

# VALUATION GUIDELINES LAID BY HIGH COURTS

## VALUATION REPORT & MRL

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## **DUNCANS INDUSTRIES LTD. V. STATE OF UP** **(2000) (1 SCC 633) (SC)**

- Valuation is basically question of fact
- Court is normally reluctant to interfere with the finding of fact if :
  - 1) it is based on relevant material on record and
  - 2) Method adopted by the relevant authority for valuation is based on such relevant material.
- Similar view taken by SC in :
  - 1) Balco's Employees Union v. UOI (2002) (2 SCC 333)
  - 2) Anil Kumar Srivastava v. State of UP (2004) (8 SCC 671)
  - 3) G.L Sultania & Another v. SEBI & Another (2007) (5 SCC 133)
  - 4) Ram Kishun v. State of UP (2012) (11 SCC 511)

## CGT V. EXE. & TRUSTEES OF ESTATE OF LATE SHRI AMBALAL SARABHAI (1988) (SUPP SCC 115) (SC)

- Correct principle of valuation applicable to a given case is a question of law.
- Parties can agree upon a principle permissible under and recognised by law.
- If two or more alternative principles are equally valid and available, it might be permissible for parties to agree upon the alternative mode of valuation in preference to another.

## COMMISSIONER OF WEALTH-TAX V. MAHADEO JALAN (1972) (86 ITR 621) (SC)

- The Supreme Court laid down the following principles (and not any hard and fast rule) in valuing the shares
  1. Quoted shares: Based on actual price of the equity shares quoted on a recognized stock exchange.
  2. Unquoted shares of a public company or of a private company: Based on the dividends reflecting the profit-earning capacity on a reasonable commercial basis. But, where they do not, then the amount of yield on that basis will determine the value of the shares. Value can also be based on an intermediate approach for ascertaining the profit earning capacity after eliminating unreasonable expenses etc. and adopting a reasonable proportion of profits.

## COMMISSIONER OF WEALTH-TAX V. MAHADEO JALAN (1972) (86 ITR 621) (SC)...

- 3) Unquoted shares of a private company: Restatement of Extraordinary and disproportionate expenses. Application of an illiquidity discount to the value of such shares.
- 4) Temporary set-back period: Discounting of yield value before set-back by a percentage corresponding to the proportionate fall in the price of quoted shares of companies which have suffered similar reverses.
- 5) Where the company is ripe for winding up or in case of fluctuating and uncertain profits: the break-up value.

## COMMISSIONER OF WEALTH-TAX V. MAHADEO JALAN (1972) (86 ITR 621) (SC)...

6. As in Attorney General of Ceylon v. Mackie (1952) (2 ALL ER 775), valuation by reference to assets would be justified where the fluctuation of profits and uncertainty of conditions at the date of valuation prevented reasonable estimation of prospective profits and dividends.
- To conclude, the yield method is the generally applicable method while the break-up method is the one resorted to in exceptional circumstances or where the company is ripe for liquidation but none the less is one of the methods.

## COMMISSIONER OF GIFT-TAX V. KUSUMBEN D. MAHADEVIA (1980) (122 ITR 38) (SC)

- SC reiterated the principles laid down in Mahadeo Jalan's case and held that if the company is a going concern, then only yield method is appropriate method and break-up method cannot be adopted to determine value of unquoted equity shares.
- Revenue's plea of adopting mean of the values arrived at by applying the break-up method and the profit earning method rejected.
- In fact, Adamson has criticized this combination of the two methods as unscientific in his book on "The Valuation of Company Shares and Businesses", (fourth edition) at page 55, where he has said:

## COMMISSIONER OF GIFT-TAX V. KUSUMBEN D. MAHADEVIA (1980) (122 ITR 38) (SC).....

- “The mere averaging of two results obtained by quite different bases of approach can hardly be said to represent any logical approach, whatever its merit as a compromise. Despite its evident popularity in many quarters, it has not been given judicial recognition in decisions involving the fixation of a value by the Court.”
- All the above cases were pronounced at a time when no valuation rules were prescribed under the Wealth Tax Act, 1957 and the Gift Tax Act, 1958.



## APEX INVESTMENTS PRIVATE LIMITED (1992) (47 DLT 456) (DELHI HC)

- High Court relied on *Mahadev Jalan*
- Also observed - *“An arrangement for reconstruction or amalgamation of a company is essentially in the nature of a contract. What should be the terms and conditions of the contract has to be left for consideration by the concerned parties from a business point of view in a commercial sense. The adequacy of consideration for making the agreement is also for them to decide. The courts will not make bargains for the parties. Except in a case of fraud or prejudice to public interest, if the proposed terms of the arrangement are acceptable to the concerned parties, for considering grant of sanction of the scheme under section 391 of the Act the court will not interfere with it.”*

## **BHARAT HARI SINGHANIA V. COMMISSIONER OF WEALTH-TAX (1994) (207 ITR 1) (SC)**

- SC held that this case is in respect of years when rules for valuation of shares were prescribed under WT Rules.
- Judgement in Mahadeo Jalan, though it was rendered in context of wealth tax, dealt with assessment years when no rules were prescribed under WT Act or Rules for determination of value of shares.
- For the relevant years under consideration, WT Rules prescribed break-up value method for valuation of shares under Rule 1D. Hence, it was held that Rules are mandatory, and therefore, unquoted equity shares have to be valued by break-up value method.

