as an incident of the seller's fiduciary obligation. However, in Canada there have been suggestion that an argument to that effect would be sympathetically entertained.[12] Securities commissions in Canada have refused permission to transfer escrowed controlling shares without a takeover bid under which all shareholders accepting the bid would be entitled to receive the same price. In the Ontario Securities Commission proposed amendments to Bill 75 (the Securities Act, 1974) the definition of an exempt offer which is not subject to the general takeover bid rules no longer contains an exemption for a private agreement entered into by 15 or more shareholders. The effect of this deletion means that a takeover bid would presumably have to be made to all shareholders and that all shareholders would share equally in a sale.

10 (1069) 1 Cal 3d 93; 460 P 2d 464 (1969)

11 445 F 2d 1337 (1971)

12 Re R J Jowsey Mining Co Ltd (1969) 2 O R 549; (1969) 6 DLR (3d) 97

Principles of valuation

Both the courts and valuation commentators have tended to deal obliquely with the valuation of control. On the part of the courts this may be because so little has been written on this topic. Certainly the various aspects of control as they might affect value have not been discussed per se, nor has there been an attempt made to suggest methods by which the value of control might, in certain circumstances, be quantified. There has, however, been general recognition that control can have value in and of itself. For example, in Gold Coast Section Trust Ltd v Humphrey,[13] Lord Simon said, "there may also be value in control", and, in Short v Treasury Commissioners,[14] which came out most clearly for a premium for control, the Court said when referring to the position of a shareholder with effective control:[15]

> It may well be that the value to be attributed to that holding (one shareholder with effective control), on a sale of it as a separate transaction, is a figure greater than the sum arrived at by multiplying the number of his shares by the market value for the time being of a single share. In such a case the shareholder in question, it may be said, has and is able to call something more than a mere parcel of shares, each having the rights as to dividend and otherwise conferred upon it by the company's regulations.

In Dean v Prince[16] the Court seemed to relate the ability to control to valuing the business in question on a going concern basis, rather than on a break-up basis as had been the approach of the auditor called in to arbitrate between dissenting shareholders. It can be argued in both this case and Short that the courts concluded that a rateable value should attach to control shares and that minority interests would generally have a lower

13 (1948) 2 All ER 379 (HL)

14 (1948) 1 KB 116 (CA), aff'd (1948) AC 534 (HL)

15 The premium suggested by the Court could be either a premium over market price for control, recognition that the public market price was not representative of underlying value, or a combination of these two factors.

16 (1953) 1 Ch 590

value than a rateable value no matter what basis was used to determine such minority value.

Under ordinary circumstances a majority shareholding in a company conferring voting control should be valued by reference to the value of the net assets of the company[17], due allowance being made where appropriate for the tax liability which would arise in the hands of a shareholder on the distribution of the company's reserves upon its winding up. The practice of making such an allowance in valuing shares for fiscal purposes is well accepted by the Department of Inland Revenue which normally accepts a deduction of 33,3 per cent of a company's distributable reserves.

The Share Valuation Division in the United Kingdom considers that a majority holding of more than 50 per cent and less than 75 per cent of the voting captial is one which should be valued by reference to the overall value of the company based on either ernings or net assets as appropriate, subject to a discount to allow for the fact that the entire company is not on the market although a control holding is.

When the figure of 75% or more of the voting shares is reached, it is indisputable that the whole value of the company on an earnings or assets basis, as appropriate, and as calculated above, is the correct method of valuation.

In the case of a minority shareholding, a valuation based on the net value of the company's assets is only appropriate if the company has disposed of its business and is in the course of winding up.[18]

The paramount factor in fixing the price which a hypothetical willing purchaser would pay to a hypothetical willing seller is the estimated dividend yield. The main bearing that the asset position has on the

17 M'Connels Trustees v CIR (1927) SLT 14

18 Re Courthope (1928) 7 ATC 536

hypothetical market price arises from the degree of security which the purchaser may expect; where the asset backing is high a purchaser would normally be prepared to accept a somewhat lower return than he would ordinarily require.

These principles, as well as the invidious position in which a minority shareholder in a private company could find himself, are illustrated by the remarks of James J in Estate Duty Case No 1:[19]

> 'Inquiry would have satisfied (a purchaser) that the private company was essentially a family one in which family loyalty and interest would make it extremely difficult for a minority shareholder to influence policy to the extent of forcing a liquidation in order to obtain a share of the capital of the company, or to sell the whole business, lock, stock and barrel as a going concern. Thus an intending purchaser would have realized that he could have but little expectation of financial profit from a disposal of the company's assets, because such disposition in the reasonably foreseeable future was very unlikely ... while the court agrees that the strong asset position of the company is a factor to which due weight must be given, it must nevertheless be borne in mind that unless there is a dramatic change in the professed policy of the company, it seems unlikely that any shareholder or potential shareholder can hope to receive any direct advantage as a result of the sale of the assets either in whole or in part within the foreseeable future ... the main bearing that the asset position has on the market price is brought about by the fact that any investment made will be well secured, and that a potential investor because of this, may be ready to accept a somewhat lower return on his money than he would normally require. The business is exceptionally sound, financially strong, well managed and has excellent prospects and in the court's view an investor knowing all the facts might well be prepared to accept a lower immediate return on his investment.'

19 (1958) 23 SATC 362

Another case which illustates the principles involved in valuing a minority shareholing is the Australian case of Gregory v Federal Commissioner of Taxation.[20] The deceased owned a minority holding in a private company which in turn owned directly and indirectly a substantial shareholding in a quoted company. The Commissioner contended that the rate of capitalization to be applied in valuing the deceased's shareholding should be determined by taking the arithmetic average yield on the underlying quoted investment. The court rejected this argument and approved the fundamental principles to be applied as stated in an earlier case, Commissioner of Succession Duties (SA) v Executor Trustee & Agency Co of South Australia Ltd[21] in the following terms:

> 'the main items to be taken into account in estimating the value of shares are the earning power of the company and the value of the capital assets in which the shareholders' money is invested. But a prudent purchaser does not buy shares in a company which is a going concern with a view of winding it up, so that the more important item is the determination of the probable profit which the company may reasonably be expected to make in the future, because dividends can only be paid out of profits and a prudent purchaser would be interested mainly in the future dividends which he would reasonably expect to receive on his investment.'

The court in the Gregory case went on to say that:

> 'If the shareholding to be valued is a majority shareholding the value of the underlying assets may assume great importance. Where, however, one is required to make a valuation of a minority shareholding in a company (company A) which holds a very substantial parcel of shares in a public company (company B), and when company A is so controlled that it appears probable, if not certain, that it will, notwithstanding the fluctuations of the market, retain its shares in company B, it would be quite unreal to say that a prudent purchaser of shares in company A would necessarily

20 (1971) 2 ATR 33

21 (1947) 74 CLR 358

expect to pay a price which would give a yield no greater than that produced by company B, because on becoming a shareholder in company A he would not enjoy all the advantages available to a shareholder in company B, and in particular would not be able to obtain the capital gain that would result from a favourable realization of the shares in the latter company.'

This principle was upheld in a later and recent case of the High Court of Australia, Executors of the Estate of M.C. Crane v Federal Commissioner of Taxation[22] where the facts were very similar to those in the Gregory case.

The depreciatory effect of a minority shareholding in a private compa. was also brought out in Holt & others v Inland Revenue Commissioners[23] where Danckwerts J in his judgment said:

'The shares did not give a purchaser the opportunity to control the company, or to influence the policy of the directors to any great extent ... any purchaser therefore would be dependent on the policy of the directors, so long as they should have the support of the general body of the shareholders. I think that the kind of investor who would purchase shares in a private company of this kind, in circumstances which must preclude disposing of his shares freely whenever he should wish (because, when registered as a shareholder, he will be subject to the provisions of the articles restricting transfer), would be different from any common kind of purchaser of shares on the stock exchange, and would be rather the exceptional kind of investor who had some special reason for putting his money into shares of this kind. He would, in my view, be the kind of investor who would not rush hurriedly into the transaction ...'

In ITC 932[24] the appellant received a minority shareholding in a private property company as consideration for services rendered. The president of

22 (1974) 5 ATR 171
23 (1953) 2 All ER 1499
24 (1961) 24 SATC 341

the court considered that the right way to value shares in a private company was by reference to the break-up value of its assets. It is submitted that this is incorrect for a minority shareholding although it should be noted that the accountant called on behalf of the appellant somewhat surprisingly valued the shares in question by reference to the underlying value of the assets of the company. Accountants commonly value minority holdings for fiscal purposes in this way, making some allowance, usually 10 per cent, for the fact that the shares constitute a minority holding. However, it must be pointed out that, except for the doubtful authority of ITC 932, this method of valuation is not supported by any other legal precedents.

The Shares Valuation Division in the United Kingdom draws a distinction between 'small' minority holdings and 'influential' minority holdings. Small minority holdings are those of less than 25 per cent in which it is accepted that a holder can do little to influence the running of the company and would not have a right to a seat on the board. He would therefore be primarily concerned with the yield he would receive on his investment and the shares should be valued on the basis of a dividend yield if a dividend is paid, but with some regard paid to earnings or on an earnings yield or price earnings ratio basis if there is no dividend. If pressed however the Shares Valuation division can usually be persuaded to accept the method of arriving at a notional reasonable distribution and discounting that figure by say, 50 per cent.

Holdings of more than 25 per cent but less than 50 per cent is considered to be influential minority holdings, where the shareholder can block a special resolution. Although it is accepted that, in practice, t is ability to block a special resolution is unlikely to have of itself a significant value, it is true that the value per share would be higher than for a small minority holding. The Revenue view is that such holdings should be valued on a basis which gives the greatest weight to the price earnings ratio, less

weight to the actual dividend paid and the weight to be attributed to the net assets value to be dependant on the size of the holding. Net assets value has a greater influence on the value of a 49,9 per cent holding than on the value of a 25,1 per cent holding. This is a not unreasonable method of valuation.

In practice, when it is remembered that the dividend yield required when there is a 'consistent reasonable dividend' should also take into account the size and the influence of the holding within the company, and that dividend yields of comparable companies (based on the sales of small minority holdings) would need to be reduced to allow for the size of the holding involved, there would be little, if any difference between a dividend orientated and an earnings orientated valuation.

50 per cent holding

In the case of a 50 per cent holding it could be argued, that although there would be a potential deadlock if the other shares were held by another 50 per cent shareholder, there would nonetheless be an assumption following the judgment in Ebrahimi v Westbourne Galleries Ltd[54], that the shareholders would act for their mutual benefit and the valuation should be by reference to the company as a whole.

If, however, the other 50 per cent of the shares are held in small numbers by other shareholders, then clearly the 50 per cent shareholder has de facto but no de jure control. Value by reference to the company as a whole, however, is again reasonable. Obviously this approach results in a discount on the going concern value of the company provided, on the assumption that the company is a going concern.

One area which can give a particular problem in practice is where there is an equality of shareholdings and as to whether as a result there is complete deadlock or a particular shareholder has control. Such a case was that of

54 (1972) 2 All ER 492

IRC v B W Noble Ltd[55]. In this case Mr Noble held 500 out of 1 000 ordinary shares. However he was also chairman of the company and as Rowlatt J stated in judgment at 926:

> 'Now this gentleman has just half the number of shares but those shares in the circumstances of this case are reinforced by the position that he occupies of chairman. A position that he occupies not merely by the votes of the other shareholders or of his directors elected by the shareholders, but by contract and so reinforced in as much as he has a casting vote he does control the general meetings, there is no question about that, and in as much as he does possess at least half of the shares he can prevent any modifications taking place in the constitution of the company which would undermine his position as chairman.'

The judge had no hesitation in holding therefore that Mr Noble controlled the company.

In Re W F Courthope (deceased)[56], the deceased owned 50 per cent of the ordinary shares and almost 50 per cent of the preference shares. The company in question had disposed of all its assets but was not in liquidation. Rowlatt J took a highly practical approach. Declining to value the shares on a dividend return basis he felt that there was some possibility that the purchaser of the shares in question might be able to compel a winding up but that there was considerable uncertainty. Taking into account that a prospective purchaser would require a profit on his investment of some 50 per cent, he discounted the value of the shares calculated by reference to the net assets of the company by 33,3 per cent. A roughly similar approach was taken in an American case, Obermer v United States[57] although the position in that case was complicated by the fact that if liquidation of the company took place, capital gains taxes would be payable.

55 (1926) 12 TC 911

56 7 ATC 538

57 238 F Supp 29 (1964)

There is much to be said for the view that a 50 per cent shareholding should be valued on a dividend return basis with, perhaps, some premium where a majority valuation would result in a higher value per share than that obtained in a minority valuation to take account of the potential for some profit in the event of a winding up -- 'a prudent purchaser does not buy shares in a company which is a going concern with a view to winding it up'.[58] While a 50 per cent holding can block ordinary and special resolutions it does not enable the holder to apply to court for a compulsory winding up under s 344(a) of the companies Act of 1973; nor would it entitle the holder to bring about the voluntary winding up of the company in terms of s 349(b) of that Act. The valuation of a 50 per cent shareholding in a company presents perhaps one of the most difficult problems involved in the valuation field.

