

Expert determination of the value for unlisted shares.

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INTRODUCTION

This paper discusses the practical issues, from a valuer's perspective, that arise for the parties and their advisors where the value of a share interest in an unlisted company is the subject of expert determination. I have focused on the valuation of those interests, rather than other property¹, as this is my area of expertise. However, I believe that many of the issues addressed will be relevant to the expert determination of the value for other assets and liabilities, and to the practice of expert determination in general, which is all about resolving disputes using a subject matter expert.

The paper is relevant in two ways to the 2017 AMINZ conference theme: *ready, steady, grow*.

1. Business growth in unlisted companies can ultimately only be realised by owners via cash flow from distribution of profit share or on the sale of their equity interest. In the latter case, realisation of the sale value may need to be established by way of expert determination.
2. My intention is to help dispute resolution practitioners grow their own practices by providing tools to assist them in developing, and guiding their clients through, expert determination valuation processes.

The paper assumes that expert determination is the required form of dispute resolution, and does not explore whether it is the most suitable method. It does not, therefore, discuss the advantages and disadvantages of expert determination relative to other forms of dispute resolution process, particularly arbitration. These issues have been discussed in prior AMINZ conference papers.^{2,3}

Expert determination clauses in agreements or company constitutions are part of broader share transfer mechanisms, which may include:

- Restrictions on share transfers (including pre-emptive rights).
- A period of negotiation before any expert determination clauses are triggered.
- Payment terms (including interest) for the subject interest.

A discussion of the broader transfer mechanism is beyond the scope of this paper.

This paper's overriding theme is that, in my experience, the most effective and workable expert determination processes tend to be those that keep it simple. They rely on clauses that are not overly prescriptive, but which establish the mandate and a broad framework – allowing the parties, working closely with their legal advisors, to agree an effective and efficient expert determination process together with an experienced valuation expert.

¹ Such as intellectual property and real estate.

² Expert witnesses and expert determinations. What is done and what could be done better. A barrister's perspective. David Connor LLB. 2011 AMINZ Conference.

³ Expert Determination, Myth or Magic? Steve Alexander. 2010 AMINZ Conference.

To that end I cover the issues listed in my paper abstract under the following headings:

- Expert determination for valuing unlisted share interests - an overview.
- The expert determination valuation clause (including the issue of defining value).
- The expert determination procedure.

But before we go any further, lets' talk about wine...

Hay & Hollows v Peregrine Estate Ltd (Peregrine Wines)

A New Zealand High Court decision⁴ last year involving Central Otago winery Peregrine Wines (**PWL**), highlighted several key features of determining unlisted company share value under an expert determination process. These features were discussed in detail in an article⁵ I co-authored earlier this year with Tim Lindsay, also a speaker at this conference. I will refer to the Peregrine Wines decision throughout this paper, and so provide an overview here.

PWL is a boutique producer of Central Otago wines. The plaintiffs (the trustees of the Greg Hay Family Trust) (**the Trustees or the Trust**) and the defendant Peregrine Estate Limited (**PEL**) are the shareholders in PWL, with the Trustees and PEL holding 25.14% and 74.86%, respectively.

The Trustees wished to sell the Trust's 25.14% shareholding in PWL and so, in March 2013, invited PEL to make an offer. PEL did so, offering \$1.57 million. However, the trustees believed the Trust's shares to be worth \$3.25 million – more than double PEL's offer.

PEL declined to pay the Trust's price, but said it would buy the shares at a price established by the expert determination procedure contained in PWL's Constitution. This called for the appointment of a valuer (acting as an expert) to determine the 'fair value' of the shares. The appointed valuer produced a valuation of \$2.62 million.

PEL declined to complete a purchase at this figure and instead engaged its own advisor who provided an alternative fair value assessment of \$1.275 million. High Court proceedings ensued. The Trustees sought specific performance (by way of summary judgement) of PEL's obligation to buy the shares at the valuer's fair value of \$2.62 million.

The High Court upheld the Trustee's application for summary judgment and ordered PEL to perform its obligation to buy the Trust's shares at the valuer's valuation of \$2.62 million.

In doing so, Matthews J made three key findings, each of which provides important guidance for both valuers and those drafting expert determination clauses:

- The valuer had fixed 'fair value' following the purposes of the Constitution.
- The valuation was final and binding on the Trustees and PEL.
- The valuation also fixed 'fair value' for the purposes of s149 of the Companies Act⁶.

Throughout the rest of this paper I comment on the importance of His Honour's findings.

⁴ *Hay & Hollows v Peregrine Estate Ltd* [2016] NZHC 2097

Lindsay, T; Shaw, J. (2017) ⁵ Expert Determination: High Court takes a wine tour. Resolution. Issue 12. Feb 2017

⁶ Where it's a director of the company who is selling or buying shares, s149 of the Act generally requires the price of the shares to be at 'fair value'.

