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The Role of Valuation in Shareholder Dispute Cases

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OUTLINE

I. The jurisdictional basis for a buy-out order
II. Reasonable offer to buy out
III. The overriding principle – to do justice
IV. Date of Valuation
V. Minority discount
VI. Case illustration

I. The Jurisdictional Basis for a Buy-Out order

- The relevant parts of S.724(1) and 725 (2), CO provide that:-
  - The Court may exercise the power … on a petition by a member of a company, if it considers that … the company's affairs are being or have been conducted in a manner **unfairly prejudicial** to the interests of the members … order **the purchase of the shares of any member of the company by another member of the company**
  - The form of the court order actually depends a lot on the particular misconduct committed

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I. The Jurisdictional Basis for a Buy-Out order

- Typical cases of unfair prejudice:
  - Mismanagement of business that is unfairly prejudicial to minority shareholder [1]
  - Improper exclusion from management [2]
  - Unfairly restricting dividends – coupled with excessive remuneration paid to directors out of profits [3]
  - Improper diversion of business opportunities to the director or majority or other companies under their control [4]

1. *Re Elgindata Ltd* [1991] BCLC 959, 1005
2. *Hogg v Dymock* (1993) 11 ACSR 14
3. *Sanford v Sanford Courier Service Pty Ltd* (1987) 5 ACLC 394
4. *Scottish Co-op Wholesale Society Ltd v Myer* [1959] AC 324; *Re Bright Pine Mills Pty Ltd* [1969] VR 1002

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I. The Jurisdictional Basis for a Buy-Out order

- A share purchase order is the most important and commonly granted remedy, as the order has the advantage of effecting a "clean break" [1]

<u>*Re* Elgindata Ltd [1991] BCLC 959 at 1005f–I</u>

A share purchase order is appropriate in a case involving ***exclusion from management*** *or where the respondent has shown a propensity for* ***using the company's assets for his personal benefit and the benefit of his family and friends****, as it would be unfair to the petitioner to be* ***"locked in" as minority*** *in the company where there is no practicable way of regulating the conduct of the company's affairs in future so that it is a case for a "clean break"*

1. *Robin Hollington QC, Shareholders' Rights*, 7th ed, §8-44

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II. Reasonable offer to buy out

- The court may strike out the petition if a **reasonable offer** to buy out is made but refused

- Basic requirements of a reasonable offer should have those features: [1]
  - The offer must be to purchase the shares at a fair value, normally on a pro rata basis without minority discount, although a discounted value may be taken in special circumstances.
  - The value, if not agreed, should be determined by an accountant agreed by the parties or in default a competent expert as an expert with the objectives of economy and expedition.
  - The offer should provide neither the full machinery of arbitration nor the halfway house of an expert who gives reasons.
  - The offer should provide for equality of arms between the parties with the same rights of access to information of the company and to make submissions to the expert.
  - Where the offer was made a long time after the litigation had been commenced, the offer should normally include the petitioner's costs.

1. *O'Neill v Phillips* [1999] 1 WLR 1092

III. The overriding principle – to do justice

- The price must be fair and the valuation must be conducted on the basis that the unfairly prejudicial conduct had not taken place [1]
- The price must be fair to the petitioner
- The price must also be fair to the respondent
  - Thus the court will not adopt a date of valuation which was near the time when the company's fortunes were at their peak if that would be "grossly unfair" to the respondent [2]

1. *Per* Lord Denning in *Scottish Co-operative Wholesale Soceity v Meyer [1959] AC 324, p.369, [1958] 3 WLR 404 HL (SC)Re Dalkeith Investments Pty Ltd* (1984) 9 ACLR 247, 254
2. *Re Elgindata Ltd* [1991] BCLC 959, p.1006

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IV. Date of valuation

- The choice of an appropriate valuation date is a matter of the court's discretion to do what is right in the circumstances of the case [1]

- **The overriding requirement: the price must be fair on the facts of the particular case**

- No hard and fast rule

- The Court of Appeal *in Profinance Trust SA v Gladstone* [2002] 1 WLR 1024 analysed the trend of authority and came up with the following propositions:-

1. *Huang Da-lin v Wong Chung Keung* (unrep, CACV No 300 of 1998)

IV. Date of valuation (Cont.)

1. The starting point is that the interest in a going concern ought to be valued at the date on which it is ordered to be purchased. [1]
2. Where a company has been deprived of its business, an early valuation date and compensating adjustments may be required in fairness to the petitioner. [2]
3. Where a company has been reconstructed or its business has changed significantly (i.e. has a new economic identity), an early valuation date may be required in fairness. [3]

1. *Huang Da-lin v Wong Chung Keung* (unrep, CACV No 300 of 1998)
2. *Scottish Co-operative Wholesale Society Ltd v Meyer* [1959] AC 324
3. *Re OC (Transport) Services Ltd* [1984] BCLC 251

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IV. Date of valuation (Cont.)