58 Gregory v Federal Commissioner of Taxation (1971) 2 ATR 33 at 45

CHAPTER 6

THE BLOCKAGE DOCTRINE

The blockage doctrine concerns the determination of the proper value of large blocks of quoted shares. When the block in question is very large relative to the normal trading volume on the market, its value differs from that obtained by simply multiplying the number of shares by the market price per share. This phenomenon, in fact, is not unique to the valuation of shares; blockage could be pertinent in almost any valuation problem.

The question of an allowance for blockage has occurred only once in a reported South African case. In Lace Proprietary Mines Ltd v CIR[1] the question arose as to how one million shares in a certain company quoted on the Johannesburg Stock Exchange, should be valued. In finding that the determination of the value of shares for tax purposes is a question of fact the court went on to say that 'the value of the shares on the (revelant date) must, of course, be ascertained by enquiring what price could have been obtained for them, by adopting some reasonable method of sale on that date. To throw the whole million shares on the Johannesburg market on a given date would obviously be the worst possible way of gauging their value. Both common sense and the evidence suggest that the quotation would become fictitious or nil long before the major portion of the shares were sold ... there are obviously other methods of effecting a sale of shares wholesale than by throwing them all on the open market. What has to be looked for is a person who is willing to buy wholesale at a price under the retail price of the stock exchange quotation. He would get his profit over a period by retail sales. Such buyer would certainly be influenced by the stability and firmness of the stock exchange daily quotation and would normally buy at something under that quotation'

Where the fair market value of quoted shares at date of death substantially exceeds their realisable value in the estate, it could be considered selling those shares in the course of the liquidation of the estate so that the

1 1938 AD 267, 9 SATC 349

benefit of the lower valuation under s 5(1)(a) of the Estate Duty Act can be obtained.

In Craddock v Zevo Finance Co Ltd[2] the issue related to the basis upon which investments acquired should be valued for income tax purposes. Lord Greene, MR held that

> 'published market quotations, which often relate to quite small and isolated transactions, are notoriously no guide to the value of investments of this character particularly when the amounts involved are large (blocks of shares).'

In Gold Coast Trust Ltd v Humphrey[3] the House of Lords adopted the same approach as that in the Lace case and held that a large block of shares could not be disposed of on the stock market without killing the market and that the normal way to dispose of a large block would be to approach trust companies or financial houses to place them.

Generally speaking, the Canadian courts have ruled that no deduction can be made in calculating the value of a large holding on account of blockage. The two leading Canadian cases on this subject are Dobieco Ltd v MNR[4] and Untermeyer Estate v Attorney-General for British Columbia.[5] In the latter case Mr Justice Mignault said:

> 'I would not deduct anything from the market value of these shares on the assumption that the whole of them would be placed on the market at one and the same time, for I do not think that any prudent shareholder would pursue a like course. To make such a deduction in a case like the one at bar, would be to render, the "sacrifice value" or "dumping value" of the shares the measure of valuation.'

Although Mr Justice Mignault did not find that a variation should be found because of blockage, he did uphold the findings of the Commissioner appointed under the British Columbia Act. The Commissioner had in fact

2 (1944) 1 All ER 566

3 (1948) 1 All ER 379

4 Exchequer Court 63 DTC 1063; Supreme Court 65 DTC 5300

5 1929 SCR 84

already reduced the listed price due to prevailing conditions. In the Dobieco case, however, no deduction was allowed for blockage. The court found that the price at which shares sell on the stock market might be regarded as prima facie evidence of their fair market value, although not necessarily conclusive if rebutted by evidence to the contrary. The court found that in the particular circumstances at hand insufficient evidence had been furnished to demonstrate that the stock market prices were not indicative of the fair market value of the shareholding under consideration.

In the United States of America both the courts and the Internal Revenue Service have shown a willingness to accept that the fair market value of large blocks and/or otherwise restricted shares may be something other than that indicated by the current market price of the company's shares. In US Revenue Ruling 59 - 60, when considering the value of a particular shareholding, consideration is to be given to 'sales of the stock and the size of the block of stock to be valued.' There have been a number of US cases dealing with both blockage and restricted shares.[6]

In some US cases the courts have applied what may be called the 'skilful broker' test - this fixes the value of a large block of shares at the amount at which a skilful broker could within a reasonable time realize the shares.

In the Australian case of Executors of the Estate of the Late Bruce-Smith v Federal Commissioner of Taxation[7] the deceased held a large block of shares in a quoted company. The number of shares in the block was several times the average monthly number of shares traded on the stock exchange. The court made an allowance for blockage following two previous Australian cases where such an allowance had been made, Myer v Commissioner of Taxes[8] and Re Hamstrup.[9]

6 See for example Helvering v Safe Deposit and Trust Co (1938) CA 4th 95 F 2cd 802

7 (1973) 4 ATR 148

8 (1937) VLR 106

9 (1960) VR 302

In Myer's case the deceased, through a holding company, controlled a total of over one million shares in Myer Emporium Limited. Martin J reduced the market price of 29s to 23s 6d to allow for the effect on the market if such a large parcel were released. As his Honour said:

> 'No-one would credit a liquidator or the executors with the folly of offering such large quantities of shares for sale on a given date, but it is obvious that anyone intending to dispose of such a number could not keep the news secret, that all brokers and many investors would learn of it, and that the market price would inevitably weaken.'

This principle, however, was not upheld by Williams J in the cases submitted for his consideration in the High Court. In Murdoch's case[10] when called upon to value 360 000 out of a total of 429 046 shares in Murdoch Investments Limited, i.e. sufficient to carry special resolutions by a three-fourths majority, he said:

> '... (Counsel) asked me to find as a fact on the evidence that there was no-one willing to purchase a parcel large enough to give this measure of control, but, to my mind, a finding on this point one way or the other is irrelevant.'

It was pointed out in the Bruce-Smith case, and, it is submitted correctly so, that an allowance would not be appropriate where the block of shares to be valued confers control over the company.

While it is clear that the size of a shareholding can have an effect upon value, the effect of size should not, however, be exaggerated. Whilst giving evidence of a general nature, stockbrokers on different occasions have indicated discounts of up to 20 per cent as being appropriate for large parcels. But it must be borne in mind that there is a point beyond which size would increase the value rather than reduce it, and that is when the

10 Perpetual Trustee Co v Federal Commissioner of Taxation (re Sir James Murdoch) (1942) 65 CLR 572

holding approaches a controlling interest. The unit value of a parcel of shares sufficient to control a company might well be greater than in the case of a small holding.

Having regard to share placements which have been made by brokers, a suitable allowance for "blockage" would range from 2,5 per cent to 10 per cent according to size, with nearness to control operating in the opposite direction.

Finally, an interesting UK case which may become important in future tax cases is that of Duke of Buccleuch and another v Inland Revenue Commissioners[11]. This case centred around the appropriate valuation of a landed estate for estate duty. The estate took the position that there was little or no market for the land sold as a whole, while the taxing authorities argued that the property could have been elaborately subdivided into a number of small units and sold separately. The House of Lords decided that neither position was realistic - i.e. that the logical approach was neither to look at a sale of the land as a whole nor in many small parcels, but rather that prudent executors would most likely adopt a policy of breaking the estate up into units for sale to developers or speculators who in turn would further subdivide the land into individual lots for sale to the public. While this case involves the valuation of land and not public company securities, it does recognize that there are certain problems in the disposition of any large asset - i.e. a large block of land or holding of shares - the market for which may be different than for a small holding of the same asset, but nonetheless a logical market does exist and the price which the asset would fetch in that market is the proper measure of its fair market value.

11 (1967) 1 All ER 129

CHAPTER 7

RELEVANT FACTORS

In estimating the value of shares in a company it is important to consider all relevant factors which will have a material effect and would be likely to affect the minds of intending purchasers[1].

In the Pietermaritzburg Corportion case[2] the Appellate Division laid down the fundamental principle that 'in deciding what the property would be likely to realize, if brought to voluntary sale, the valuers would be entitled to take into consideration every circumstance' surrounding the valuation. Similary, the American legislation has provided identical requirments. In Tri-Continental Corporation v Battye[3] the Supreme Court stated: 'In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value.'

The court in the Pietermaritzburg Corporation case went on to say that it would be impossible to enumerate all the circumstances which would have to be considered by the valuer in order to ascertain the market value. These important dicta are basic to the valuation process. It is pertinent, however, to consider some of the most important individual factors taken into account by the courts in valuing shares where there is no ready market.

History of the trade or industry

In Holt and Others v Inland Revenue Commissioners,[4] Danckwerts J held that the purchaser of share in a private company 'would consider carefully the prudence of the course, and would seek to get the fullest possible information about the past history of the company, the particular trade in which it was engaged and the future prospects of the company'

1 Estate Duty case 1 (1958) 23 SATC 362
2 1911 AD 501
3 31 Del Ch 523, 74 A 2d 71
4 (1953) 2 All ER 1499 at 1501

General conditions of the trade or industry - economic and political
In Attorney-General of Ceylon v Mackie[6] Lord Reid stated:

'Evidence was given in the District Court as to the value of the shares. The leading witness for the respondents was Mr Lander, a chartered accountant, who had experience of rubber companies. The gist of his evidence was that a buyer would first ask what was the last dividend and when it was paid, but, as no dividend had been paid for many years, it was impossible to value the shares on a yield basis. He then pointed out that in 1940 the future was unpredictable and it was difficult to find anyone who was willing to invest large sums of money on speculation. He valued the shares on a balance sheet basis because, in his view, no one would have paid more than that at the time. When asked in cross-examination whether a buyer would not have taken into account the probability that the high profits of 1940 would last for some time, he said that the buyer would have needed to know precisely what was going to happen in the world which was devastated by a war, the length of which could not be guessed by the man in the street. In other words, if a purchaser could have guessed that there was going to be a long war, no government interference, no form of increased taxation, and that he was not going to have competition from others, he might take that view. He would be a brave man. It would possibly be a gamble. In his view, no goodwill attached to the business. Similar evidence was given by other witnesses for the respondents.'

Similarly in the Holt case,[7] Danckwerts J remarked that

'the fluctuating nature of West African trading, would be likely to have a greater effect upon the mind of the hypothetical purchaser than was admitted by the witnesses for the Commissioners of Inland Revenue.'

6 (1952) 2 All ER 775 at 778
7 Supra footnote 4 at 410

Prospects of the trade or industry

In addition to the general economic and political situation, the valuer should consider the particular prospects for the industry in which the company is operating and its relative position within that industry. If that industry is composed of a number of sectors for example, as in the engineering and chemical industries, it is that sector in which the company operates that needs to be considered. This was brought out in the case of The Trustees of Johan Thomas Salvesen v IRC[8] where Lord Flemming included in the relevant facts affecting the valuation of shares of the company, the history of the whaling industry and the prospects of the whaling industry generally at the date of valuation, and of the company in particular. In considering the future prospects of the industry and of the company his Lordship referred to the speculative nature of the industry, the fact that the British Government had sent the research ship 'Discovery' to make scientific observations which might serve as the basis for the regulation of the whaling industry, but that no report was yet available. He referred to the government licences of shore based stations and the revocability of licences and prospects of further government control and restrictions. He thought that it was important that the directors of the company 'were so confident that there was no immediate prospect either of the disappearance of the whales or of the industry being prejudicially affected by government interference that they had spent large sums of money in recent years on purchasing whaling vessels, though their previous policy had been to hire them, and had also committed themselves to the extent of £300 000 for that season's trading. The evidence of Mr Borley, a naturalist in the employment of the Colonial Office, indicates that, though the matter was engaging attention at this time, there was no evidence to suggest that there was any likelihood of the disappearance or even serious diminution in the number of blue whales and fin whales, which constitute the major portion of the catch. He expressed the view that there was not likely to be any decline or collapse of the industry for a very considerable number of years after 1926, and in point of fact it appears from his evidence, and from the report of

8 (1930) 9 ATC 43

the "Discovery" investigation, that the seasons 1926-27 and 1927-28 were very successful.'

Marketability of the shares

It is obviously important to consider the marketability of the shares and restrictions on the transfer of the shares once a prospective purchaser is registered as a shareholder.

One of the assumptions to be made is that the hypothetical purchaser steps into the shoes of the hypothetical vendor and holds the shares subject to the memorandum and articles of the company and any restrictions contained therein. This principle was first clarified in the judgment of Chief Barron Palles in Attorney-General v Jameson[9]. The hypothetical sale and purchase must:

> 'Be a sale of the property which the deceased had in the shares at the time of his death, that is of the entire legal and equitable interest therein, of that interest by virtue of which the deceased had been, and had been entitled to be, "a member" of the company in respect of such shares; a sale by virtue of which the purchaser thereat would have been entitled to have had that which he had bought vested in him in the same manner as it had been vested in the deceased, and consequently under which he would be entitled to be registered as a member of the company in respect of those shares.'