EXPERT DETERMINATION FOR VALUING UNLISTED COMPANY SHARE INTERESTS – AN OVERVIEW

Expert determination generally

Although I intend this paper to be practical in nature, I need to begin with a short discussion of the meaning and general principles of expert determination.

In that respect, I refer to Green & Hunt on Arbitration Law and Practice⁷ (**Green & Hunt**). That authority defines expert determination as: *'a dispute resolution process in which the parties agree to instruct a third party to resolve an issue or dispute. The third party is usually an expert in the area in which the dispute has arisen and is chosen for that expertise'*.

Green & Hunt also highlight the following general principles of expert determination, which I paraphrase below:

- The determination of the expert is final and binding on the parties. This is the principal difference between expert determination and other forms of expert opinion and evidence.
- Expert determination is based on contractual agreement between the parties, who decide all matters relating to the determination including the procedure, the expert and their role, and the manner in which the decision might be enforceable.
- The contractual basis of expert determination is what distinguishes it from arbitration and other statutory processes such as adjudication under the Construction Contracts Act 2002.
- Enforcement of an expert determination agreement (including whether as an arbitration agreement or reference to expert determination) is a matter of contract construction.
- Enforcement of an expert's determination is by way of civil proceedings (as in Peregrine Wines).
- An expert's binding determination will generally only be reviewed by the court if there has been an error in the expert's interpretation of the instruction or agreement, and not if there has been an error in the exercise of the expert's judgment.⁸

In relation to the last point, in Peregrine Wines, PEL's strongest criticism of the valuation report was that the valuer did not apply a minority shareholding discount to the value of the Trust's (minority) shareholding. However, the High Court found that this amounted to no more than a challenge to the merits of the expert's conclusion, which was not a reviewable error. Mathews J concluded:

'[45] In my view these aspects of Mr Shiels' argument only raise the prospect that Ms Millar was mistaken in her view, or possibly that she made an error in not enquiring further on this point. This does not amount, however, to departing from her mandate to assess fair value.'

The finality of the decision by an expert valuer who has acted within their mandate is one of the advantages of expert determination. However, this can be a double-edged sword for the parties if the valuer, although acting within their mandate, does not 'get it right'.

⁷ Green & Hunt on Arbitration Law and Practice (online edition). (2017). EX1 Expert Determination.

⁸ Green and Hunt refer to *Glaister v Amalgamated Dairies Ltd* [2003] 1 NZLR 829, at 840-843, per Heath J, cited in *Greymouth Petroleum Acquisition Co Ltd v Petroleum Resources Ltd* HC Auckland CIV-2003-404-6984, 22 December 2003, at [39].

Expert determination to establish the value of unlisted company share interests

Unlisted company share interests which are the subject of an expert determination of value typically have these three features in common:

1. Shares that are the subject of an expert determination will nearly always be non-controlling or minority share interests (less than 75%).
2. The transaction will nearly always be between identified parties – either between shareholders, or from a shareholder to the company. Those parties may have a relationship extending beyond commonality of ownership: they may have founded the company together, one may have financed the other into ownership, one may be treating the other oppressively. They may also be directors of the company.
3. The circumstances in which the expert determination is required are often contentious, with the parties likely to have already attempted to negotiate, but been unable to agree, a value for the shares.

This means that:

- There may be minimal or no available transaction data that is comparable to ownership interests in the subject company. It is even less likely that there will be comparable data on minority share transactions for the subject company.
- It will usually be necessary to consider the nature and quantum of minority discounts that may be required to reflect the absence of control and marketability (liquidity) in the minority interest.
- The existing relationship between the parties means that, in addition to assessing intrinsic value, the valuer may also need to consider what is 'fair' between the parties.

These features complicate the inherent challenge of valuing shares in unlisted companies. Valuation is often described as an art and not a science, requiring the valuer to enter *'a dim world peopled by the indeterminate spirits of fictitious or unborn sales. It is necessary to assume the prophetic vision of a prospective purchaser.... and firmly to reject the wisdom which might be provided by the knowledge of subsequent event.'*⁹ The valuer is asked to do no less than predict the future in respect of a company's future operating and financial performance.

This is problematic, particularly when research on prediction has shown that experts may be no better at predicting the future than 'dart-throwing chimps', and are consistently less accurate than even simple statistical algorithms.¹⁰ Fortunately, other studies have shown there are ways to improve predictive ability and much of business valuation 'best practice' reflects those.

The specific nature of the exercise (i.e. 'what is the value of x% of the shares in ABC Limited?'), combined with its inherent challenges, means that the valuation of unlisted company share interests is well suited to expert determination. In the absence of an active and liquid market (and perhaps a fully functioning crystal ball), resolving the question of 'how much are these shares worth?' requires the expertise of a valuation specialist.

⁹ Danckwerts J in *Holt v. Inland Revenue Commissioners* [1953] 1 WLR 1488.

¹⁰ Discussed in Tetlock, P.E. and Gardner, D (2016) *Super Forecasting: The Art and Science of Prediction*.