4. Where a minority shareholder has a petition on foot and there is a general fall in the market, the court may in fairness to the claimant have the shares valued at an early date, especially if it strongly disapproves of the majority shareholder's prejudicial conduct.

5. The petitioner is, however, not entitled to a one-way bet, and the court will not direct an early valuation date simply to give the most advantageous exit from the company, especially where severe prejudice has not been made out.

6. The above points may be heavily influenced by the parties' conduct in making and accepting or rejecting offers either before or during the course of the proceedings.

4. *Re Cumana Ltd* [1986] BCLC 430
5. *Re Elgindata Ltd* [1991] BCLC 959
6. *O'Neill v Phillips* [1999] 2 BCLC 1

1. She Wai Hung v Juliano Lim [1]

- Background
  - The only substantial business of the company had been diverted to another company approximately four and a half years before the petition was presented
  - The company had formally ceased business approximately two and a half years before the petition was presented.
  - Kwan J found that the shares were not of a going concern and it was clearly inappropriate to order that the date of valuation should be the petition date since by that time the value of the petitioner's shares had been affected by the altered status of the company.
- The judge considered that fairness would require that the valuation of the shares should **relate back to a date prior to the presentation of the petition, and before the occurrence of unfairly prejudicial acts**.

1. (unrep, HCMP No 6472 of 2001) – judgement handed down on 26 November 2007

1. She Wai Hung v Juliano Lim (Cont.)

- She fixed the date at approximately 4.5 years before the petition date, which was the day before the petitioner's resignation from his positions in the company took effect and just before the main business of the company was wrongfully diverted by the respondents and taken over by the respondents' company.

V. Minority discount

Why applies minority discount?

- recognizes the disadvantage of holding a minority of shares in a company; primarily a lack of control and marketability

Whether there should be any minority discount?

- a question of law for the court to decide
- the amount of discount is a question of valuation to be decided on the valuers' evidence

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V. Minority discount – Quasi-partnership

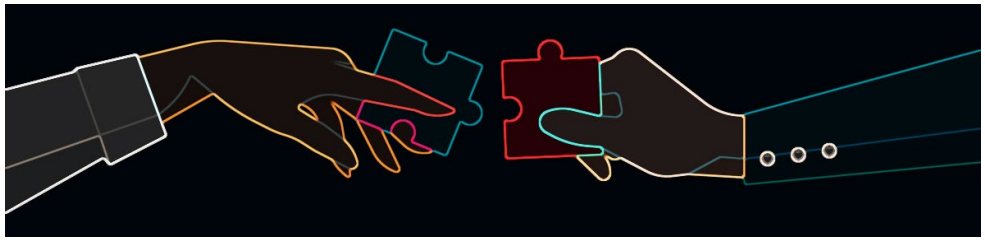
- In general, fair to value the minority shares on the pro rata basis without minority discount

- 3 non-exhaustive elements favouring no discount: *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360, p.379 (absence of any element not necessarily fatal)
  - An association formed or continued on the basis of a personal relationship, involving mutual confidence
  - An agreement, or understanding, that all, or some of the shareholders shall participate in the conduct of the business
  - Restriction upon the transfer of the members' interest in the company

V. Minority discount – Quasi-partnership (Cont.)

- Minority holding 15% shares would not disentitle the court to come to a finding of quasi-partnership where shares were not acquired purely as an investment but on the understanding that the petitioner would play an important part in the affairs of the company and which the petitioner in fact did so [1]

- Presumably, if not a quasi-partnership, the shares would likely be purchased as an investment and, a discount should be applied



1. *Lu Jun v Yu Qi* [2014] HKCU 505 (unreported, CACV 76/2013, 7 Feb 2014) (CA)

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V. Minority discount

A buy-out order on a pro-rata basis may also be appropriate in certain circumstances even in a non-quasi-partnership context [1]

In *Blue Index Ltd*, Robin Hollington QC in dealing with valuation of the petitioner's 3% shareholding, said at para. 26:

"…the whole purpose of the unfair prejudice remedy is to grant the oppressed minority a remedy which it would not otherwise have. It would substantially defeat the purpose of the new remedy if the oppressing majority were routinely rewarded by the application of a discount for a minority shareholding"

In *Re AMT Coffee Ltd*, the court followed *Re Blue Index* and declined to make any discount on the price to be paid for shares in the absence of any finding of quasi-partnership. Without expressing a view on a general rule as to whether minority shareholding would attract a discount in valuation, the court held that:

"…so far as concern the debate between the contrasting view ... it is not necessary ... to express any concluded view but it is at least clear that the weight of authority is that there is a discretion to be exercised."

