The best bits by FAR

November 2012

Dear All

Back in July I wrote an article on the work we do assisting third party litigation funders “underwrite” cases brought before them for funding. It seems to me that the very issues that funders now face in looking to decide whether or not to back a case will be the same for litigators considering whether or not to enter a “damages based agreement” with a client post 1 April 2013.

In this newsletter we look at DBAs, outlining the current state of play, before then considering the potential need to get an accountant involved when formulating the terms of a DBA. We also take a look at valuations in the context of matrimonial cases. In our “Numbers in the News” section we reflect on Starbucks’ tax exposure in the UK.

Best wishes,

Greg Lacey, Managing Director

Numbers in the news... Starbucks’ tax affairs!

At the end of October, Reuters issued a report that was picked up by The Guardian newspaper which sought to highlight Starbucks’ failure to pay UK corporation tax. The story suggested that Starbucks had paid just £8.6 million in taxes on a reported £3 billion of UK sales since 1998. Only this week, the chief financial officer of the company, Troy Alstead, faced a (medium) roasting before the public accounts committee – with Google and Amazon also in the dock.

Firstly, whilst it might make a good headline, any comparison of corporation tax paid against turnover is clearly meaningless, as corporation tax is only payable if a company makes profits. In the latest filed accounts to 2 October 2011 Starbucks Coffee Company (UK) Limited made a loss of £32.8 million, of which £25.7 million reflected licensing and royalties. In other words, ignoring royalties, Starbucks in the UK made a loss of £7.1 million. It made a real loss the year before too (£9 million).

I appreciate that the situation is rather more complicated due to other intra-group trading. Most significantly, all its coffee is supplied through a Swiss subsidiary company that charges a generous margin. Of course, the tax rates in Switzerland are famously beneficial (a fact seemingly not lost on Lewis Hamilton).

Nevertheless, and to its credit, last year Starbucks employed 8,763 people in the UK, and it paid £9.86 million in employer’s national insurance. Based on its filed accounts we estimate it also paid at least £15.5 million in other payroll taxes on behalf of its employees and paid probably at least a further £20 million to the exchequer in respect of net VAT. The aggregate tax paid in the UK by Starbucks last year then was probably at least around £45 million. So don’t feel quite so bad whilst sipping on your festive eggnog latte. The position might not be quite as damning as The Guardian suggests!

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DBAs – if it's not the new Bond car, then what exactly is it?

Greg Lacey summarises the new "damages based agreements" that will be available from next April

DBA is the natty acronym for "damages based agreements" – this is the basis on which from 1 April 2013 lawyers will be able to charge a contingent fee for contentious work. It is one of the reforms suggested within the Jackson proposals first published in 2010.

Until now it has always been possible for lawyers to work on a contingent fee basis, where the fee charged is based on a percentage of any settlement figure (rather than the work done by the lawyer), but only in non-contentious cases. An exception to this was in respect of tribunal cases. Lord Justice Jackson's report proposed allowing contingent fee arrangements in contentious cases, including both personal injury cases and commercial dispute cases.

This particular reform comes arm in arm with other proposed reforms dealing with limitations of recoverability of certain costs from an unsuccessful party in litigation, such as ATE policy premiums and excessive CFA uplifts.

The terms outlined by Lord Justice Jackson followed an approach applied to DBAs in Ontario, this provides for base costs (i.e. costs incurred at a standard hourly rate) to be recovered from an unsuccessful opponent. It is then intended that these recovered fees would be offset against the DBA fee, reducing the amount payable by the successful claimant to the shortfall (if any) between recovered costs and the DBA fee.

A working party was convened to look at the issue of DBAs and it reported its recommendations on 25 July 2012.

In summary its conclusions were as follows:

- There should be no cap on the level of a contingency fee that can be charged in commercial cases. If a cap is deemed appropriate for consumer/small business claims it should be set at 50% [Comment - the cap for personal injury cases has been set at 25% of damages];
- Lawyers should not be liable for adverse costs if they act under a DBA [Comment: this retains an important distinction between the position of lawyers acting under a DBA and third party funders funding a case – who are liable for adverse costs];
- Partial DBAs should be permitted [Comment: so you do potentially get your cake and get to eat it too];
- There should be no obligation to notify opposing parties where a lawyer acts under a DBA [Comment: this makes good sense as the DBA would have no effect on an opponent's exposure to costs].