Later he proceeded[10]:

> 'And upon this assumption, which is the supposition the statute directs us to make, we must exclude the consideration of such provisions in the articles of association as would prevent a purchaser at the sale from becoming a member of the company, registered as such in respect of the shares purchased by him at such supposed sale. If we do not, we do not

9 (1904) 2 IR 644 at 683

10 Supra footnote 9 at 689

effect to the assumption that the statute coerces us to make.'

These passages were quoted by approval by Lord Blanesburgh in Re Crossman and Re Paulin[11]. His lordship also stated:

'And, next, if the commissioners' notional sale is to be a sale of the entire share just as it belonged to the deceased immediately before his death, then registration of the share in the name of the notional purchaser must also be offered.'

The special factors to be taken into account and the problems involved in valuing minority shreholdings and shares in private companies are dealt with in Chapters 5 and 9.

Prospects of the company

A purchaser of shares is usually concerned with the potential of the company and with the likely profits of the company after his acquisition. Obviously the past results of the company are important in estimating the future profits.

In A-G of Ceylon v Mackie[12] Lord Reid summed it up as follows:

'Their approach was more theoretical. They assumed that it was possible to estimate the future average maintainable profit by means of an arithmetical calculation from past results and losses, and that a purchaser could have been found who would have paid a price for the shares determined by a further arithmetical calculation from that average maintainable profit. One witness said that "a buyer would concentrate on the last five years' profits because that is most likely to represent what would happen in the future"; and another witness went so far as to say that a prudent buyer would take it for granted that conditions would remain the same. It may be that these assumptions would be justified in many cases. Where the past history of a business shows consistent

11 (1936) 15 ATC 94 at 108

12 (1952) 2 All ER 775

results or a steady trend and where there has been no disruption of general business conditions it may well be possible to reach a fair valuation by a theoretical calculation. But in this case neither condition was satisfied. The profits and losses of the company had fluctuated so violently in the past that, as the second witness for the appellant admitted, it is impossible to choose any five consecutive years in the company's history, the result of which would be reflected in the next year's profits. It is therefore, in their Lordships' judgment, not possible in this case to derive by an arithmetical calculation from past results anything which could probably have been regarded in 1940 as an average maintainable profit, and in addition there were extremely uncertain conditions in 1940.'

Whatever the number of years selected, the valuer should ensure that any abnormal or extraordinary items of income or expenditure be scrutinized to see whether they should be eliminated.

In The Trustees of Johan Thomas Salvesen v IRC[13] the profit record of the company was examined from the date of its incorporation on the 24 June 1909 to the date of death on the 24 October 1926 in considering the trend of profits in the Salvesen case Lord Fleming succeeded in eliminating an exceptional receipt when he stated:

'I should however qualify these figures by stating that, as regards the year 1923-24, the company had a windfall from a PPI insurance of about £50 000 and I understood all the witnesses to be agreed that this windfall should not properly enter the profit and loss accounts at all.'

Dividend record

The dividend paying capacity and record of a company is obviously an important factor in the valuation of shares.

13 (1930) 9 ATC 43

In A-G of Ceylon v Mackie[14] no dividends had been paid on the management shares for many years and as these shares represented the entire equity share capital an attempt was made to value them on the basis of the capitalised earnings for the last five years, but in view of the highly volatile nature of the profits this was not supported by the court and the shares were valued on the basis of the value of the tangible assets of the company.

In Re Holt[15], the deceased held 6,2 per cent of the ordinary issued share capital in the company. For 27 years prior to the shareholder's death, the practice of the company had been to limit dividend distributions on the ordinary shares to 5 per cent less tax and to build up its reserves by accumulating surplus profits in good years.

Danckwerts J expressed the importance of the dividend record as follows:

> 'Now, it is plain that the shares do not give a purchaser the opportunity to control the company, or to influence the policies of the directors to any great extent, as the shares available only represent 43,698 shares out of 697,680 ordinary shares which had been issued. Any purchaser, therefore, would be dependant upon the policy of the directors so long as they should have the support of the general body of the shareholders.'

A witness for the Crown, Sir Harold Barton, a chartered accountant;

> 'Took the extremely low yield figure of 3% and on this basis reached a price of 33s.4d to which he added eight pence for the dividend expected for the year 1947, making a price of 34 shillings.
>
> "Apparently Sir Harold Barton was impressed by the evidence of the petitioners' witnesses, and in particular Mr Holt's emphasis on the policy of restricting the dividends, to the extent of increasing his

14 (1952) 2 All ER 775

15 (1953) 32 ATC 402

yield figure to 4% producing a price of 25 shillings .... A great many of Sir Harold Barton's answers seem to me somewhat vague, and it would appear that he had not examined the position of the company in any great detail. It is not at all clear that Sir Harold Barton considered the effect which the restrictions on transfer of shares contained in the company's articles of associations would have on the purchaser.'

In arriving at a figure of 19s per share, Danckwerts J stated[16]:

'But I think that the witnesses for the Commissioners of Inland Revenue have over-valued the prospect of an increased dividend and of the issue of ordinary shares in the future on March 11 1948. On the other hand, owing to the fall in the value of money, 5% on the ordinary shares did represent a much smaller return in fact to the members of the family than that dividend presented in pre-war years, and there might have been pressure by the family in 1948 or later to increase the dividend having regard to the ample earnings of the company. Moreover some possible hypothetical purchaser might well have thought that the company would be forced to raise further capital by an issue of further shares to the public instead of adopting the method of an issue of preference shares, or debentures, or unsecured notes. Any such anticipation could have been no more certainty than a guess. But I think that the petitioners' witnesses have undervalued this element in the price which the hypothetical purchaser might pay in this hypothetical open market.'

Another case in which dividend yield has been an important factor is that of Re Lynall, Lynall v IRC[17]. At the date of Mrs Lynall's death she held 28% of the issued share capital in a company. The financial statements for the year ended 30 June 1962 reflected a dividend of 15 per cent, covered over eight times by net profit. Plowman J expressed the problem of valuation in the following terms:

16 Supra footnote 15 at 140

17 (1971) 47 TC 375

'In these circumstances there are, I think, three principal factors which effect valuation: (1) the appropriate dividend yield; (2) the prospective dividend; and (3) the possibility of capital appreciation. The evidence suggests certain general observations which may be made about them.

(1) Dividend yield

Two approaches to the problem of an appropriate yield have emerged during the course of the case. The first is to take a purely arbitrary figure based on experience and expertise and work from that. The other is to ascertain the yield which can be obtained on investments in companies in the same general field of industry in the public sector, and then to apply an arbitrary figure of discounts for the fact that one is dealing not with a public company but with a private company. The latter method has the advantage over the former that it at least starts on a factual basis, but it is open to criticism on a number of counts. For example, dividend policy in a private company is likely to be entirely different from dividend policy in a public company; and the regulations affecting the transfer of shares are likely to be entirely different in the two cases. Moreover, it is in the company, Linread Ltd and its management and not in the industry that the hypothetical purchaser is likely to be interested. These are only examples and there are no doubt numerous other factors which influence the stock market but are irrelevant in considering the value of shares in a private company, and in particular this company. It can, however, I think, safely be said that any method of calculation involves the introduction of at least one arbitrary figure somewhere along the line.

(2) Prospective dividend

A number of factors enter into any assessment of the dividend which a company is likely to pay in the future. Past dividends are obviously an important consideration. In the case of the present company the profit

and dividend record, the dividend policy of the board and the capital position would have suggested that at the lowest a 15% dividend would be maintained. The likelihood of the increase would have to be judged in the light of the known policy of the directors, but that would not rule out the probability of an increase. A number of factors point in that direction, such as the upward trend of profits, the high dividend cover, the risk of surtax directions, the employment of surplus profits in the expansion of the business which itself might well lead to an increase of profits.

(3) The possibility of capital appreciation
It is common ground that in the present case this need only be considered in the context of a possible flotation. The probability of such a flotation was a matter depending primarily, but not entirely, on the wishes of the board. The board's hypothetical known assessment of the position at Mrs Lynall's death was that the prospect of flotation was "doubtful and remote." But against that attitude must be set the fact that it was at least a tenable view on the published information, including the family nature of the business and the ages of the family shareholders, that the board would be forced willy-nilly to go public sooner or later in order to provide for death duties, or for some other financial reason urged upon them by their advisers, such as the fear (justified by the event) of the imposition of a general capital gains tax. Mr Lynall's subjective view of the situation must be discounted accordingly.'

Liquidity
The company's liquid position and financial commitments must be a relevant factor in any valuation. In Re Holt[18] Danckwerts J stated:

'At this date two of the five ships owned by the company were of an age which demanded their replacement. The company had a large overdraft at

18 (1953) 32 ATC 402 at 404

its bank which approached £1 million in 1947. It was really common ground that the company was over trading, and that the large figures for profits in the years 1946 and 1947 reflected the contemporary inflation.'

Also in The Trustees of Johan Thomas Salvesen v IRC[19], Lord Fleming stated:

'I think it may be taken that the liquid assets of the company, that is to say assets that could be turned into cash at short notice, amounted to over £500 000 ...

Prior to the testator's death, the company had made arrangements for trading in the ensuing season and had either expended or committed itself to an amount of about £300 000.'

Gearing

The effect and implications to the company of gearing has to be taken into account. Lord Fleming in Findlay's Trustees v IRC[20] summed it up as follows:

'It seems to me clear that the circumstances that a considerable part of the capital required to run the business can be raised at a comparatively low rate of interest on the security of the assets cannot have any effect in depreciating the value of the goodwill. On the contrary it would rather appear to me that it might have some effect in increasing its value. There is, however, no evidence to this effect and I take it that the existence of the debentures is an immaterial circumstance in so far as the ascertainment of the value of the goodwill is concerned. But this does not mean that their existence is to be disregarded in fixing the value of the interests of the partners. The debentures are a debt of the business and must be deducted from its value before the interest of the partners can be determined.'

19 (1930) 9 ATC 43 at 49

20 (1938) 22 ATC 137 at 439

Provisions and contingent liabilities

In valuing the shares in a company, it is necessary to take into account whether the company has contingent liabilities and provisions in respect of expenditure to be paid, e.g. taxation.

In the case of Winter (Sutherland's Trustees) v IRC[21], Lord Reid dealt with the problem as follows:

> 'No doubt the words "liability" and "contingent liability" are more often used in connection with obligations arising from the contracts than with statutory obligations. But I cannot doubt that if a statute says that a person who has done something must pay tax, that tax is a "liability" of that person. If the amount of the tax has been ascertained and it is immediately payable, it is clearly a liability; if it is only payable on a certain future date it mut be a liability which has "not matured at the date of death" within the meaning of (FA 1940, s 50(1)). If it is not yet certain whether or when tax will be payable, or how much will be payable why should it not be a contingent liability under the same section?'

21 (1961) 40 ATC 361

CHAPTER 8

PUBLIC COMPANIES

For valuation purposes, one of the fundamental differences between privately and publicly owned business interests is their relative marketability. Restrictions imposed by the Companies Act tend to restrict the marketability of shares in private companies. Few such restrictions exist for shareholders in public companies. Where restrictions exist, however, they are extremely important in considering the value of a shareholding.

For the vast majority of investors holding relatively small numbers of shares in public companies, the value of their investments is a direct function of the current stock market quotations for the company's shares.

Current market price is not necessarily indicative of fair market value
It has long been recognized that there may not necessarily be any relationship between the current quoted price of a particular public company's shares and the fair market value of the company as a whole - i.e. the maximum amount which an informed prudent investor acting at arm's length and under no compulsion would be willing to offer to acquire 100 per cent of the company's outstanding shares. The daily price quotations of stocks of publicly-owned companies traded on stock exchanges reflect the public's appraisal of relatively small lots of such stock. This price may or may not be indicative of the fair market value of the company as a whole.

To summarize this point, reference is made to the comment in 1946 of the Council of the London Stock Exchange:

> The (Stock Exchange) quotations ... definitely do not represent a valuation of a company by reference to its assets and its earning potential.

> Moreover, any valuation by reference to Stock Exchange quotations must introduce indefensible anomalies such as between one stock and another of similar standing.
>
> ... considerable fluctuations take place upwards at times and in circumstances when it is possible to demonstrate that no known change has taken place in the capital value or the earnings potential of the underlying assets.

In Hinchcliffe v Crabtree[1], Russell LJ, in commenting on subsection (3) of section 44 of the UK Finance Act stated:

> '... cases may occur of a control holding where mere muliplication of the quoted price for a single stock unit will not represent the price obtainable on a sale of the holding; or there may be cases where the Stock Exchange quotations, due to the lack of bargains, are out of date or stale. But there are many factors - ignorance, optimism, pessimism, false rumour, inside information - that contribute to a Stock Exchange quotation, and it would obviously be wholly disruptive of the value of subsection (3) if those matters were to be the subject of analysis on valuation. ...'