1. Fancourt J in *Re Edwardian Group Ltd* [2019] 1 BCLC 171
2. [2014] EWHC 2680 (Ch)
3. [2020] 2 BCLC 50

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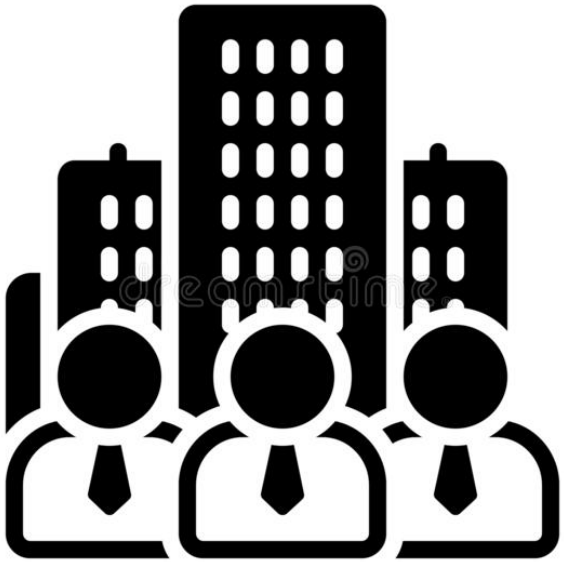
VI. Case Illustration

Choi Chi Wai v Cheng Ka Shing and Others [1]

Hong Kong Agriculture Special Zone Limited
("**the Company**")



Mr. Cheng **Mr. Choi** **Mr. Lee**

Equal shares
Directors

1. HCMP 729/2012

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VI. Case Illustration – Choi Chi Wai

19 Jun 2006	• Incorporation
31 Aug 2007	• The China Chamber of Commerce of Foodstuffs and Native Produce (中國食品土畜進出口商會) ("CCCFNP") announced that it would appoint a Hong Kong company to be its third authorized agent. Mr. Choi made an application in the name of the Company with the consent from Mr. Cheng and Mr. Lee
22 Oct 2007	• CCCFNP decided to appoint the Company as the third authorized agent to import and sell live pigs from the Mainland into Hong Kong.
22 Oct 2007 - 31 Dec 2007	• Mr. Choi, with the assistance of his family members managed to establish the entire network and business model required for the agency business. The Company was managed and operated by Mr. Choi alone. He was assisted by Mrs. Choi and other family members. Mr. Cheng and Mr. Lee had no involvement in the day-to-day operation of the Company or its business.

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VI. Case Illustration – Choi Chi Wai

20 Dec 2007	• At the Board of Directors' meeting, Mr. Choi agreed to gradually return the operation of the Company to Mr. Cheng and Mr. Lee from 1 January 2008.
8 Mar 2008	• At the EGM, resolutions were passed by Mr. Cheng and Mr. Lee to remove Mr. Choi as director of the Company.
1 May 2008	• Mr. Cheng and Mr. Lee caused the Company to enter into an agreement with Hong Kong Agriculture Special Zone Management Ltd ("**Management Company**"), which was incorporated by 8 individuals from the Hong Kong Agriculture Special Zone Development Association ("**Association**"). They are friends of Mr. Cheng and Mr. Lee.
May 2009	• It was discovered that the Management Company had overcharged its remuneration, despite which, Mr. Cheng and Mr. Lee did not take any step to recover the amount overpaid from the Management Company. Instead, they continued to retain the Management Company.

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VI. Case Illustration – Choi Chi Wai

15 Sep 2010	• The appointment of the Management Company was terminated, and no step had been taken by the Company to recover the overcharged balance for about 2 years until 27 Sep 2012.
16 Apr 2012	• Mr. Choi presented an “unfair prejudice” petition, alleging that Mr. Cheng and Mr. Lee have conducted the affairs of the Company in an unfairly prejudicial manner.
7 Nov 2012	• Obtained the default judgment against the Management Company but no step was taken to enforce the default judgment.

VI. Case Illustration – Choi Chi Wai

Held:

- The Company is a *quasi* partnership so it is not fair or equitable for Mr. Cheng and Mr. Lee to exclude Mr. Choi from participating in the management of the Company;
- Mr. Cheng and Mr. Lee have put the interest of the Association ahead of that of the Company and, therefore, acted **in breach of their fiduciary duties;**
- The Management Company did not carry out any substantive work for the Company. So the remuneration paid to it was excessive and wholly unjustified;

VI. Case Illustration – Choi Chi Wai

Held:

- The remuneration Mr. Cheng and Mr. Lee paid to themselves were excessive;
- The failure on the part of Mr. Lee and Mr. Cheng to cause the Company to pay any dividends to the shareholders (but high remuneration to themselves) was both unfair and prejudicial to the interests of Mr. Choi.