A couple of other important issues relating to DBAs that are probably worth mentioning at this point stem from the potential conflicts/tensions that will arise between the basis on which a lawyer prefers to be engaged on a case and the basis on which clients would prefer their lawyer to act. Whilst Lord Justice Jackson recommended that clients be required to obtain independent legal advice before entering into a DBA, the government has announced that this is not mandatory. It also seems that it will be possible for lawyers to enter into both a DBA and a CFA with their clients, whereby the DBA operates until such time as it becomes apparent a matter might be headed for trial, at which point the CFA kicks in to supersede the terms of the DBA.

Given the potential lucrative returns to be had under DBAs where the claim is significant and there is obvious scope for early settlement, lawyers need to be alive to the risks they run in looking to cherry pick these cases.

For richer, for poorer: the art of business valuation

Phil Southall considers some of the issues facing an accountant when valuing a private company in a matrimonial dispute

When discussing business valuation work with colleagues and contacts, my opening gambit is generally the dictum "valuation is more an art than a science".

This is frequently met with a polite smile. Another fence-sitting accountant leading with caveats and excuses, no doubt!

Nevertheless, this is not simply a representation of my risk-averse nature. Mathematical precision is all but impossible in valuations – and should not really be expected by the parties. This is a consequence of both efficiency and practicality.

Not only would the search for precision be extremely expensive (arising from the time-intensive investigation of financial documentation, analysis of distinguishing features of comparator businesses etc), there is also an inherent uncertainty in almost all valuation exercises, regardless of how much time and money is spent.

For example, most businesses that trade profitably as a "going concern" are valued by reference to their potential to make future profits (most commonly, on either a capitalised earnings or discounted cash flow approach). After all, a potential acquirer of the business will be looking to make a return on his investment from those profits. Whilst past financial performance might provide an *indicator* of future profits, there can be no guarantees. Two separate potential purchasers might quite easily have different perceptions of how the business might evolve, and so might have different ideas as to the worth of the business.

An accountant evaluating the business would normally make an assessment of future financial performance. Under a capitalised earnings approach, this would be manifested in the "multiplier". The multiplier will reflect, amongst other things, the quality of the company's management, its reliance on individual products and customers, and regulatory changes in the industry. Quite often, where there is a competing accountant advising the other party, we disagree on the appropriate multiplier. This is quite natural, and might reflect the different assumptions we have adopted. Of course, it may well be that none of our assumptions will reflect the ultimate reality.

Consequently, in matrimonial cases, the Courts increasingly take the view that valuations cannot properly and fairly be taken as anything other than a guide to a range of future value.

Some of these issues can be illustrated in the case of *Jones -v- Jones*. At the time of the marriage in 1996, H had a business valued at around £2 million. When H and W separated in

2006, the accountants (a jointly instructed accountant from KPMG and one separately instructed by W) both valued the business at around £12 million. However, the business was sold the following year for £25 million (net of expenses and tax). The change in value of the business during the course of marriage proved fundamental to W's entitlement, due to the concepts of marital acquest and non-matrimonial property.

The trial judge commented that, although accountants do their best to put an accurate value on a company applying the hypothesis of a willing buyer and seller, the hypothetical nature of the exercise and its methodology (which can lead to wide differences if components and multiples are varied within a permissible range) means there is uncertainty in the valuation and often a wide range of reasonable figures.

The judge sought to explain the difference in values reached by the accountants (£12 million in 2006) and the subsequent sale (£25 million in 2007), and used the principle of latent potential, which he referred to as the "springboard" effect that should have been implicit in the value of the business at the point of separation.

The Court of Appeal endorsed this principle, and suggested that the underlying value of the business (including both the "springboard" effect and inflationary factors) increased from £9 million at the start of the marriage to £25 million at the end. W was entitled to a 50% share of the increase (i.e. 50% x £16 million = £8 million).

Perhaps not surprisingly, the Court described its own valuations as "highly arbitrary", and some critics have suggested that this was simply fancy footwork to justify an equitable award to W (the ultimate award fell broadly mid-way between the amount offered by H and requested by W).