This is why expert determination is a common mechanism to resolve unlisted company share value in New Zealand, when parties are unable to agree a share value by negotiation. In Peregrine Wines, the expert determination clauses were contained in PWL's constitution, a standard form 'Avon Publishing' document with the relevant provision (clause 11) printed without alteration. In addition to many standard form company constitutions, expert determination valuation clauses exist in numerous shareholder, partnership, and other ownership agreements.

THE EXPERT DETERMINATION VALUATION CLAUSE

A key feature of expert determination is that it is up to the parties to agree the matters relating to the process – including details of the valuation procedure, the appointment of the expert and their role, and the enforceability of the determination. Some of these matters must be addressed with the 'expert determination clause' and, in this section, I explore the nature of these clauses.

Out 'in the wild' I have seen a wide range of expert determination clauses. These range from conceptual to highly prescriptive, and can be anything from a few sentences to multiple-clause, multiple-page approaches. Except for those that are contained in standard form constitutions, it is relatively rare to see two identical clauses.

In my experience, the clauses that work most effectively are those that keep things relatively simple:

- They make it clear that what is being described is a reference to expert determination.
- They include only those matters which must be agreed before the expert determination process can start (these that are likely to be very difficult to agree once the clause is triggered).
- Aside from stating the required definition of value, they steer away from technical valuation matters and terminology (such as prescribing methodologies), leaving those instead to the valuer.
- They exclude procedural matters relating to the valuation process itself, leaving the parties to settle those with the valuer, following his or her appointment.

The good news is that a large number of expert determination valuation clauses do follow these general principles. The following are examples of expert determination clause precedents I have seen reflecting the general principles of this approach. These are relatively standard and should be familiar to those of us who deal regularly with expert determination clauses:

1. *If the parties are unable to agree on the value for the shares, the [fair] [fair market] value shall be determined by an [independent] valuer either agreed on by the parties or, failing agreement, appointed on the application of either party, by a person nominated by the president of [organisation] or his or her nominee.*
2. *The decision of the independent valuer shall, in the absence of manifest error, be final and binding on the parties.*
3. *The independent valuer shall act as an expert and not an arbitrator.*
4. *All costs incurred by the independent valuer shall, unless the valuer determines otherwise, be paid by [x].*

These clauses cover only the reference to expert determination and the key matters to be agreed up front. I further expand on these two topics below.

The reference to expert determination

As indicated by Green & Hunt, the expert determination clause must make it clear that the procedure described is actually an expert determination. This means that the clause must provide for a final and binding outcome for the parties.

Without this reference, there can be no contractually-based expert determination.

This is usually achieved quite simply, by way of a reference clause in the agreement that provides for the decision of the expert valuer to be final and binding on the parties, such as the wording contained in clause 2 of the example above.

As in clause 2, the reference clause may also provide for the determination to be final and binding *'in the absence of manifest error'*. The inclusion of these additional words provide a further window of opportunity for challenging a flawed expert determination, although a leading UK authority¹¹ suggests that the courts appear to interpret very narrowly the meaning of *'manifest error'* to exclude errors of judgment, restricting them to *'sights and blunders so obvious and obviously capable of affecting the determination as to admit to no difference of opinion.'*¹²

In other words, you are likely to know a manifest error when you see it. In the decision in Walton Homes¹³, Peter Smith J indicated that a manifest error might be confined to *'something like an arithmetical error, or a reference to a non-existent building and the like'*. That decision also refers to Lindley & Banks on Partnership, which states (at paragraphs 10-73) that manifest error *'applies only to errors in figures and obvious blunders, not to errors in judgment e.g. in treating as good debts which ultimately turn out to be bad or in omitting losses not known to have occurred'*.

From a share valuation perspective (although ultimately for the courts to decide) a manifest error appears likely to be something like a fundamental mathematical error in the valuation model, valuing the wrong number of shares, or a valuation at the wrong date. This is as opposed to an error in judgement, such as in the assessment of a discount rate, or an estimate of expected future earnings for the business (or as in Peregrine Wines, the absence of a minority discount).

As in clause 3 above, it is also common for the reference clause to clarify that the process described is not an arbitration. In Peregrine Wines the PWL constitution states at paragraph 11.4 (2) *'The expert (when nominated and in certifying the sum which in the expert's opinion is the fair value of the shares) is an expert and not an arbitrator'* and at 11.4 (3) *'Accordingly the Arbitration Act 1996 does not apply'* – this is another example of common determination clause wording.

Matters to be agreed in the reference

As shown in the precedent clauses above, the key matters to be agreed in the reference are:

- What is the standard of value required for the valuation?
- How will the expert be appointed?
- What will be the form of the determination?

I will now comment on each of these in turn.

¹¹ Freedman, C; Farrell, J (2015) Kendall on Expert Determination (5th Edition) at 14.11

¹² Veba Oil Supply & Trading GmbH v Petrotrade Inc [2002] 1 All E.R. 703 at [33]. cited in Kendall on Expert Determination (5th Edition) at 14.11 (2).