In Professor James C Bonbright's 1937 treatise, Valuation of Property, which has long been considered a leading authority by the valuation profession, several situations are suggested in which stock market prices may not be reflective of value:

> 1) Prices are influenced by a stock market boom and connot be taken as an index of 'true value';
> 2) There are only a few stock market transactions;
> 3) The size of a share block makes it saleable only at a discount from market price;

1 (1971) 2 All ER 104

4) A large block is valuable for purposes of control;
5) Shares are rendered less valuable by virtue of agreements restricting their sale;
6) Sales were the result of a high pressure sales campaign; and
7) Reported sales have already exhausted the market.

Not only are current market prices not necessarily indicative of the fair market value of the company as a whole, they are not necessarily indicative of the value of any relatively large block of shares (as distinguished from small holdings). The fair mmarket value of a relatively large block of shares is not a function of the current market price of the company's shares, but rather is dependent on:

* the fair market value of the company as a whole;
* the relative importance of that particular block (i.e. whether it represents absolute control, effective control, part of control, a large minority interest);
* any restrictions attaching to the particular shares; and
* the nature of the market for the shares

and may be considerably higher or lower than the current market price.

For estate duty purposes, stocks and shares (as defined in s 1(1) of the Estate Duty Act) which are quoted on any stock exchange, are valued for estate duty purposes like any other property. The quotation need not be on the Johannesburg Stock Exchange, but can be elsewhere.

Quoted shares sold in the course of the liquidation of an estate
S 5(1)(a) of the Act provides for the valuation of property (other than unquoted shares, which are valued under s 5(1)(f) bis of the Act, and property subject to conditions imposed by any person as a result of which the value of that property is reduced at or after death, which is valued

under the proviso to s 5(1)(g) of the Act) disposed of by a sale which in the opinion of the Commissioner is a bona fide sale in the course of the liquidation of an estate. The value of such property to be included in the estate is the gross price realised by the sale. Expenses incurred in connection with such sale, eg brokerage, are deductible as part of the administration and liquidation expenses under s 4(c) of the Act.

Therefore, if quoted shares are disposed of by a bona fide sale in the course of the liquidation of an estate, the valuation for estate duty purposes is the gross price realised by such sale.

Quoted shares not sold in the course of the liquidaiton of an estate

S 5(1)(g) of the Act provides for the valuation of property (other than limited interests, bare dominium, unquoted shares and deemed property specifically dealt with in s 5(1)(b) to (f) ter of the Act) not disposed of by a sale which in the opinion of the Commissioner is a bona fide sale in the course of the liquidation of an estate. The value of such property to be included in the estate is the fair market value thereof as at the date of death of the deceased as determined by a sworn appraisement by an impartial valuator appointed by the Commissioner. Such valuation is, however, subject to adjustment by the Commissioner in terms of s 8 of the Act. Any aggrieved person may, under s 24 of the Act, object to and appeal against such valuation adjustment by the Commissioner.

Therefore, if quoted shares are not disposed of by a bona fide sale in the course of the liquidation of an estate, the valuation for estate duty purposes is the fair market value as at the date of death. In practice a sworn valuation will not be insisted upon. It will be sufficient to furnish a certificate by a stockbroker certifying the value of the quoted shares on the stock exchange as at the date of death. The broker normally gives the average or middle market price (i.e. a price approximating to the mean between the sellers' and buyers' quotations) which is accepted for estate

duty purposes as representing the fair market value.

When a large parcel of shares is involved, the fair market value could be considerably less than the middle market price of the day. (See chapter 6)

Where the fair market value of quoted shares at date of death substantially exceeds their realisable value in the estate, it could be considered selling those shares in the course of the liquidation of the estate so that the benefit of a lower valuation under s 5(1)(a) can be obtained.

Sometimes the broker's valuation is cum dividend. However, the dividend should be excluded for the valuation if reflected separately as part of the dutiable estate.

CHAPTER 9

PRIVATE COMPANIES

A private company is defined by section 20(1) of the Companies Act, 1973, as one which by its articles:

(a) restricts the right to transfer its shares; and

(b) limits the number of its members to fifty (excluding employees and ex-employees); and

(c) prohibits the invitation of public subscriptions for its shares and debentures.

From the point of view of valuation of the shares, the most important of these conditions is (a), relating to restrictions on transfer. How does such a provision in a company's articles of association influence the value of its shares, considering that according to the judgment in the Pietermaritzburg Corporation case[1], the term 'value' means what a purchaser would pay for the shares in the open market. As was mentioned earlier, the estate duty legislation in the United Kingdom specifically requires an open market to be assumed.

A further problem arising in regard to private companies, is the fact that more often than not, the articles of association provide that shares are first to be offered to the existing shareholders at a price laid down in the articles before they can be transferred.

Section 5(1)(f) bis of the Estate Duty Act, introduced in 1960 as a result of the decisions in CIR v Isaacs NO[2] and CIR v Estate Adelson[3], provides that in the case of shares in any company not quoted on any stock exchange, the value of such shares in the hands of the deceased at the date of his death as determined, subject to the provisions of section eight, by some impartial person appointed by the Commissioner, subject to the following provisions, namely -

1 Pietermaritzburg Corporation v South African Breweries Ltd 1911 AD 501 at 524

2 1960 (1) SA 126 (A); 23 SATC 142

3 1960 (1) SA 418 (A); 23 SATC 166

(i) no regard shall be had to any provision in the memorandum and articles of association or rules of a company restricting the transferability of the shares therein, but it shall be assumed that such shares were freely transferable;

(ii) no regard shall be had to any provision in the memorandum and articles of association or rules of the company, whereby or whereunder the value of the shares of the deceased or any other member is to be determined;

(iii) if upon a winding-up of the company the deceased would have been entitled to share in the assets of the company to a greater extent pro rata to shareholding than other shareholders, no lesser value shall be placed on the shares held by the deceased than the amount to which he would have been entitled if the company had been in the course of winding-up and the said amount had been determined as at the date of his death;

(iv) no regard shall be had to any provision or arrangement resulting in any variation in the rights attaching to any shares through or on account of the death of the deceased;

(v) there shall be taken into account any power of control exercisable by the deceased and the company whereunder he was entitled or empowered to vary or cancel any rights attaching to any class of shares therein, including by way of redemption of preference shares, if, by the exercise of such power he could have conferred upon himself any benefit or advantage in respect of the assets or profits of the company;

It follows from (i) and (ii) above that the valuation on the statutory basis of shares in a private company involves in a sense a double hypothesis. The

provisions of section 5(1)(f) bis assume that the asset to be valued is sold in the open market at the time of death. As respects most assets the only hypothesis lies in the assumption that an open market sale which was possible at the death did in fact then take place. In these cases it is frequently possible to deduce the duitiable value from the evidence of contemporaneous transactions in a true open market. But in valuing most unquoted shares it is necessary to assume a sale that not only did not actually take place, but was of a kind in practice quite impossible. 'An actual sale in open market is out of the question. A feat of imagination has to be performed'.[4]

Furthermore, regardless of the provisions of section 5(1)(f) bis, the problem of restricted transferability in fiscal valuations still arises in valuations for donations tax and income tax purposes and indeed for estate duty purposes where shares comprise the underlying assets of a company in which the deceased held a majority holding. In this last instance the provisions of s 5(1)(f) bis do not apply to the valuation of shares held by a company in which the deceased held an interest.[5]

The principle to be applied where, under the articles of association of the company, the right to transfer of shares is restricted because the directors have power to veto a transfer, was considered in Re Smith & Fawcett Ltd[6]. The English Court of Appeal held that where directors have a discretion to refuse transfer, that right of discretion should be exercised bona fide in the interests of the company; and it is to be assumed that such right has been so exercised unless there is clear evidence to the contrary. The court went on to hold that if the directors state upon oath that they have exercised their discretion in a way which they consider - and not in a way which a court may consider - to be in the interests of the company, that statement must prevail unless it is shown to be wrong. It will ordinarily be extremely difficult for a person seeking to obtain transfer against the wishes of the directors to succeed where the articles are framed in this way.

4 Salvesen's Trustees v IRC (1930) SLT 387 at 391

5 CIR and another v Isaacs NO and another 1960 (1) SA 126; 23 SATC 142

6 (1942) 1 All ER 542

The principle to be applied where, under the articles of the company, the right to transfer shares is restricted because they cannot be sold in the open market without being first offered to other members at a price which is either fixed in a prescribed manner, was initially considered in Ireland in Attorney-General v Jameson[7]. In the King's Bench Division, Palles CB[8] held that

> 'we must exclude the consideration of such provisions in the articles of association as would prevent a purchaser at a sale from becoming a member of the company, registered as such in respect of the shares purchased by him at such a supposed sale.'

However, the majority in the King's Bench Division took the exact converse view. It held that the shares must be valued on the basis that any purchaser in the open market will take the shares subject to the risk of them being claimed by existing shareholders at the price fixed by the articles; and that once the purchaser was on the register he would then be subject to a limitation in regard to his rights of alienation.

The Court of Appeal took an intermediate view, to the effect that the value of the shares ought to be estimated on the terms that the purchaser should be entitled to be registered as a holder of the shares and should take and hold them subject to the articles of association, including the articles relating to alienation and transfer.

The problem next arose in the case of Salvesen's Trustees v CIR[9]. The court followed the principle established by the Court of Appeal in the Jameson case, with one additional condition, viz. that where the articles confer a right of pre-emption on other shareholders at a price which is below the market price, the advantage to the purchaser once he is on the register of having the right to purchase the shares of other members desiring to transfer, must be taken into account.

7 (1905) 2 IR 218
8 (1904) 2 IR 689
9 (1930) SLT 387

The principle to be applied in respect of this problem was finally laid down by the House of Lords in Inland Revenue Commissioners v Crossman & Others, Commissioners of Inland Revenue v Mann & Others[10]. In the court of first instance the decisions in the Jameson and Salvesen cases were followed. The court of appeal reversed the decision and held that the value was the restricted price which the executors were entitled to receive under the articles of association if the shares were offered for sale. The House of Lords by a three-to-two majority decided the case on the basis estateblished in the Jameson and Salvesen cases.

Crisply stated the arguments in favour of the Crown in the Crossman & Mann case were as follows:[11]

(a) While the deceased lived he was in unrestricted possession of the shares and it is that unrestricted possession which has to be valued.
(b) Restrictions on transfer, options of purchase and rights of pre-emption in terms of the articles of association are not an essential part of the property represented by shares but are matters of collateral contract affecting only title to the property.

The case for the executors relied on the definition of a share as set out in Borland's Trustee v Steel Bros & Company Limited[12]: 'A share is the interest of a shareholder in the company measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all of the shareholders inter se in accordance with the Companies Act 1862. The contract contained in the articles of association is one of the original incidents of the share.' On this definition, so the executors contended, it was impossible to treat a share as being an interest in the company's assets, or an aliquot share in the company's capital, and to regard the contract contained in the company's articles of association as a separate and independent thing; the contract and the right and liabilities which

10 (1936) 1 All ER 762
11 See Legal aspects of the valuation of shares by B C Berelowitz De Rebus, April 1979
12 (1901) 1 Ch 279

flow from it are of the very essence of the share.

The views of the majority in the House of Lords in the Crossman & Mann case may be summarized as follows:

(a) The UK Finance Act expressly requires a sale on the open market to be assumed. If property cannot be sold on the open market that property will escape valuation and any argument on these lines must be wrong. However the restrictions in the articles cannot be ignored entirely and therefore it must be assumed that a hypothetical purchaser would procure transfer of the shares into his name but would hold them subject to the restrictions on transfer contained in the articles.

(b) The right to receive a fixed price under the articles of association is only one of the elements making up the value of the share. Other elements include the right to dividends and the right to acquire shares from other shareholders who wish to transfer their shares. The value of these last two rights must be valued as well as the value of the right to receive the fixed price under the articles. All these rights are indivisible and as such 'passed' to the deceased shareholder's executors. The entire legal and beneficial interest of the deceased shareholder has to be valued. It must be assumed that the purchaser would be able to step into the deceased shareholder's shoes. Accordingly the price of the shares should be 'what a man of means would be willing to pay for the transmigration into himself of the property which passed from (the deceased) when he died'.[13]

Both dissenting judges in the House of Lords were of the opinion that there was nothing in the UK Finance Act which justified leaving out of account the conditions and restrictions affecting the alienation of shares in a hypothetical sale in the open market.

In Re Lynall, Lynall v IRC [14] counsel for the Lynall estate invited the House of Lords to reverse their earlier decision in Re Crossman where, on

13 The test propounded by Fitzgibbon LJ in Attorney-General v Jameson (1905) 2 IR 218 at 230

14 (1971) 47 TC 375

similar facts, it was decided that the value of the shares was to be estimated at the price which they would fetch if sold in the open market on the terms that the purchaser would be entitled to be registered and regarded as the holder of the shares; and that he should take and hold them subject to the provisions of the articles of association, including those relating to alienation and transfer. The House of Lords did not reverse their earlier decision but, in fact, by a unanimous judgment affirmed the correctness of the Crossman case. Passages from two of the judgments are of special interest:

Lord Morris

> 'I have not been persuaded that the decision in Crossman's case was erroneous. Section 7(5) requires an estimate to be made of the price which the property would fetch "if sold" in the open market. So a sale in the open market must be assumed and this in some cases will involve an assumption of the satisfaction of such conditions as would have to be satisfied to enable such a sale to take place.'