As an accountant, the Court's conclusions don't sit comfortably with me, and in particular Lord Justice Wilson's statement that:

> *"[A] professional valuation calculated by reference to future maintainable earnings will generally reflect the value of any such spring-board. But there will be rare cases in which a judge may be persuaded that it has failed to do so; and in the present case this court must work on what in my view are clear findings by the judge, not subject to appeal, that at each of two different dates there were spring-boards in place in the husband's company which the respective professional valuations failed to reflect."*

The decision to cast aside the evidence of the accountants seems severe.

I would suggest that that the Court was swayed by the subsequent sales value; it certainly is a truism that the only time that a private company might be valued with any reliability is on arms length sale. As the Court was unable to reconcile that sales value to the accountants' figures, the concept of "springboard" was introduced.

Nevertheless, in my opinion, the application of the "springboard" effect is misleading. Any latent potential should have been reflected in the valuation multipliers. Whilst it is clear that the valuations produced by the accountants were unsatisfactory, this may have been due to the paucity of information available to them. Clearly, the quality of the assumptions adopted by an accountant will depend on the completeness and reliability of the underlying data on which they are based. In *Jones*, for example, neither of the accountants was made aware of the forecasts for H's business, nor the plans for sale. Had the later sale not arisen, no doubt the Court would have happily accepted the accountants' valuation evidence.

This only goes to emphasise the intrinsic difficulties in estimating the value of any business. Judges have repeatedly made the point that the court does not require more than a broad analysis of what assets are available to the parties, and that the parties should not spend a great deal of time and money attempting to obtain a definitive valuation. This echoes with the work we are frequently instructed to perform at FAR Consulting – the preparation of high-level "desktop" valuations. Using our experience and expertise, we are able to quickly and cost-effectively generate a broad assessment of the worth of the business. More often than not, that is sufficient to enable the parties to agree a way forward. Unless Lord Justice Wilson gets his hands on it, that is!

To DBA or not to DBA? That is the question

Simon Paley gives some practical advice to those choosing to dabble in DBAs

In our earlier article on the background to DBAs we referred to the government's decision not to require that independent advice be sought by clients looking to enter into a DBA with their lawyers.

On the basis that lawyers are likely to be better off going to trial under a CFA rather than a DBA, but would be better off acting on a DBA than a CFA where it is likely that a case will settle early – an obvious conflict of interest arises. This conflict becomes more pronounced when the ability to recover costs from a defeated opponent is restricted to base costs – as planned under the Jackson reforms.

To avoid any chance of a negligence claim arising from an allegation that a lawyer advised a client to enter into a DBA where a CFA would be foreseeably better for the client or vice versa, it will be necessary to demonstrate the rationale behind any advice. That advice, given the nature of DBAs, will therefore necessitate consideration and investigation of the likely damages that are expected to be recovered.

In some instances the damages will be self evident – VAT tribunal cases for instance often revolve around a specific amount, such as the VAT withheld etc. However, in commercial loss of profit claims and shareholder disputes, for example, the amount of damages may be less than obvious and indeed may depend on expert accounting evidence.

In order to form a view as to whether a case is suitable for a DBA, and indeed what proportion of damages should be agreed as the contingency fee, and also to get your client's informed approval of this and to demonstrate the agreement reached

is/was appropriate at the time it was entered into, it will be necessary at the outset to obtain a realistic, objective and credible assessment of the value of any claim.

Undertaking these sorts of reviews as part of a scoping exercise is exactly the same exercise we currently undertake for third party funders. This is unsurprising as the third party funders' considerations are exactly the same as the lawyer looking to act on a DBA, but with the added emphasis that the lawyer needs to demonstrate that on entering a DBA it was in the client's best interest.