¹³ Walton Homes Ltd v Staffordshire County Council [2013] EWCH 2554 (Ch)

What is the standard of value required for the valuation?

The expert determination clause must go further than stating that the expert is to determine ‘the value’ for the shares. It should also specify the definition of ‘value’ that is to be used for the valuation. This is of particular importance because, depending on the definition applied, the value conclusion can be materially different – particularly for minority interests in unlisted companies.

There are two value definitions (standards of value) most commonly used in expert determination clauses, *fair market value* and *fair value*. I will briefly expand on the meaning of each of these before considering the circumstances in which one or the other might be most appropriate for expert determination.

Fair market value

Fair market value has no statutory definition in New Zealand, nor is there a single accepted definition. However, definitions used tend to be broadly similar – one is:

*‘The highest price expressed in terms of money or money’s worth obtainable in an open and unrestricted market between informed and prudent parties, dealing at arm’s length, neither party being under any compulsion to transact’.*¹⁴

The principles that underpin fair market value were originally developed to make it workable to value unlisted shares for tax and estate duty purposes. It is based on the concept of ‘value in exchange’, being the price the asset could be sold (exchanged) in a free and open market. Value is assessed as between a hypothetical buyer and seller, both willing and not anxious. Fair market value tends to underpin all other concepts of value, including fair value.

The general concepts of fair market value are, in my opinion, relatively well understood (at least among valuers), although there is no universal agreement. For example, there are different views on what ‘fair’ in ‘fair market value’ means¹⁵ and on the extent to which strategic purchasers willing to pay a higher price should be included in the universe of potential purchasers.¹⁶ Differences in the interpretation of these issues can lead to significant differences in the value ultimately opined.

¹⁴ Hagen, J.C (1990). Valuing shares and businesses (revised and updated). NZSA, at page 7.

¹⁵ For example, the view of Hagen JC (1990) in *Valuing shares and businesses* (at page 6) is that ‘fair’ qualifies market value and so seeks to rule out the effects of transient booms or sudden panics in the market. The view expressed by the Court in *MMAL Rentals v Bruning* (2004) 63 NSWLR 167. (cited in *Fong v Wong* (2010) CA46/2010 NZCA 301 at paragraph 21) is “*fair’ market value suggested that the valuation should proceed on the assumption, which could be contrary to the facts of a particular contractual relationship, that there was no impediment to the process of bargaining either on the terms of availability of information or restraints arising from the characteristics of a particular vendor or purchaser*”.

¹⁶ For example, in *Glover, CJ* (1986) Valuation of Unquoted Securities. page 29, “*The existence of a special purchaser is not always apparent, and where it is, the assessment of his effect on price may be almost impossible to quantify. No doubt for reasons such as these market value usually excludes the effect of a special purchaser. In the authors view, however, it is unrealistic to exclude the effect of a special purchaser where one is known to exist. If market value is the most probable buy/sell price, and the most probable buyer is the one with the special interest in the property, then it is unrealistic to value that property without taking into account the special buyer*”.

Fair value

Fair value also has no statutory definition in New Zealand, nor is there a single accepted definition nor unanimous consensus on its meaning. However, a discussion of fair value principles that is often referred to New Zealand is similar to that expressed in Glover (1986)¹⁷, paraphrased below:

- Fair value is distinct from market value.¹⁸
- The essence of the fair value concept is the desire to be equitable to both parties.
- Fair value recognises the transaction is not in the open market.
- Buyer and seller have been brought together by the operation of a legally binding agreement in a way which excludes other potential buyers and sellers.
- As a result, the buyer has not been able to shop around for the lowest price nor has the seller been able to hold out for a higher price.
- In those circumstances, fair value must as a minimum take into account what the seller gives up, and what the buyer acquires, in value through the transaction.
- The valuer must therefore assess the benefits accruing to both vendor and purchaser from owning the asset (value in use).

I note that *fair value* in this context differs from the meaning of *fair value* for international financial reporting purposes¹⁹, which is regarded to have a meaning similar to that of fair market value.

Fair value and market value

In my opinion, the principal distinction between fair market value and fair value is that:

- Fair market value requires consideration of market (exchange) value as between a hypothetical buyer and seller for a notional or real transaction.
- Fair value, which not limited by the use of the word 'market', requires the valuer to instead assess an equitable value as between an identified buyer and seller for an actual transaction.

This requirement to consider the specific circumstances under fair value, compared to consideration of the market generally under fair market value, can lead to a difference in the fair value and fair market value opined for the same percentage holding.

From this, it follows that whether there will be a difference will depend on the circumstances under which a fair value must be assessed – and in some situations the value opined under both definitions will be the same.

With equity share interests valued under expert determination tending to be of minority interests (less than 75% of the shares held), any differences that arise tend to be in the application of minority discounts to the pro-rata fair market value for 100% of the shares in the company when expressed on a controlling interest basis – often the starting point for the assessment of fair value for a minority interest.