Viscount Dilhorne

> 'There could be no sale in the open market on 21st May 1962 unless the directors agreed to the registration of the transfer of the shares and Mr Lynall refused to purchase the shares at £1 a share. Therefore, for the price the shares would fetch if sold in the open market to be assessed, it must be assumed that the directors had so agreed and Mr Lynall had refused to buy. ... If property is only saleable in the open market in certain circumstances, then when the Act requires the property to be valued at the price which it would fetch if sold in the open market one must proceed on the basis that those circumstances exist. This does not mean that the shares change their character. The shares bought by the hypothetical purchaser will be subject to the restrictions.'

In deciding that the value of the shares was £3-10s, the law lords specifically stated that sufficient facts must be 'assumed' to contemplate a sale in the 'open market'. If the concept of 'fair market value' implies an open and unrestricted market where every would-be purchaser is regarded as present, the valuator would have to assume whatever facts are necessary with respect to a particular property to contemplate its sale in such a market. In this regard, it is useful to compare the decision of the House of Lords in Re Lynall with the decision of the Supreme Court of Canada in Beament v MNR.[15]

Mr Beament incorporated X Ltd in 1961 with Class A and Class B shares all with $1 par value. The Class A shares were entitled to a 5% cumulative preferred dividend while the Class B shares were entitled to receive as dividends the remainder of the company's net earnings (excluding capital gains). Upon dissolution, the Class B shareholders were entitled to recover only the par value of their shares plus any net earnings which had not been distributed; and the Class A shareholders were entitled to the remainder of the distributable assets. Shares of both classes were voting. In summary, the Class A shares were like a preference share as to dividends but like a common share on dissolution; and the Class B shares were like a common share as to dividends but like a preference share on dissolution.

Mr Beament and his two children agreed in 1961 (i) that he would subscribe for 2 000 Class B shares if they would each subscribe for 12 Class A shares and (ii) that he would retain the 2 000 Class B shares till death and instruct the executors of his estate to cause X Ltd to be wound up. When Mr Beament died in 1966, X Ltd had net earnings of $8 725 which had not been distributed; and so the executors of his estate valued his 2 000 Class B shares at $10 725 (including the $2 000 paid-up par value). But the company also had net capital gains of $114 239 which were either realized or accrued. The Minister of National Revenue used reasoning analogous to that found in the assessment which was sustained in Barber v MNR[16] to

15 (1970) SCR 680

16 (1966) DTC 315

originally value the 2 000 Class B shares at $154 964 - the total of the value admitted by the executors plus the amount of the net capital gain in the company at death.

When the appeal came on for hearing, the Minister revised his estimate to $110 000 and the issue was whether the 'fair market value' of the 2 000 Class B shares at death was $10 725 or $110 000. Considering the magnitude of the discrepancy between what the executors and the Minister alleged to be the appropriate value, it is disappointing that the Supreme Court did not take the opportunity to comment more fully on the concept of fair market value. The executors' appeal was allowed and the Chief Justice, writing for a majority of the Court, stated:

> 'It is plain, as the learned President points out, that no sensible person would have paid more for them than $10 725,98, and that on winding-up the executors could not receive more than that amount. Once it is established (and it has been conceded) that the contract binding the deceased and his executors to have the Company wound up was valid, the real value of the shares cannot be more than the amount which their holder would receive in the winding-up. To suggest that they have in fact any other value would be altogether unrealistic. When the true value of the shares in the circumstances which exist is readily ascertainable, I can find nothing in the Act that requires the computation of the value they would have had under completely different circumstances. ...'

However, it is submitted that the Court was not required to ascertain what a 'sensible person would have paid' or the 'real value' or 'true value'. The Estate Tax Act required the Court to determine 'fair market value' and there is ample authority to establish that fair market value contemplates a hypothetical market without limiting conditions where the prudent willing seller meets all the prudent would-be purchasers. Notwithstanding the

differences between the provisions of the UK Finance Act the Canadian Estate Tax Act, no one has suggested that the hypothetical market which would determine value in Re Lynall is different from the hypothetical market which would determine value in Beament v MNR

In the above passage from Viscount Dilhorne's judgment, he said: "... for the price the shares would fetch if sold in the open market to be assessed, it must be assumed that the directors had so agreed (to register the transfer) and Mr Lynall had refused to buy (at par value)." It appears that the Supreme Court of Canada declined to 'assume' the one essential fact in determining fair market value: i.e. that the hypothetical purchaser would not cause X Ltd to be wound up on Mr Beament's death.

It is difficult to understand why a contractual restriction which was personal to Mr Beament and did not 'attach to' the Class B shares should affect the determination of their fair market value when, in the Crossman and Lynall cases, an enforceable obligation to offer certain shares to other shareholders at a low price did not deter the House of Lords in both cases from deciding that the 'market value' of the shares was a higher amount. The dramatic difference in the results of the cases arises from the facts which the House of Lords was prepared to assume and the facts which the Supreme Court of Canada declined to assume.

In terms of South African legislation there is no statutory provision compelling a sale in the open market to be assumed; except for cases falling under section 5(1)(f) bis of the Estate Duty Act. However, a sale in the open market is normally assumed to be the basis for arriving at a valuation. If the shares to be valued are held to be freely transferable where the articles provide otherwise, then once the hypothetical purchase is on the register as a member his shares must be valued at that point. And if that is done it must again be assumed that there are no restrictions on transfer and this leads inexorably to the conclusion that it must always be assumed

in the case of shares in a private company that there is no restriction on the transfer of shares at all. But this line of reasoning was expressly rejected by Viscount Hailsham LC, one of the majority judges in the Crossman & Mann case, in the following terms: 'To value the shares on the basis that the restrictions contained in the articles were to be ignored would be to value a property which the deceased never owned and which did not pass on his death.'

Finally, it remains to discuss the possible approach which would be adopted by a South African court in fixing the price of shares where the articles confer a pre-emptive right for the shares to be acquired at a fixed price.

In CIR v Estate Whiteaway[17] and Estate Robottom v CIR[18] the courts had to consider the implications of agreements entered into by deceased persons whereunder shares or partnership interests were to be sold after death at pre-determined values. In both cases the court held that were a partnership agreement provided that on the death of a partner the surviving partner should purchase the deceased partner's interest in the firm at the valuation prescribed by the deed, it was not correct to value the deceased's share in the partnership by reference to the amount of the purchase price fixed by the partnership agreement.

The same principle was applied in CIR v Estate Kirsch & Others[19] where the property in question was shares in a private company. The deceased, during his lifetime, had entered into an agreement in terms of which two other people had to purchase and the deceased's executors were obliged to sell the shares held by the deceased at a fixed price. The court ignored that price for the purposes of valuing the shares.

It is interesting to note that the South African courts in the Whiteaway and Robottom cases came to the same conclusion as the Australian court in Findlay's Trustees v CIR[20]; and the court in Findlay's case followed the

17 1933 TPD 486; 6 SATC 188

18 1961 (1) SA 33 (c); 24 SATC 56

19 1951 (3) SA 496 (A); 17 SATC 412

20 (1938) 22 ATC 437

priciple established in the Jameson, Salvesen and Crossman cases.

CHAPTER 10

VALUATION PROCESS NOT AN EXACT SCIENCE

It could be argued that the valuation of shares of a company is an art rather than an exact science. Eminent authorities on valuation have disagreed on prices to be paid for shares as often evidenced by the number of increases from initial bid price in the acquisition of a number of public companies. The valuator must follow the basic rules of financial analysis and operations appraisal. Even after all his study, his vauation is only an opinion, albeit an informed opinion, resting upon a delicate equilibrium of fact and judgment.

In Gold Coast Selection Trust Ltd v Humphrey Inspector of Taxes[1] the court recognised that

> 'valuation is an art, not an exact science. Mathematical certainty is not demanded, nor, indeed, is it possible. It is for the commissioners to express in the money value attributed by them to the asset their estimate, and this is a conclusion of fact to be drawn from the evidence before them.'

In the Pietermaritzburg Corporation case[2] the court also recognised that only approximate results can be obtained through a process of valuation. Innes J held that

> 'it may not be always possible to fix the market value by reference to concrete examples. There may be cases where, owing to the nature of the property, or to the absence of transactions suitable for comparison, the valuator's difficulties are much increased. His duty then would be to take into consideration every circumstance likely to influence the mind of a purchaser, the present cost of erecting the property, the uses to which it is capable of being put, its business facilities as affording an opportunity for profit, its situation and surroundings, and so on. There being no concrete illustration ready to hand of the operation of all these considerations upon the mind of an actual buyer, he would have to

1 (1948) 2 All ER 1499

2 1911 AD 501

employ his skill and experience in deciding what a purchaser, if one were to appear, would be likely to give. And in that way he would to the best of his ability be fixing the exchange value of the property.'

The irrational behaviour of market prices was also recognized in Salvesen's Trustees v CIR[3] where the court held that 'the estimation of the value of shares by a highly artificial standard which is never applied in the ordinary share market must be a matter of opinion and does not admit of scientific or mathematical calculation'.

In Re Hayes Will Trusts, Pattinson & another v Hayes & another[4] the court held as follows:

'It is in this context that the words "best possible price that is obtainable" appear. They are directed to the sale being in such manner as would obtain the best possible price in the market. It does not mean that the price to be fixed by valuation is the highest possible price that might be obtained. It has been established time and again in these courts, as it was in this case, that there is a range of prices, in some circumstances wide, which competent valuers would recognise as the price which "property would fetch if sold in the open market". Neither the section, nor Sankey J requires that the top price of that range should be the price fixed for estate duty. That price together with the lowest price in the range may be expected to be the least likely price, in the absence of consultation between the valuers representing conflicting interests, would presumably be the mean price.'

It is interesting to compare this with Earl of Ellesmere v CIR[5] where 'the price in the open market' was interpreted as 'the best possible price that is obtainable'.

In Estate Duty Case No 1[6] James J, in fixing the value of shares, approved of the dictum that ' the application of (valuation) principles is not a

3 (1930) SLT 387

4 (1971) 2 All ER 341

5 (1918) 2 KB 735

6 23 SATC 362

matter of pure mathematics, and there is room for wide differences of opinion as to relative weight to be given to each of the several factors in the circumstances of any particular case'.

CHAPTER 11

THE DIVIDEND BASIS OF VALUATION

In theory, the value of a share, like that of any other financial asset, is the present value of the future cash flows associated with ownership. For an individual shareholder, the cash flow consists of dividends received plus the proceeds of eventual sale of the shares. But, for all present and future investors in total, expected cash flows consist only of future dividends, barring of course a sale or liquidation of the company. In other words, the eventual proceeds of sale will themselves be the capitalised value of future dividends expected to be received from then onwards. On this view, the value of the share is calculated at the present value of an infinite stream of dividends.

Basic approach

If dividends were expected to be constant, they would be valued as a perpetuity. Thus, a share paying a dividend of 20 cents gross would be valued at 133 cents, assuming an appropriate rate of return of 15 per cent. This can be stated in general terms as follows:

$$V = \frac{D}{r}$$

where V = the value of the share
D = the dividend per share
and r = the required rate of return.

Where a share has no growth prospects, the rate of return is simply the expected dividend yield.

Dividends, of course, are rarely constant and the problem in dividend based valuations is to know what dividends are going to be declared in the future, as well as the appropriate rate at which they should be discounted. If the dividend policy is unlikely to change, i.e. if the payout ratio remains the same, dividends should grow in line with earnings. More often than not, however, the payout ratio varies from year to year. This is because firms

like to maintain a steady growth in dividends, whereas profit growth tends to be uneven. This fortuitous circumstances makes it easier for the valuer to project a dividend growth rate into the future. If, for example, dividends have grown at the rate of 5 per cent a year compound over the previous five years and the historical pattern of profits growth is unlikely to change in the future, the valuer might well conclude that dividends are likely to grow by 5 per cent a year in the future.

Where it is posible to make a statement like this about dividends, the 'normal' or constant growth dividend valuation equation, set out below, can be used:

$$V = \frac{D}{r - g}$$

where V = the value of the share
D = the prospective gross dividend per share
r = the required rate of return
and g = the expected growth rate.

Thus a share with a prospective dividend of 20 cents gross, expected to grow at 5 per cent a year compound, would be valued at 200 cents on the basis of a required rate of return of 15 per cent, as calculated below:

$$V = \frac{20}{0{,}15 - 0{,}05} = \frac{20}{0{,}10} = 200 \text{ cents}$$

The prospective dividend yield in the above example is 10 per cent (i.e. 20 cents dividend by 200 cents). This must not be confused with the expected rate of return which is 15 per cent.