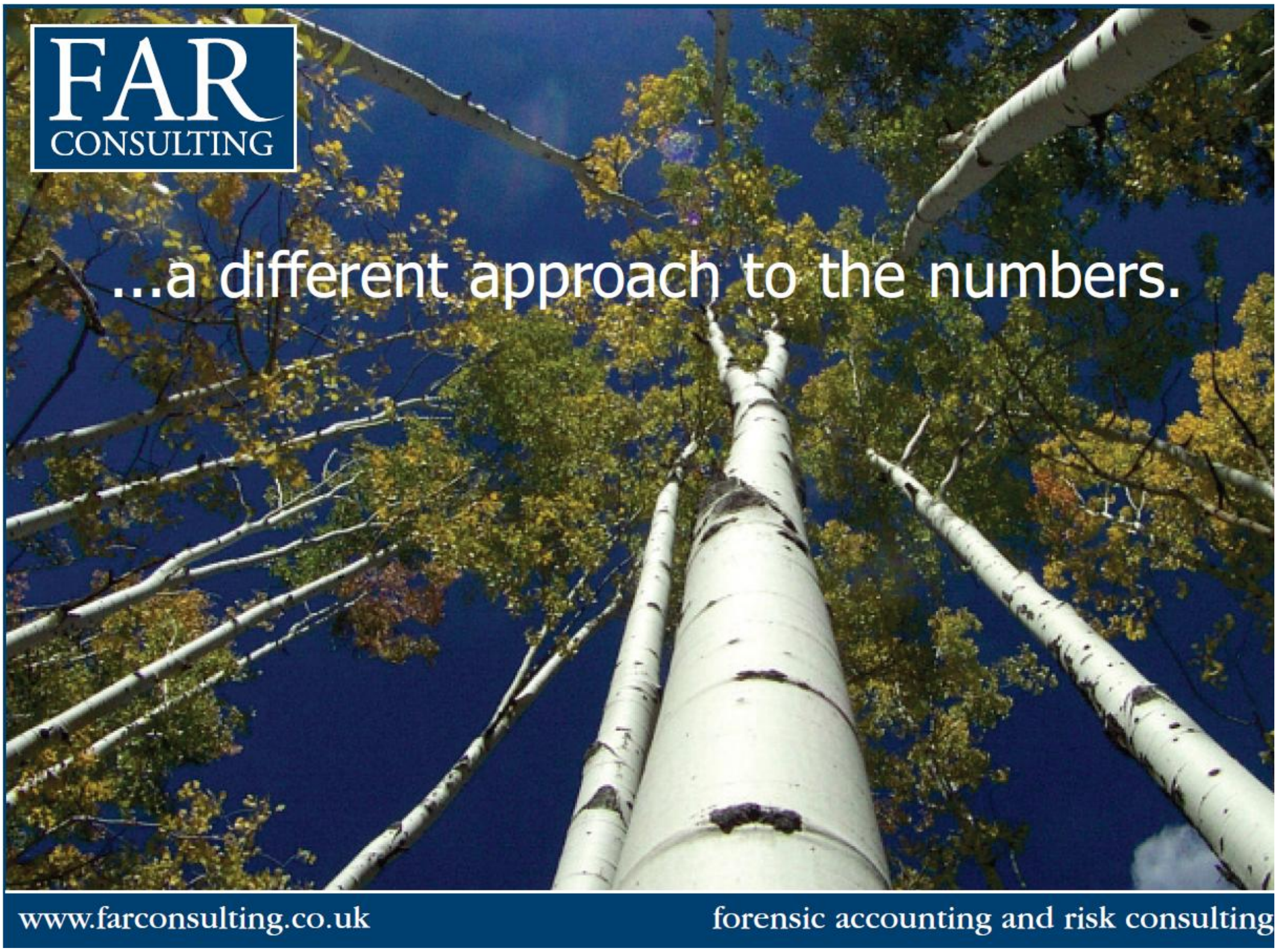
The third party funder/prospective "lawyer acting under a DBA" will chiefly be concerned with the following:

- Is the respondent good for the damages we might be claiming?;
- Does our case have a reasonable chance of success?;
- What are our likely costs to trial and what is the timeframe?; and
- What is the claim "really" worth?

So long as the respondent is good for the money, these remaining elements form the basis of a classic financial decision model – the only other element to factor in is the cost of capital.

To assess whether a claim is worth running on a DBA it is then a matter of looking at the percentage contingency you would need to recover.

Of course, achieving buy-in from your client will depend on getting them to appreciate the realistic value of their claim. If your anticipated costs are (say) £160,000, there may be no point working on a contingency of 20% on a £1 million claim, if it turns out that in fact the claim is only worth £400,000. However, you are unlikely to persuade your client to accept a 40% contingency unless you can produce a realistic, objective and credible assessment that shows that the claim's real value is only £400,000. In circumstances where the value of the claim initially presented by your client appears overstated, you will obviously need to demonstrate why a higher contingency was agreed.



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