¹⁷ Glover, CJ (1986) Valuation of Unquoted Securities. Page 31.

¹⁸ Glover is a UK text. So, 'market value' can be taken to have a similar meaning to fair market value in NZ.

¹⁹ I.e. IFRS 13: Fair value measurement. Appendix 1: 'The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

These discounts are typically applied to reflect levels of:

- Control – the degree of control the interest confers over the company’s affairs.
- Liquidity – the ease, cost and certainty at which the interest can be converted into cash.

Under fair market value, the valuer will evaluate these factors in the context of a ‘willing buyer and a willing seller’, giving consideration to:

- The size of the interest being valued, including relative to key control thresholds – being 25% (negative control), 50% (normal resolutions), and 75% (special resolutions) of the shares.
- Key existing contractual features including pre-emptive rights, director appointment rights, veto rights in relation to business decisions, and any drag/tag-along rights.
- Any other circumstances relevant to a willing buyer and seller including, for example, the extent of historic dividend payments and the potential market for the shares.

Under fair market value, it is usual for minority discounts to be applied to reflect these factors and the size of these discounts typically increases as the size of the interest decreases.

Under fair value, the above control and liquidity considerations are also likely to be relevant but in the context of achieving an equitable value between an identified buyer and seller for an actual transaction. So, issues specific to those circumstances should be taken into account, such as:

- The basis on which the seller initially acquired their shares. For example, would it be fair to apply a minority discount to shares which were acquired on an undiscounted basis?
- Whether the company be considered to be in the nature of a ‘quasi-partnership’.
- What additional control, if any, is conferred to the identified purchaser(s) of the shares. Will it take them over one of the 25%, 50%, 75% thresholds, for example?
- The intentions of the parties regarding the use of the assets owned by the subject company following the sale of the shares (affecting liquidity).
- Whether the seller is also a departing employee. If so, issues such as their contribution to the business and the terms of their departure may need to be considered.

Evaluation of the specific circumstances may mean the valuer assesses the same discount under fair value as for fair market value – or a different discount, no discount or even a premium may apply.

If there is some agreement between valuers in this area, it is that fair value does not preclude the application of a minority discount. For example, in the Court of Appeal’s decision in Fong v Wong²⁰, the advice of a share valuation expert, Mr Hagen, on applying a minority discount in the context of fair value, was:

‘I am not of the view that the standard of “fair value”, of itself, bars the application of a discount for minority shareholdings. For example, if there were a situation where a shareholder had acquired a minority interest which had a minority discount applied to it then on sale, under the “fair value” standard, it would seem quite reasonable that a minority discount should also apply. Furthermore if the shareholding was a small minority in a widely held company with no unusual rights then I would expect a minority discount to apply.’

²⁰ Fong v Wong (2010) CA46/2010 NZCA 301, at paragraph 16.

I agree with Mr Hagen's view, which also appears consistent with that publicly expressed by the accounting firm PWC.²¹

Selecting an appropriate standard of value for expert determination

In my opinion, where the parties' preference is for the valuation to have specific regard to the proposed transaction, and to the relationship between the parties (based on equitable considerations), fair value would appear to be the preferred standard of value. Where the parties prefer to exclude specific consideration of these factors in the assessment of value, fair market value is more likely to be the appropriate standard.

In addition to the use of fair value and fair market value, the parties also have the option of including their own definitions of value. These may even be referred to in the clause as being 'fair market value' or 'fair value' even when even though they are inconsistent with the generally understood meaning of those terms. The value definition may prescribe a defined formula for assessing value. It may prescribe that no minority discount is applied. It may also set out certain valuation methodologies and assumptions to be adopted.

For several reasons, I believe careful thought should be given to the merits of including a more precise definition beyond simply stating that fair market value or fair value should be adopted.

1. There is a risk that the value definition agreed will no longer be suitable when the expert determination clause is triggered, leading to an inappropriate valuation. Examples include:
 - A value definition which requires the shares to be valued as a 'going concern' when, at the trigger event, the company is no longer economically viable.
 - A value definition which requires the shares to be valued at 'x times earnings' when subsequent company operations mean that will result in substantial under/over valuation.
2. There is the risk that value is defined in a way that is unworkable for the valuer. For example, a clause I have seen calls for value to be assessed '*so that no regard shall be had to the control of the Company, or to any premium for control or discount for lack of control*'. However, it may not be possible to value shares fairly without regard to the issue of control – a share interest will reflect either the existence or the absence of control, there is no middle ground.
3. Parties should be aware that where they depart from the fair value standard (either through the use of fair market value, or some other prescribed definition), the decision of the Court of Appeal in Fong v Wong²² indicates that any specific agreement between the parties on value definition may be overridden should s.149 of the Companies Act 1993 apply. In general terms, s.149 provides that current directors who hold price sensitive, non-public information obtained in their capacity as a director must pay no less than 'fair value' when buying shares in that company and must receive no more than 'fair value' when selling them.