VI. Case Illustration – Choi Chi Wai

The Court Ordered:

- **Share Purchase Order:** Mr. Choi to buy out Mr. Cheng and Mr. Lee

- **Date of Valuation**: actual date of sale
  - *"The Company is a going concern and has been making profits. There is no reason why the profits made by the Company should not be taken into account in the valuation."*

- **Basis of Valuation**: the Company should be valued as a whole and on a going concern basis

- **Discount or premium: NO**
  - *"Given that the shareholding of the Shareholders is equal, there should be no discount or premium applicable to any of their shareholding."*

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VI. Case Illustration – Choi Chi Wai

The Court Ordered (cont.):

- **Adjustments to Valuation, including:**

  1) In relation to exclusion from management, the Company is liable to pay $60,000/m to Mr Choi as his remuneration as director from 1 Apr 2008 to 31 Dec 2009;
  2) In relation to the engagement of the Management Company, Mr. Cheng and Mr. Lee are liable to repay $4,405,000.98 to the Company;
  3) In relation to directors' remuneration, Mr. Cheng and Mr. Lee are liable to repay $13,884,000 to the Company for the remuneration received up to 31 Mar 2016 and any further amount received by them from the Company from 1 Apr 2016 onwards.

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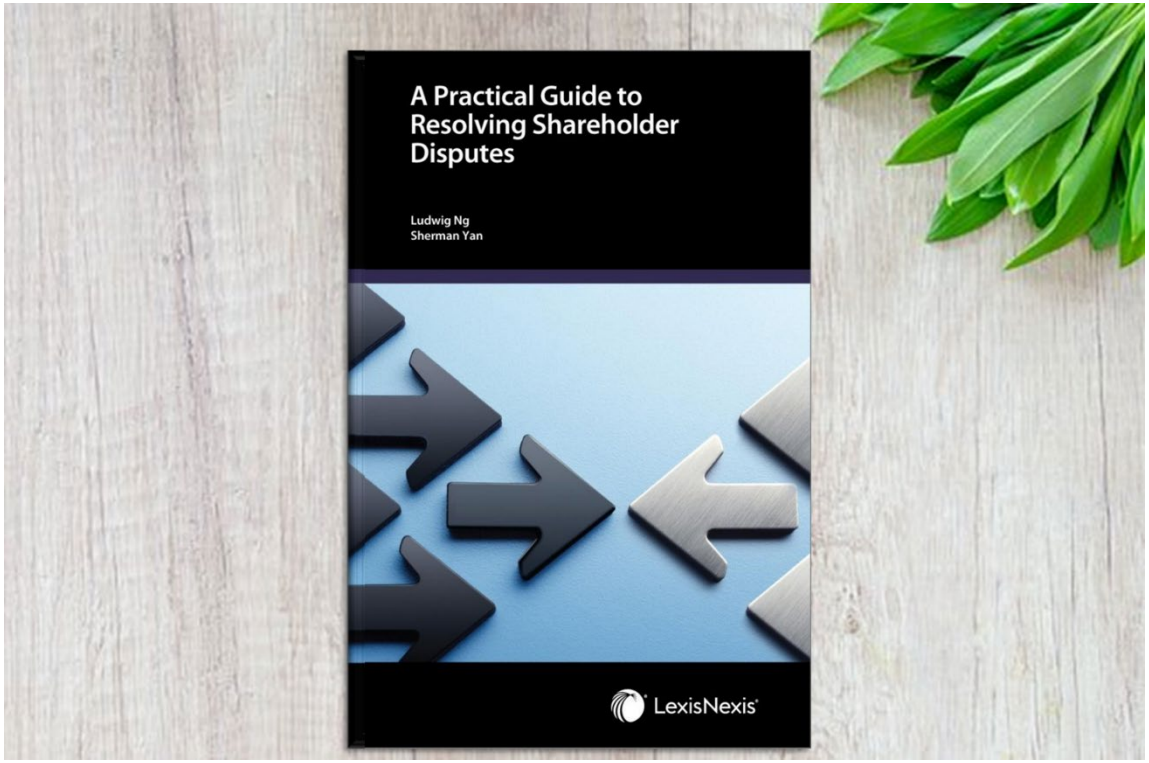
Reference:

A Practical Guide to Resolving Shareholder Disputes, co-authored by Ludwig NG and Sherman YAN, LexisNexis, 2021



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Thank You

Important

Please note that the laws and procedures on this subject are very specialised and complicated. This presentation is just a very general outline for reference and cannot be relied upon as legal advice in any individual case.

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