The required rate of return

What rate of return should the investor require for a particular investment? In theory, he will require the same rate of return as he can obtain on alternative investments of similar riskiness. In practice, when unlisted shares are being valued, this usually entails a search for comparable listed

shares are being valued, this usually entails a search for comparabl listed companies.

Comparison with quoted shares

However, it is unlikely that a quoted company would serve as a direct comparison with the shares being valued but allowance for difference in size and diversity of business can always be made in arriving at the price. some of the problems of such a comparison have been referred to by Plowman J in his comments in Re Lynall, Lynall v IRC[1]. In the Court of Appeal in re Lynall[1], Cross LJ Stated:

> 'Another point which was argued in favour of the public information test was that the price of shares quoted on the Stock Exchange depends on the market's assessment of published as opposed to confidential information, and that it was desirable that the same standards should be applied to the valuation of every sort of share. I connot follow this argument at all, for the market of the sale of quoted shares is completely different from the market for the sale of holdings in private companies. No one will be a "willing" purchaser of shares quoted on the Stock Exchange at a price higher than the quoted price, and if he happens to have confidential information showing that the shares are worth less than the quoted price he will not be willing to buy at all.'

In considering any comparison with quoted public companies it is worth bearing in mind the comments of Sachs LJ in Hinchcliffe v Crabtree[2]:

> 'The fact remains that day in and day out there occur on the London Stock Exchange situations in which it may well be said that an announcement should have been made by some company which if made would affect the price of the quoted shares. This can and does happen in relation to many and various events. For instance, it happens in relation to news of the success or failure of boreholes affecting the prospects of mining

1 (1971) 47 TC 375

2 (1971) 47 TC 419 at 437

companies; to the publication of a company's accounts being deferred beyond the proper time; to the effects of important matters which may only later become public when published accounts appear; or to the imminence of the successful completion of some negotiations resulting in a highly valuable contract. Sometimes the absence of that information may result in the quoted prices on the Stock Exchange being higher than had it been available, and sometimes lower. That all forms part of the pattern of the general circumstances in which the market operates and under which prices are rixed having regard to supply and demand. The Stock Exchange, like other bodies concerned with the good name and best interest in the city, may be taken to do its best to see that as much information as practicable is available to those who deal in the market. It does not, and cannot, guarantee the availability of that information, and having regard to the general circumstances in which it operates, it a cannot be said to be a special circumstance merely that in some particular instance information has not become available.'

But, the valuer need not be deterred by the fact that no two companies are identical or equivalent. It is generally possible to reflect differences between companies in the required rate of return. This, in fact, is what modern financial theory tells us the stock market does: prices of assets in capital markets adjust until equivalent risk assets have identical expected returns.

Having selected listed companies of a closely similar size and activity as possible to the subject company, the valuer must exercise his professional skill and judgement in selecting a rate of return which takes into account the differing investment merits (in essence, the differing risk) of each company in the comparison. To do this he first needs to know the rate of return implied by the share prices of the listed companies.

The abovementioned principles were confirmed by Maguire J in McNamee IRC[3]

> 'Mr Cave, Mr Scanlon and Mr Abrahamson have gone to great trouble to prepare comparative tables of other companies carrying on similar business having stock exchange quotations for their shares. Those have been examined and explained. I am satisfied without going into details, but having considered all the evidence that the analogies which they have drawn from other companies are far from complete, and that they are misleading. I am satisfied too that the inferences they ask me to draw cannot fairly be drawn in the case of these shares in the Convoy Woollen Company. The affairs of each company must be considered in relation to its own position, its own difficulties, and its own domestic control.'

To calculate the rate of return for the selected listed companies, we have to solve for 'r' in the dividend valuation equation given above. This can be restated as:

$$r = \frac{D}{V} + g$$

In words, the rate of return is equal to the prospective dividend yield plus the growth rate. As the share price (V) is known, and the prospective dividend (D) should not be too difficult to forecast, we need to know only the value of g, the future growth rate in dividends, in order to calculate the rate of return.

If the listed company's share price is 200 cents, its prospective dividend 20 cents per share gross, and if dividends are expected to grow by 5 per cent a year, the implied rate of return is 15 per cent, as calculated below:

$$r = \frac{D}{V} + g = \frac{20}{200} + 0{,}05$$

$$= 0{,}10 + 0{,}05 = 0{,}15$$

3 (1954) IR 214

The expected rate of growth in dividends is not publicly available in formation, but, in an efficient, well informed market, investors' views as to the likely dividend growth rate should be within certain bounds. The valuer must put himself in the shoes of the investor and form an opinion as to the dividend growth rate that might reasonably be inferred from the evidence available. To do this, the valuer should be as knowledgeable about the selected listed companies as he is about the subject company. (In practice, this is not always possible because of lack of information.) It is important to remember that in this process the valuer forms an opinion as to the expected growth rate, and hence as to the required rate of return. It is his expert opinion, but there is nothing absolute about it.

With an appropriate rate of return for the subject comapny derived from the selected listed companies, the value of the subject company's shares, as listed, can be calculated using the dividend valuation equation. (However, the model must not be used where the dividend growth rate exceeds the required rate of return. If the equation is used in this situation, the results are meaningless.) The value of the shares, as listed, should then be discounted for the lack of marketability to arrive at the final valuation.

Comparison with other investments

If analogies are not drawn from companies listed on the Stock Exchange, the required rate of return has to be found from other sources. The prospective investor in shares in an unquoted company, being a careful and prudent investor, would also be influenced by the potential yields and likelihood, or otherwise, of capital appreciation in ther forms of investment than equity shares whether quoted or unquoted.

These could include gilt-edged securities, savings certificates, building society and bank deposits, quoted debentures and preference shares. The investor is likely to be interested in the net amount after tax on such

investments in comparison with that available on the unquoted shares and such return is therefore going to have some effect on the price which he would be prepared to pay for unquoted shares.

However, these are different forms of investment, and the analogy is accordingly weaker. In theory, the rate of return on equity investments should be higher than that required on risk-free securities such as gilts.

The valuer who believes strongly that comparisons with the stock market are invalid must arrive at the appropriate risk premium on a judgemental basis. He may feel that a premium of x per cent is justified, and he may be right. But, if he cannot point to independent evidence supporting his conclusion, the authority of his valuation will be weakened. This is a serious drawback if the valuation report is to form the basis of negotiation, whether fiscal or otherwise, or if it is to be used in Court.

Initial Yield Method

This method has a wide following in practice. It consists of applying the appropriate initial yield to the current dividend. If the appropriate initial yield is ascertained, a correct valuation will result. This can be illustrated using the example given above of the share with a prospective dividend of 20 cents gross, expected to grow at 5 per cent a year. If the valuer concluded that the appropriate initial dividend yield was 10 per cent, he would value the share at 200 cents - exactly the same figure as arrived at by using the required rate of return.

The initial yield method has significant disadvantages. As is clear from the dividend valuation method, the initial yield is merely an amalgam of the required rate of return (r) and the expected growth rate (g). By not considering these two vital constituents of the valuation in a formal manner, the element of intelligent guesswork or inspired hunch - alas, present to some degree in most valuations - is greatly increased.

Furthermore, the rate of return implied by the valuation may be inadequate for the valuer's client but this will not be apparent using the initial yield method. Lastly, there could be a tendency in inexpert hands for the yield to be confused with the rate of return.

CHAPTER 12

THE EARNINGS BASIS OF VALUATION

Earnings are the bedrock of business values. They are the fund form which dividends are paid and they are ultimately the basis of all asset values.

A significant decision was given in the Supreme Court of New South Wales in October 1931, in what is known as the Fairfax case,[1] where it was necessary to determine the value of shares in John Fairfax & Sons Ltd, for the purpose of assessing stamp duty payable by the trustees of a deceased estate. In the course of his judgment, Halse Rogers J said:

> 'In my view the most satisfactory basis on which to make the necessary investigation as to value is to consider first the figures showing the earning power of the company at the relevant date.'

He proceeded to take the average annual profits for the preceding four years and capitalized them on the basis of an eight per cent return being applicable to that type of business. He then reduced the price so ascertained by twenty-four per cent, because between the last day of the financial year (30 June 1929) and the date of the deceased's death (27 April 1930) stock exchange quotations for practically all first-class stocks showed an average fall of that rate.

In the American case of Cottrell v Pawcatuck Company[2] it was held in the Supreme Court by Southerland CJ that a sale of the undertaking of a company, challenged by a minority shareholder, was not at a grossly inadequate price.

Although the debtors were sold at their face value, patents which had a bookvalue of $52 828 were sold for $1 and stock, plant and equipment with a book value $5 395 000 was sold for approximately $2 223 000. Southerland stated at 229:

1 Fairfax v commissioner of Stamp Duties (1931) 48 WN (NSW) 255
2 128 A 2d 225 (1957)

'It has been repeatedly held in this State that upon a sale of corporate assets of an industrial corporation the book value is of far less importance than earning power and that reproduction cost less depreciation and valuation for insurance purposes are of little help in determining market value of plant and equiptment. See Baron v Pressed Metals of America Del 123 A 2d 848, and cases cited. These principles are applicable here. There was produced in this case, as in the Pressed Metals case, an insurance valuation. It totalled $13 000 000 on physical properties. The plaintiff also produced an engineer's appraisal of plant and equipment of $6 094 000 on the basis of reproduction cost new, less depreciation. A consideration of the evidence touching going concern value based on earnings will disclose that little weight can be attached to these appraisals in determining whether the price received was grossly inadequate.'

Later on he stated:

'When we turn to the testimony of the experts upon the issue of value we find that they all are apparently in agreement that some form of capitalised earnings is the most appropriate method of evaluating the worth of the old company. But they are in marked disagreement both in computing net earnings and in selecting the basis of capitalisation.

The important point arising from this case is confirmation that the value of a business sold as a going concern is to a large extent dependent on the capitalised value of its earnings.

The importance of earnings is recognised in the widespread use of the price/earnings ratio as an investment criterion for listed shares. This ratio is simply the price of a share dividend by its earnings. It is the earnings yield expressed in another way, namely:

Share price	100 cents
Earnings per share	$12\frac{1}{2}$ cents *
$\frac{\text{Earnings}}{\text{Price}} = \frac{12\frac{1}{2}}{100}$	$12\frac{1}{2}\%$
P/E ratio	
$\frac{\text{Price}}{\text{Earnings}} = \frac{100}{12\frac{1}{2}} =$	8

* Earnings per share are defined as the profit attributable to each equity share, based on the consolidated profit of the period after tax and after deducting minority interests and preference dividends, but before taking into account extraordinary items.

Nothing could be more straightforward, it seems, than an earnings based valuation: one simply choses the appropriate P/E ratio from suitable comparable companies and apply it to the relevant earnings per share and a correct valuation should result. In practice, however, the path to this sort of valuation is strewn with pitfalls. The difficulties are twofold and fundamental. Firstly, published earnings per share figures are no longer comparable as between companies and, secondly, the P/E ratio itself has come under attack both from market practitioners and from theoreticians and it is no longer universally accepted as the infallible indicator of the market's opinion of a share.

The P/E Ratio

The demise of the P/E ratio has been brought about to some extent by the lack of generally agreed earnings per share figures for individual companies and also by investors' growing realisation that in times of high inflation earnings calculated under the historical cost convention may be totally misleading. However, the concept of the P/E ratio itself - its usefulness as an investment yardstick - has been questioned, and there is little doubt that the P/E ratio has lost its pre-eminent position. In fact, it is being increasingly recognised that P/E ratios are not the determinants of stock

prices but are merely derivatives of them.

Modern Portfolio Theory, with its risk measurement techniques and the concept of beta, has not had the same impact on the investment community in this country as it has had overseas. Nevertheless, the new techniques are practised to some extent here and, of course, the theories themselves have been widely disseminated. The valuer of unlisted shares, although not as intimately concerned with these new theories as is the stock market professional, should nevertheless be familiar with them. He will probably want to keep an open mind on the new techniques which, like the P/E ratio, may turn out to be just another investment fashion.

Lastly, in cataloguing the woes of the P/E ratio, mention should be made of the high rates of interest prevailing and the effect on earnings of the economic recession. With earnings growth the exception rather than the rule and cash flow an important consideration, the dividend basis of valuation has regained some of its former popularity, largely at the expense of the P/E ratio.

Controlling Interests

The purchase of a controlling interest in a company usually entails a major outlay of funds. It is essential from both the buyer's and the seller's viewpoint that the investment is evaluated logically and unambiguously. From the previous remarks about earnings per share and the P/E ratio it will be apparent that neither of these tools is satisfactory.

As company tax is virtually an optional impost for most companies, the view is often expressed that pretax profits are the most suitable basis for valuing controlling interest. One of the significant advantages of this basis is that the resultant pretax profits yield, as adjusted for the growth rate, is directly comparable with the internal rate of return which the corporate purchaser/vendor has set for its own capital investment programme.

It is also directly comparable with yields available in the capital markets (e.g. gilt redemption yields, money market rates, and so on).