Related to this, an important finding in Peregrine Wines was that the expert's 'fair value' valuation also fixed 'fair value' for the purposes of s149 of the Companies Act. This suggests that unless the expert exceeds their mandate, parties to a fair value expert determination are unlikely to be able to use s149 as a backdoor route to re-litigating a fair value determination.

²¹ PWC. 2012 Company Valuations Masterclass. Concepts of value: fair value and fair market value. Presented by Eric Lucas. at slide 19, states: "PwC view is that discounts can still apply in Fair Value assessments (but value sharing occurring)"

²² Fong v Wong (2010) CA46/2010 NZCA 301

How will the expert be appointed?

In addition to an appropriate standard of value definition, the expert determination clause should also set out the basis on which the expert is to be selected, including who will pay their costs.

A common approach to the expert appointment, as shown in precedent clause (1) above²³, is that the parties should seek to reach appointment on a valuer within an agreed timeframe. Then, if agreement cannot be reached, the parties agree that the valuer will be nominated by a suitable independent party, such as a professional body.

Issues the parties may wish to consider in agreeing expert appointment clauses include:

- Should the expert be independent of the parties?
- Who should be the nominating body if the parties cannot agree on an expert?
- Who should pay the expert's costs?

Independence

The parties will typically prefer the expert to be independent. Aside from the obvious benefit, where the expert is a member of Chartered Accountants Australia and New Zealand (**CAANZ**), the preparation of an independent valuation engagement will require that member to comply with the professional standards of CAANZ, including Advisory Engagement Standard 2 – Independent Business Valuation Engagements (**AES-2**).

The purpose of AES-2 is to establish standards and to provide guidance on the performance of an independent business valuation engagement and the preparation of an independent business valuation report. However, where independence between the business valuer and the appointing party is not asserted, or reasonably assumed by a user of the report, AES-2 does not apply. In other words, there appears to be no requirement for a non-independent valuer (say the company' existing auditor or accounting advisor) to comply with AES-2 should they be appointed as the expert.

Nominating body

Often, expert determination clauses require that where the parties cannot agree on a suitable expert, the expert will instead be nominated by the president of a professional body. However, the parties should ensure that the professional body nominated is willing and able to act in this role. For example, many clauses provide for the CAANZ president to nominate an expert. However, CAANZ ceased offering this service in 2015, and my recent discussions with CAANZ indicated they have no current intention for this service to resume.

Many appointment clauses refer the 'nomination' of the expert by a third party – but what happens if the parties accept the nomination, but one of the parties does not sign up to the letter of engagement appointing the expert? This issue was considered in the long running UK case Cream Holdings & Ors v Stuart Devonport and, in the most recent Appellate decision²⁴, the court resolved this issue by implying a term into the agreement that the parties could not unreasonably refuse to sign the expert's terms of appointment.

²³ (1) If the parties are unable to agree on the value for the shares, the fair value shall be determined by an [independent] valuer either agreed on by the parties or, failing agreement, appointed on the application of either party by a person nominated by the president of [organisation] or his or her nominee.

²⁴ Cream Holdings Limited v Davenport [2011] EWCA Civ 1287.

Legal commentary on this case²⁵ indicates that to avoid a dissident shareholder stymieing the process, the expert determination clause should state that only the company need agree the expert's engagement letter, including on behalf of the shareholders.

Expert's costs

It is preferable if the expert determination clause sets out the basis on which the expert's costs will be met. In my experience, silence on this issue sows fertile ground for subsequent disagreement. Options include for the expert's costs to be met:

- By the company.
- By the shareholders in proportion to their holdings.
- By the shareholders equally.
- By the proposed transferor or transferee alone.
- As decided by the expert.

It is relatively common for this clause to specify the precise basis on which costs will be met, but with the caveat 'unless the expert determines otherwise'. For example, in *Kendall on Determination*²⁶, the accountancy expert precedent clause provides that '*All costs incurred by the Independent Accountant shall be borne by the Vendors and the Purchasers in equal shares unless the Independent Expert determines otherwise*'. In my opinion, it is a sensible approach to allow for the expert to be guided by the parties' wishes regarding costs, but to have the final say.

What will be the form of the determination?

In *Peregrine Wines*, one of the Defendant's (PEL) arguments was that the valuer did not provide adequate reasons to support the valuation in their valuation report. However, this argument failed as the court found that neither the expert determination clauses nor the terms of the valuer's appointment placed any obligation on the valuer to provide reasons.

The court's finding in *Peregrine Wines* is consistent with my understanding of developed United Kingdom law – which is that, absent an express term in the expert determination clause, the expert is not required to give reasons for their decision.²⁷ This is often referred to as a 'non-speaking' decision. In contrast, a 'speaking decision' is one with reasons given for the decision. Typically, a non-speaking decision is in the form of a 'certificate' setting out the instructions and value determined, whereas the latter is a detailed valuation report.

In my experience, most expert determination clauses in New Zealand are silent on whether the expert's decision should be 'speaking' or 'non-speaking'. On that basis, one could expect most decisions given here to be 'non-speaking', however most do tend to be 'speaking' decisions. A speaking valuation also appears to have been the form in *Peregrine Wines*, although the valuer's report was not as detailed as PEL would have liked.

²⁵ The Cream Holdings case on expert determination of fair value. A&L Goodbody. At <http://www.lexology.com/library/detail.aspx?g=cdd31747-0150-45fa-84fe-09af9346da3e>

²⁶ Freedman, C; Farrell, J (2016). *Kendall on Expert Determination* (5th Edition). Page 483.

²⁷ Freedman, C; Farrell, J (2016). *Kendall on Expert Determination* (5th Edition). Page 172.

Important drafting issues for parties to consider in relation to the determination form include:

- In the absence of an express term as to the determination form the valuer may be under no obligation to provide reasons – which may be contrary to the parties’ wishes.
- Whether they wish to be able to challenge the expert’s decision. If so, a speaking decision together with a ‘manifest error’ clause may be the preferred approach.
- For those that wish to simply end the dispute, a non-speaking decision may be the preferred option, because it limits the grounds for challenging the decision.

If the expert determination clauses appropriately set out the matters which must be agreed before the expert determination process can start (those likely to be very difficult to agree once the clause is triggered), the valuer, following their nomination, can then agree with the parties the procedural matters relating to the valuation.

THE EXPERT DETERMINATION PROCEDURE

This final section considers issues relating to the procedure by which the valuation expert undertakes the expert determination. In broad terms, that expert determination procedure, once agreed, will require the valuer to achieve the following three tasks within an agreed timetable:

- Gather the information and explanations they require for the valuation.
- Undertake the valuation procedure in accordance with usual valuation methods.
- Report their decision, either speaking or non-speaking.

Assuming the expert determination clause reflects the issues discussed in the previous section (including whether the expert’s decision will be a speaking or non-speaking), the parties will need to reach agreement in relation to:

- The basis on which the parties will provide, and the valuer will receive, the information and explanations they require to undertake the determination (information gathering).
- The timetable for undertaking the determination.

In my experience, legal and other advisors to the parties play a vital role in helping their clients to agree an expert determination procedure and in assisting them through the agreed process, including in the preparation of expert submissions where applicable.

I will now discuss some common issues relating to both information gathering and timetable.

Information gathering

In general terms, the valuation of unlisted shares for expert determination purposes requires the valuer to gather information and explanations regarding:

- The subject company and its operations (including market research).
- The parties’ own views on value (and/or those of their valuation advisors, if appointed), which may include the basis of valuation, primary valuation drivers and ultimate value.
- Information about the circumstances giving rise to the expert determination (particularly where fair value is the required definition of value).

In addition to information the valuer can obtain from public and commercial sources, further information will generally be available from one or more of the following parties:

- The company that is the subject of the valuation.
- The parties to the expert determination and their advisors.
- Other outside parties (such as legal advisors and other experts appointed by the parties).

The company that is the subject of the valuation

Share valuations (and those prepared for expert determination purposes are no different) generally begin with the valuer forwarding a standard information request for the basic information required for the valuation. This includes documentation such as financial statements, budgets and forecasts, company business and marketing collateral, board papers and business or strategic plans.

Often, the party that will be best placed to provide this standard information is the company itself – so where the company is not a party to the expert determination, it is helpful if the parties can agree with the valuer a mechanism for them to obtain this information directly from the company (acting as an agent for both the seller and purchaser).

That mechanism may simply extend to an agreement for the company to directly provide information and explanations for the valuation, including discussions with management. Beyond that, the parties (and the company) may also wish to consider agreeing that a company representative be appointed to provide any assistance requested by the expert, including both information provision and timetabling matters.

The parties to the expert determination (and their advisors)

The parties to the expert determination, working with their advisors, will wish to provide information they consider relevant to the valuation. Issues to consider include:

- Disclosure of information shared during initial negotiations.
- The form of the information provided.
- How the parties will provide the information to the expert.

Disclosure of information shared during initial negotiations

Expert determination processes typically allow for an initial negotiation period, where the parties seek to agree a value between them before an expert determiner is appointed. During that time information will often be shared, and offer and counter-offers may be made for the shares. If a value cannot be agreed and the issue is referred to expert determination, the parties may wish to consider the extent to which they share this ‘negotiation period’ information with the appointed expert. Although it is for the parties to decide, I believe most valuers would prefer to understand the issues that arose during negotiations, as a further reference point for their determination.

The form of the information provided

Another issue for the parties to consider is whether the expert determination should be undertaken solely ‘on the documents’ (i.e. written submissions only) or whether oral submissions can be also provided. Expert determinations based solely on the documents tend to result in a more cost-effective and efficient process. However, unless the submissions are very comprehensive, there is a risk that the provision of written documentation only will not provide the valuer with a complete factual matrix. For that reason, an approach where written submission is the dominant form of

delivery, but which also allows for the valuer to meet with each of the parties, may be preferable albeit appropriate safeguards will be required to ensure the rules of natural justice are observed.