Great care must be taken in assessing the company's profit potential. The profits to be capitalised will generally be those immediately in prospect unless for special reasons these are unrepresentative of the underlying potential.

The rate of capitalisation

How does one select the capitalisation rate? There are basically two approaches:

(a) the comparable company method; and

(b) the investment approach

If the valuer uses method (a) he derives his capitalisation rate from an examination of the terms of recent takeover bids in the stock market. Put simply, if company X was successfully bid for on a prospective pre-tax profits yield of 20 per cent, other things being equal the subject company would be capitalised at the same rate. If method (b) is used, the capitalisation rate is objectively determined by reference to the rates of return on various alternative forms of investment, as adjusted for the perceived degree of risk. Alternatively the purchaser's/vendor's own required rate of return may be used.

The comparable company method has many adherents but, in the author's view, the investment approach to selecting a capitalisation rate is superior. Unless one was actually privy to the confidential negotiations for a takeover, one can never be sure merely from examining the public entrails of the bid to have correctly identified the profits which the purchaser and vendor had in mind when they agreed the bid price. It could be misleading merely to take the published profit figure. Furthermore, the comparable company approach seems to be based on the somewhat artificial concept of an

open market value for an entire company. But controlling interests in companies do not change hands with the frequency and facility of normal stock market trading. Potential buyers are few and far between and the subject company may have many different values to each potential buyer. The price struck in a particular bargain is a function of two sets of values: those of the purchaser and those of the vendor. In routine portfolio investment on the stock market the value gap between purchaser and vendor is so small that one can generally take the latest recorded price as an indication of market value and be sure of buying or selling at or near that price. This is not so with controlling interests. The comparable company approach does not identify the value gap and therefore ignores a potent influence on price. It could lead to negotiations being broken off because the price being asked is too high or it could induce a vendor to accept a needlessly low price.

Under the investment approach, the capitalisation rate is selected by reference to rates of return available in the marketplace, the degree of risk attaching to the company's operations, and the client's own required rate of return. Using this approach, one should be able to assess the value of the company to the client, this sets the highest price he should be prepared to pay, if a buyer, or the minimum he should accept, if a seller. The likely price for the company will depend on the value placed on the business by the other party, be he purchaser or vendor. For this reason, it is generally essential in the valuation of controlling interest to envisage a specific purchaser or class of purchaser. This is not as difficult as it sounds. Obvious potential purchasers can usually be found in the ranks of competitors or those in closely allied industries. More often than not, however, the client will already have a third party in mind.

Nevertheless, it has to be admitted that sometimes the client has no third party in mind and no obvious purchaser is around. The client wants to know what his company is worth and the valuer has to value in a vacuum. He then

has to select the capitalisation rate purely from his own experience and judgement. Clearly, however, it cannot be less than the risk-free rate of return available on gilts. Profitable, established, well managed, medium-sized companies are generally capitalised on pre-tax profits yields of 20-25 per cent. Small, well managed companies would sell on higher yields, generally 30-35 per cent. These are general indications. They would be lower for companies with superior management, high profits growth and strong asset backing; they could well be much higher if management is bad, the industry background depressed and the asset backing poor. These yields will not be valid for all time. The investment scene is constantly changing.

It is appropriate at this stage to digress slightly and recall the distinction between the yield and the rate of return on an investment. The yield expresses the immediate profits (or dividend) as a percentage of the price. The rate of return is that discount rate which will equate the present values of the future returns to the current price/value of the investment. The future annual profits of a business ad infinitum are unknown and the simplifying assumption of a normal annual rate of growth in

profits usually has to be made. Assuming such a normal or constant growth rate, the rate of return is found by adding the expected growth rate in profits (or dividend, as appropriate) to the yield. If no growth is expected the yield and the rate of return are identical.

The mathematical formula which expresses the value of a business in terms of its future earnings on the simplifying assumption of a normal growth rate is as follows:

$$V = \frac{E}{r - g}$$

Where V = the value of the company

E = earnings (i.e. pre-tax profits)

r = required rate of return
g = expected growth rate in profits.

This is the same formula as used for dividend based valuations but with appropriate change of symbols.

This formula can be restated to show that the required rate of return (r) is equal to the yield plus the growth rate (g) namely:

$$r = \frac{E}{V} + g$$

The proof of the first equation, and how the second equation is derived from the first, is given in most financial or investment textbooks

No one invests merely for the next year's profit or dividend but for a stream of future returns. Thus the initial yield (whether it be profits or dividends) is meaningless on its own; its adequacy or appropriateness can only be considered in the light of the expected growth rate. The average 'rule of thumb' yields suggested in the third preceding paragraph are all based on the assumption that the companies concerned will have average growth prospects. With inflation currently running at around 16 per cent, companies must grow by at least this rate in order to maintain their position. Thus, at least 7 percentage points have to be added to all the yields in order to obtain the implied rates of return. On this basis, the lowest rate of return would be 36 per cent (i.e. initial yield of 20 per cent plus the 16 per cent growth rate) and the highest (for the well managed small company) 51 per cent (i.e. 35 per cent plus 16 per cent). These rates of return are over twice or even three times the rate of return on gilts and give some crude measure of the heavy price exacted by investors for assuming equity risk in the present economic climate.

Minority Interests

The minority shareholder has no say in the management of his company and he cannot realise its assets. The return on his shares comes solely in the form of dividends. Any profit on sale will be based on dividend paying potential since the eventual buyer, too, will realise that all he can expect to get out of the company is dividends. In the author's view therefore, it is an error to value minority shareholdings in unlisted companies on an earnings basis i.e. as though the relevant proportion of the earnings of the company will be credited to the minority shareholder and be available for withdrawal at his behest. In the valuation of minority shareholdings earnings are relevant not as the return on the investment but as an indicator of the dividend paying potential. Not everyone would accept this arguing that the attention given to earnings in stockbrokers' circulars and the financial press is proof that listed companies are valued on their earnings, and therefore minority hodligns in unlisted companies may also be valued on their earnings. However, this is a superficial view which does not stand up to close inspection.

An earnings based valuation will generally be higher than a dividend based one since earnings normally exceed dividends by a comfortable margin. Consider, for example, a company with the following investment characteristics:

Earnings per share as reported	45 cents
Dividend per share	15 cents
Likely annual growth rate in dividends and earnings	12½%
Required rate of return	20%
Required yield (20 per cent less 12½ per cent)	8½%

If the yield of 8,5 per cent is applied to the gross dividend, a value of 176 cents emerges; if it is applied to the earnings a value of 529 cents results. This substantial difference highlights the importance of using the

correct basis.

Paradoxically, when one uses the P/E ratio to value minority holdings, the difference between the earnings-based value and the dividend-based one is not so marked. In fact, if the dividend cover of the company being valued and the comparable company are identical, there may even be no difference in the values produced by the two different bases. This can best be illustrated by an example of a fictitious listed company with the following investment characteristics:

Share price	176 cents
Earnings per share (fully taxed)	45 cents
Dividend per share	15 cents
Net assets per share	209 cents

Therefore:

Dividend yield (gross)	$\frac{15}{176}$	8,5%
P/E ratio		3,9
Discount to net assets		16,0%
Dividend cover		3,0
Return on net assets		21,5%

If we were valuing an unlisted company by comparison with this listed company and both company's dividends were three times covered, there would be no difference between the dividend yield valuation and the valuation using the above P/E ratio. But this is pure coincidence, and does not mean that the P/E ratio can be relied on to give the right answer. For instance, if we additionally assume that the subject company also has the same rate of return on assets as the listed company, we could simply apply the discount of 16 per cent to its net assets and the same valuation would be produced. This is illustrated below:

Private Co. Ltd

Earnings per share	64,5 cents
Dividend per share	21,5 cents
Net assets per share	300 cents

Therefore:

Dividend cover	3,0
Return on assets	21,5%
Valuations:	
Dividend yield $\frac{21,5 \text{ cents}}{8,5\%}$	252 cents
P/E ratio 64,5 cents x 3,9	252 cents
Net assets: 300 cents less discount of 16%	252 cents

This convergence of the three valuations is a coincidence but it underlines nevertheless the fact that dividends, earnings and assets are all facets of the one reality. The are closely related to one another but this relationship is highly unstable and one is prone to fall into serious error in valuing minority holdings on an earnings basis just as one is by valuing such holdings on an asset basis. At best one will obtain a correct valuation using invalid methods.

In practice, of course, companies do not have the same dividend cover. More often than not, the private company will have a much higher cover than the listed analogue and in these cases the use of the P/E ratio will produce substantially higher valuations.

CHAPTER 13

THE ASSETS BASIS OF VALUATION

The notion that the shares of a company, other than one whose assets are easily realised, are worth the sum of its individual asset values, less its liabilities, has no basis in theory or fact. The value of a company's share, from the shareholders' point of view, derives from that company's ability to earn profits and pay dividends. The ability to earn profits arises from the combination and co-operation of labour (i.e. management and workforce) and capital (i.e. the assets); it is fallacious therefore to look at the assets on their own.

There are exceptions to this rule. The shares of a company whose assets have a realisable value independent of the business are generally valued on an assets basis alone. For example, the shares of a property company or an investment trust company might well be valued solely on an assets basis. The classic case for an asset basis of valuation is provided by the company either in the course of, or expecting to be, wound up.

The assets basis is not appropriate for valuing minority shareholdings unless the company is expected to go into liquidation. Nevertheless, the net asset backing per share may have an influence on such valuations. A company with substantial asset backing will usually be a safer investment than one with slender asset backing, even though both companies may have similar earnings and dividend prospects. The company with the substantial asset backing will therefore merit a higher multiple.

One of the first legal decisions in Australia to indicate that assets value must not be ignored entirely was that of Piper J in the Supreme Court of South Australia, in his judgment in Elder's Trustee Co v Commissioner of Succession Duties[1]:

'I think buyers and sellers in an open market would be more directly

1 (1932) SASR 10 at 15

> influenced by the apparent earning power than by complex calculations on net assets, but those assets would be regarded generally for assurance that returns would be maintained....'

The following quotations from two judgments of Williams J under the Estate Duty Assessment Act in the High Court of Australia, express the same principle that while assessment of the value must be based mainly upon the income yield, regard must be given to the asset backing of the shares -

Abrahams' case:[2]

> 'The final assessment of the value of the shares must be made principally on the basis of the income yield ... but where, owing to exceptional circumstances the valuation of this basis presents "enormous difficulties" it is legitimate ... to rely more than usual on the assets value.'

Murdoch's case:[3]

> 'The main items to be taken into account in valuing shares are the earning powers of the company and the safety of the capital assets in which the shareholders' money is invested.'

The valuer should not lose sight, however, that the basis of valuation must depend on the circumstances. This point was considered where valuable farmland had been transfered to a farming company in M'Connel's Trustees v IRC[4]. It was stated by Lord Flemming:

> 'The petitioners found upon the fact that for each of the three years after its formation the company made a loss and they say there was never any prospect of the company earning profits or being in a position to pay

2 (1944) 70 CLR 23 at 42
3 (1942) 65 CLR 573 at 580
4 (1927) SLT 14 at 15

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2 (1944) 70 CLR 23 at 42
3 (1942) 65 CLR 573 at 580
4 (1927) SLT 14 at 15

a dividend. They maintained that the shares must be valued on the footing that the company is a going concern, and with references to the provisions of the memorandum and articles of association and also to the past history and future prospects of the company, from a dividend earning point of view. These are all circumstances which fall to be taken into account, but in my opinion they are by no means the only factors in the calculation. A share in a limited company gives the holder a right, not only to participate in the division of the profits, but also to participate in the division of the capital. ... A purchaser of the shares buying them as an ordinary investment and considering what they were worth, would certainly have been influenced by the fact that the holder of these shares would be in a position to put the company into voluntary liquidation, and to realise the whole assets and divide the value thereof amongst the shareholders. Even if the shares are being sold in a number of different lots, I feel satisfied that the purchasers would all have given a price which was related to the capital value of the undertaking on realisation. A purchaser of a small lot of the shares would naturally have assumed that purchasers of the remaining shares would wish to make the most they could out of their shares and would concur with him in taking the necessary steps to have the assets of the company realised to the best advantage.'

In that case the commissioners estimated the value of the net assets of the company, took 998 thousandths of that estimated value, as the deceased held 998 shares out of a thousand, and deducted therefrom a reasonable sum to cover the estimated expenses of liquidating the company. Lord Fleming approved this method of valuation.

This case dealt with 99,8% of the shares but it will be noted that the judge

referred to 'a purchaser of a small lot of shares' and his natural expectations. It is submitted that in any case in which there are valuable assets but no profit or any prospect of a profit, the break up value of the shares must be a factor in the valuation. The extent of the influence of that factor on the price must depend on the circumstances and in particular on the nature of the assets, the identity of other shareholders and the size of their holdings.

Where net asset backing is a subsidiary factor, as it is in most valuations, very rough approximations are made. In a typical case, net assets as shown by the latest balance sheet, would be adjusted by any undervaluation of properties, and intangibles would be eliminated. The valuer's routine annalysis of the balance sheet should provide him with enough information to make a rough calculation of net asset backing per share for most purposes. It is worth remembering, however, that balance sheet or book values are merely the amounts at which the company's assets happen to be recorded for accounting purposes. They are not necessarily market values. This is particularly true of fixed and non-current assets.

Occasionally the purchaser and vendor agree to be bound by an independent valuation of the company on a net assets basis. These full-scale asset valuations are often detailed lengthy exercises, in which independent professional valuations of all properties, plant and machinery and other fixed assets are commissioned. The parties might resort to this basis of valuation because it is thought to be less subjective and therefore less contentious than an earnings based valuation. But there is plenty of scope for differences of opinion in an assets based valuation. The professional valuation of fixed assets, for example, is dependent on the assumptions used in the valuation. Thus, a valuation on an existing use basis assuming adequate profitability may be considerably different from one based on actual profitability.

A company's asset value also provides a useful comparison or cross-check against an earnings based valuation. If there is a substantial difference between the two figures, the valuer should satisfy himself that the implications of the difference accord with his own understanding of the company. For example, if the earnings based valuation is substantially below the asset value this may be because the company's management is poor and incapable of obtaining a proper rate of return on the assets; it may be because of depressed conditions in the industry - and it may of course be because the valuer has selected an inappropriate capitalisation rate!

CHAPTER 14

OTHER VALUATION METHODS

Although dividends, earnings and assets are widely used as the basis for share valuations, other methods are also encountered from time to time. This chapter briefly reviews four of these methods, namely, the discounted cash flow method, the super profits approach, the dual capitalisation method and miscellaneous formulae:

Discounted cash flow

Discounted cash flow techniques are commonly used in the appraisal of major capital expenditure. As the purchase of a company or a business is itself usually a major investment, the DCF method is an obvious choice for appraising such an investment.

For a company, as for a capital project, the most important, and also the most difficult, task in the DCF exercise is the estimation of future cash flows. Cash flow for this purpose is not the popular conception of earnings plus non cash expenses such as depreciation, but a figure that reflects all cash inflows and outflows, including reciepts and expenditures that affect the balance sheet but not the profit and loss account. Outflows must therefore include repayment of loans, investments in fixed assets and additions to working capital. Cash inflows would include collection of debtors, sales of assets and reduction of net working capital. In addition, the valuer has to decide the number of years to cover in the analysis and how the terminal value of the company is to be estimated.

Clearly, therefore, a DCF valuation is a major exercise in which company management must participate. Estimates will have to be prepared on slaes volume and sales price, raw materials cost, operating expenses and a host of other variables. All these variables have then to be co-ordinated into pro forma profit and loss accounts and balance sheets for each year to support

the cash flow figures. The terminal value of the business may be estimated in a variety of ways. The most conservative would be to assume liquidation of the business, unreal though this assumption is. Book net assets attributable to the equity, as shown in the pro forma balance sheet at the end of the discounting period, or the capitalised value of earnings or cash flow thereafter, may be used.

The DCF method is probably the most theoretically satisfying valuation technique for business acquisitions but it is not used as often as it should be because of obvious practical difficulties. Few businessmen have much confidence in specific forecasts of result ten years, or even five years ahead, and the evidence suggests that investing institutions are sceptical about numerical profit forecasts beyond two years. Given such doubts, it is hardly likely that the detailed, time-consuming and costly investigation necessary for DCF purposes would be seen as worthwile. Furthermore, the notion of a finite life for the business is unreal, as is the notion that the value of the business ten or more years hence can be estimated with any degree of accuracy. The DCF method appears to be popular where income or profits can be estimated with some confidence. It might, for instance, be used to value a ship-owning company whose vessels are the subject of long-term charter parties and financed mainly by borrowings. It could also be appropriate for a property company.

The DCF basis of valuation will not necessarily produce a market valuation. Because the discount rate is the buyer's required rate of return, and not necessarily the market rate of return, the resultant figure will be the value to the particular buyer. It indicates the maximum price he should pay or if a vendor the minimum he should accept. An approximate idea of market value can be obtained by reference to recent acquisitions of listed companies.

Super Profits Approach

The super profits approach has a long and ancient pedigree and appears in one form or another in most texts. The idea behind it is that there is a normal rate of return that can be earned on assets of a certain type, but over a number of years it may be possible to earn profits in excess of this normal level. This method assumes that the purchaser will buy, in addition to the normalised value of the assets, a number of years' super profits. The procedure is to estimate the value of the net assets on a going concern basis and to add to this the value of the super profits. The annual super profits are calculated by deducting from maintainable profits a sum which is equivalent to the normal rate of return on net assets. These super profits are then multiplied by a factor representing the number of years' purchase. The value of the super profits is entered in the accounts as goodwill.

The super profits method has the theoretical attraction that it recognises the transitory nature of above-average performance. In practice, it has serious shortcomings. The pre-occupation with net asset value, which in practice is based on balance sheet amounts, is unhealthy. Few businessmen would admit that their company's growth rates were a temporary phenomenon, nor would most of them recognise the concept of super profits. The going rate of return on net assets must be a highly subjective assessment as must also be the amount and duration of super profits. How is one to know the going rate for the purchase of super profits? This valuation basis leads to highly esoteric arguments divorced from reality.

Dual Capitalisation

The dual capitalisation technique takes into account the earnings and the assets of the company being valued. An earnings-based valuation is carried out by capitalising maintainable profits using an acceptable rate of return and the net tangible asset are valued on a going concern basis. The mean of these two values is then taken. This averaging method is not inspired by any theory. It is simply a compromise which may provide a practical solution

if the bargaining parties cannot agree on the basis of valuation.

Miscellaneous Formulae

In certain types of business, generally small personally managed firms, it may be customary to value on some rule-of thumb formula. Thus, one may find that a small retail business in a particular line of trade might be valued at x times the sales plus stock at valuation. Professional practices sometimes change hands on a multiple of gross fees. Despite their lack of proper theoretical justification such formulae can serve a useful purpose as a guide to value where the financial statements are unreliable or non-existent.

These formulae should not be used to value professionally managed companies where adequate financial information is available for valuing the business by reference to expected future returns. These formulae are, nevertheless, encountered occasionally in the valuation of substantial businesses. For example, fund management companies are frequently valued on a percentage of funds under management basis. Such a basis makes no distinction between a well managed fund and a poorly managed fund. Where this type of formula is customary, it should never be used in isolation; the conventional method i.e. one which assesses the return on the investment should always be used as well.

CHAPTER 15

CHOOSING THE APPROPRIATE VALUATION BASIS

There are three approaches to the valuation of shares - dividends, earnings and assets. In a particular valuation, one, two or all three approaches may be used. They are in fact related to each other in the sense that dividends are a function of earnings, earning power is the basis of asset values and the assets themselves affect earning power. However, a dividend approach will generally produce a different valuation to an earnings approach, and the asset value approach will normally produce a valuation different from either of the other two. It is therefore a matter of considerable practical, as well as theoretical, interest as to which basis should be used in a given set of circumstances.

Perhaps it is appropriate to start by recording the measure of agreement amongst the experts. When a controlling shareholding is being valued, almost everyone agrees that the dividend basis is inappropriate. A controlling shareholding is generally valued on an earnings basis, usually accompanied by an appraisal of asset backing. Sometimes the asset value alone might be used. The discounted cash flow basis, which is theoretically more satisfying than the earnings basis requires a lot of time and suffers from certain practical difficulties. It is particularly suitable where income and expenditure can be projected into the future with some certainty.

As regard minority shareholdings there appears to be some difference of opinion as to the appropriate valuation basis, although, a few notable exceptions (e.g. property companies) most practitioners would agree that the assets basis alone is not suitable. The disagreements tend to arise as to whether dividends or earnings should be used for valuing minority shareholdings.

The question of the relative importance of dividends and earnings in the determination of the share prices of listed companies has been the subject of a lively academic debate for some years. Miller and Modigliani could be considered as the champions of the view that a company's dividend policy has

no effect on the value of its shares. For MM 'values ... are determined solely by 'real' consideration - in this case the earning power of the firm's assets and its investment policy - and not by how the fruits of the earning power are 'packaged' for distribution.

Myron Gordon, on the other hand takes the view that a company's share price is not independent of the dividend rate. He believes that investors value a dollar of profits paid out in dividends more highly than a dollar of profits retained in the business. He acknowledges that a low payout ratio today should result in increased dividends later on and that the present value of the future increase in dividends should equal the value of the dividends foregone now, assuming an ideal world of constant rates of return on capital and a discount rate equal to the rate of return. However, Gordon maintains that in the real world of uncertainty the investor will view the more distant distributions as riskier than the nearer ones and will accordingly dicount the former at a higher rate than the latter. If the single figure discount rate which equates future dividends to the price of a share is seen as the weighted average of different discount rates applied to different year's distributions this average will rise, and share prices therefore will fall, and the time pattern of future dividends changes from the near to the more distant future. Increasing or reducing the dividend therefore affects the share price.

Space does not allow us to go into the pros and cons of this dispute nor is it necessary for the purpose in hand. Both Gordon and MM and no doubt all theorists and practitioners in the field of finance agree that the return on an investment in shares consists of dividends received plus any profit or minus any loss on eventual sale. It is clear from that discussion that the purchaser of a minority shareholding in an unlisted company is generally locked into his investment. If we ignore for the moment the special cases of those companies which are likely to be taken over or are likely to obtain a Stock Exchange listing for their shares, it is clear that the purchaser of a minority shareholding in an unlisted company will find it very difficult to sell his shares and if the Articles have fair value pre-emption clauses,

the price at which he sells could well be outside his control.

No one enters into such an arrangement other than on the understanding that it is of a long-term nature. This means that the proportion of the total return that is accounted for by dividends will be much larger in an investment in unlisted shares than it is in listed shares. Furthermore, the capital gain element of the total return will typically not be realised until after many years - 10 years would not be an unusual time span for an unlisted investment. If we accept Gordon's logical assertion that higher discount rates are appropriate for the more distant, i.e. more uncertain, cash flows, the significance of the terminal value to the total return is further diminished.

Dividends, therefore, loom much larger in the return on unlisted shares than they do on listed shares (looked at from the viewpoint of an individual investor), and consequently one would expect a greater emphasis on dividends in the valuation of unlisted shares. This statement holds irrespective of the basis on which the terminal value is arrived at. In practice, the eventual prospective buyer, again say 10 years hence, will be in the same position as the current purchaser, and a significant part of his future return, and therefore of the value at the date of his purchase, will be represented by dividends. Today's purchaser, therefore, should value his shares purely on the dividend stream.

If a minority shareholding is valued on a earnings basis i.e. if earnings are seen as the return on the investment, the purchaser will pay a significantly higher price; for earnings exceed dividends often by a factor of three or more to one. The stream of dividends - again let us say for 10 years - will represent an inadequate return on their own, and the price can only be justified on the assumption of a substantial capital gain on eventual sale. If we continue to ignore the special cases of a company which is likely to obtain a listing and one which is 'bid-prone', it must be folly indeed to pin one's hopes for an adequate retun on the occurrence of an event so far into the future and in all the circumstances of such

questionable probability. The whole basis of such an investment is the improbable assumption that the unmarketable will prove marketable. The fallacy of the earnings approach has been summed up by John Burr Williams in a classic text, "The Theory of Investment Value":

> 'Earnings are only a means to an end, and the means should not be mistaken for the end. Therefore, we must say that a stock derives its value from its dividends, and not its earnings. In short, a stock is worth only what you can get out of it.'

In those exceptional cases where a company is likely to be taken over or to secure a listing for its shares different considerations apply. In both these cases the terminal value or sale proceeds will generally be much higher than the ordinary minority price. This is because the discount for lack of marketability will no longer be appropriate and, in the case of a takeover, the price will reflect a premium for control. Furthermore, the investor who buys on the expectation of a listing or a takeover will not expect to be locked in to his investment indefinitely. For the takeover or listing to be foreseeable it must presumable be within two or three years of the present time. In these two special situations the shares should be valued on the expectation of a listing or a takeover, as appropriate, with a suitable discount for uncertainty and waiting time. Dividends likely to be received in the intervening period should also be taken into account.

A recurrent theme of this paper has been the danger of relying on the balance sheet amounts of net assets often mistakenly terms 'values', and the pitfalls of looking at such assets 'values' in isolation from earnings potential. The assets basis alone should be used only to value companies which have readily realisable assets with a value independent of the business. Property companies, investment trusts and ship-owning companies and, of course, companies in liquidation are examples of business which might well be valued on this basis. Nevertheless the value of small minority holdings in such companies other than those in liquidation should always be justifiable in terms of the dividend yield since barring a

take-over or possibly a listing the only way those assets are likely to represent a cash return to the minority shareholder is in the form of future dividends. A review of the asset backing, as distinct from the direct derivation of a share's value from the value of the underlying assets, is an essential element in all share valuations. High asset backing indicates a more secure investment and calls for a higher capitalisation rate in both dividend and earnings based valuations.

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