How the parties will provide the information to the expert

The parties must agree the process by which information will be provided to the expert. The leading UK text *Kendall on Expert Determination* describes precedent procedural directions²⁸ which reflect, in my experience, a relatively established procedural pattern for many expert determinations. To paraphrase, these directions call for the following process to take place within an agreed timetable:

- A starting date for the commencement of the expert determination process is agreed.
- The company, as agent for the parties, provides the basic documents requested by the valuer for their valuation.
- The parties each make a written submission on matters they consider relevant to the determination (**First Submission**), which are then distributed to every other party.
- The parties are then each entitled to make a second submission (**Second Submission**), typically restricted to additional explanations in respect of the other party's First Submission. Each parties' Second Submission is also distributed to every other party.
- To obtain any necessary further information and explanations, the expert can ask the parties to make further submissions, or request a meeting with the parties, either separately or together (however, the parties have no right to call for a meeting).
- During the determination process, should the expert decide it is necessary to take legal advice on the issue to be determined, a firm will be appointed after notifying the parties and obtaining their agreement on fees. Preferably this should be the subject of a written request for an opinion and that, together with the advice received, provided to the parties.

Following that, the precedent in *Kendall* calls for the expert to undertake their valuation and issue the decision. There is a second option at that stage – for the expert to produce a factual memorandum for the parties, setting out their understanding of the 'facts' on which the valuation will be based (the memorandum excludes any valuation evidence). The parties then have the opportunity to provide a final submission on the factual memorandum.

The purpose of the factual memorandum is to ensure that the valuation is, as far as possible, based on the correct factual matrix and, if there are differences in the parties' views on the 'facts', these are fully understood by the valuer. Following receipt of submissions on the memorandum, the valuer then undertakes their valuation work and issues their decision.

Other outside parties

The expert may consider they need to obtain advice from third parties for matters that fall outside their mandate, such as legal advice, or specialist technical expertise. For example, there may be an aspect of the expert determination clause which the expert considers requires legal interpretation, such as clarification of the issue to be determined. The valuer may also consider the valuation of an asset owned by the company (such as real estate, forestry or farming assets) requires the appointment of a specialist valuer, or that specialist industry expertise is required.

The decision in *Peregrine Wines* indicates that the expert is able to seek outside assistance for issues that might be considered to fall within their own mandate, but would be unwise to rely on that

²⁸ Freedman, C; Farrell, J (2016). *Kendall on Expert Determination* (5th Edition). Page 483.

advice without also undertaking their own evaluations. In that case, PEL complained the valuer had incorrectly delegated their authority, as they had sought the advice of a law firm in relation to the application of a minority discount, an issue which would appear to fall within the experts' mandate.

The court rejected this complaint on the facts because the valuer had, albeit with the benefit of having received advice, also arrived independently at the conclusion that a minority discount should not be applied. However, it appears that, had the valuer not also undertaken their own independent assessment, this may have been grounds to over-turn the determination.

Timetable

The expert determination procedure is undertaken under a timetable agreed between the parties. It is helpful if the timetable agreed is realistic enough to enable the parties to prepare their submissions, and the valuer to prepare their opinion. Unfortunately, it is not unusual to see expert determination timetables (especially those specified in expert determination clauses) that simply do not leave enough time to undertake the process. The process should be conducted within an agreed 'reasonable' timeframe, to avoid both unnecessary delay and any time pressures that could compromise the process.

CONCLUSION

This paper has explored some of the practical issues around the use of expert determination to value share interests in unlisted companies. Nearly always, such interests tend to be minority interests between related parties and so their assessment of value is inherently challenging, with debates over value definition, discounts and premiums a common feature.

I have explored a variety of issues with an overriding theme that, in my experience, for unlisted share valuation purposes, effective and workable expert determination clauses and processes tend to be those that keep it simple. They rely on clauses which establish the mandate and a broad framework and allow the parties, working closely with their legal advisors, to agree an effective and efficient expert determination process with an experienced valuation expert.

ABOUT THE AUTHOR

Jay Shaw is a partner at the global accounting firm Grant Thornton and leads their valuation and forensic accounting service line in New Zealand. He has over twenty years accounting experience both in New Zealand and in the United Kingdom across a range of industries, from entrepreneurial private businesses to large listed multinationals.

Much of Jay's work relates to providing expert witness and expert determination services, including business, share and intangible asset valuations, loss of profits, financial investigations and relationship property. He also prepares valuations for commercial purposes including mergers and acquisitions, accounting, taxation, fairness and restructuring purposes.

Jay currently serves on the Business Valuation Board of the International Valuation Standards Council (IVSC), the established global standards setter for the business valuation profession. He is a Chartered Accountant, and has a Bachelor of Management Studies in Accounting (1st class honours) from Waikato University. He is widely published and presents regularly on valuation issues.

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