## HINDUSTAN LEVER EMPLOYEES UNION V. HINDUSTAN LEVER LTD AND OTHERS (1995) (83 COMP CASE 30) SC

- Facts - Tata Oil Mills Co. Ltd. ("TOMCO") was merged into Hindustan Lever Ltd. ("HLL"), a subsidiary of Unilever ("UL"), a London based multinational company.
- Method adopted - The valuation of the shares for exchange ratio was determined by combining three well-known methods –
  - 1) the net worth method
  - 2) the market value method
  - 3) the earnings method.

## HINDUSTAN LEVER EMPLOYEES UNION V. HINDUSTAN LEVER LTD AND OTHERS (1995) (83 COMP CASE 30) SC...

### ○ Principles:

- 1) Jurisdiction of the Court in sanctioning a scheme of merger is not to ascertain with mathematical accuracy if the determination satisfied the arithmetic test.
- 2) A company court does not exercise an appellate jurisdiction. It exercises a jurisdiction founded on fairness.
- 3) It is not required to interfere only because the figure arrived at by the valuer was not as better as it would have been if another method would have been adopted.

## HINDUSTAN LEVER EMPLOYEES UNION V. HINDUSTAN LEVER LTD AND OTHERS (1995) (83 COMP CASE 30) SC...

- 4) What is imperative is that such determination should not have been contrary to law and that it was not unfair to the shareholders of the company which was being merged.
- 5) Court's obligation is to be satisfied that valuation was in accordance with law and it was carried out by an independent body.
- 6) Since 95% of the shareholders who are the best judges of their interest and are better conversant with market trend agreed to the valuation determined, the court declined to interfere with the same.
- 7) .

## **HINDUSTAN LEVER EMPLOYEES UNION V. HINDUSTAN LEVER LTD AND OTHERS (1995) (83 COMPCASE 30) SC)...**

- 7) In case of amalgamation, a combination of all or some of the methods of valuation may be adopted for the purpose of fixation of the exchange ratio of the shares of the two companies
- 8) It is to be noted that even in such a situation, the book value method has been described as "more of talking point than a matter of substance".
- 9) Therefore, net assets may be given relatively lower weight while arriving at a weighted average.

## MIHEER H. MAFATLAL V. MAFATLAL INDUSTRIES LTD. (1997) (1 SCC 579) (SC)

### ○ Facts –

- 1) Mafatlal Fine Spinning Industries Limited ('MFL') was proposed to be amalgamated with Mafatlal Industries Limited ('MIL').
- 2) Mr. Miheer Mafatlal ('MM') was the director of MFL and also a Shareholder of MIL.
- 3) MM did not object and approved the resolution for mergers as Director of MFL, but objected as a Shareholder of MIL
- 4) Therefore, Bombay HC approved the Scheme in case of MFL
- 5) Gujarat HC after rejecting the objections by MM, approved the Scheme.
- 6) SC upheld the Gujarat High Court Decision

## MIHEER H. MAFATLAL V. MAFATLAL INDUSTRIES LTD. (1997) (1 SCC 579) (SC)...

- Held:
- It is not for the Court to substitute its exchange ratio, when :
  - 1) the exchange ratio of the shares of the transferee-company to be allotted to the holders of shares in the transferor company has been worked out by a recognised firm of CA's who are experts in the field of valuation.
  - 2) No mistake can be pointed out in the said valuation.
  - 3) Same has been accepted without demur by the overwhelming majority of the shareholders of the two companies



## MIHEER H. MAFATLAL V. MAFATLAL INDUSTRIES LTD. (1997) (1 SCC 579) (SC)...

- The High Court in sanctioning any scheme of merger or amalgamation has no jurisdiction to act as a court of appeal and sit in judgment over the informed view of the concerned parties to the compromise, as the same would be in the realm of corporate and commercial wisdom of the concerned parties.
- Court has neither the expertise nor the jurisdiction to delve deep into the commercial wisdom exercised by the creditors and members of the company who have ratified the scheme of merger by the requisite majority.
- Consequently, the company court's jurisdiction to that extent is peripheral and supervisory and not appellate.

## MIHEER H. MAFATLAL V. MAFATLAL INDUSTRIES LTD. (1997) (1 SCC 579) (SC)...

- The Supreme Court further held that valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy.
- Pennington in his 'Principles for Company Law' mentions four factors which had to be kept in mind in the valuation of shares:
  - 1) Capital Cover,
  - 2) Yield
  - 3) Earning Capacity, and
  - 4) Marketability

## MIHEER H. MAFATLAL V. MAFATLAL INDUSTRIES LTD. (1997) (1 SCC 579) (SC)...

- For arriving at the fair value of share, three well known methods are applied :
  - 1) Manageable profit basis method (the Earning Per Share Method)
  - 2) Net worth method or the break value method,
  - 3) Market value method.
- The Supreme Court concluded that the exchange ratio was not unfair or unreasonable. It quoted and affirmed ratios of the decisions in Hindustan Lever Employees' Union and CWT vs. Mahadeo Jalan.
- The Supreme Court also referred to Weinberg and Blank's "Takeovers and Mergers" for factors to be considered in determining exchange ratio.

## FACTORS TO BE TAKEN INTO ACCOUNT IN DETERMINING THE FINAL SHARE EXCHANGE RATIO

- Take-overs and Mergers- *by Weinberg and Blank:*
  - 1) The Stock Exchange prices of the shares of the two companies before the commencement of negotiations or the announcement of the bid.
  - 2) The dividends presently paid on the shares of the two companies. It is often difficult to induce a shareholder, particularly an institution, to agree to a merger or a share-for-share bid if it involves a reduction in his dividend income.
  - 3) The relative growth prospects of the two companies.

## FACTORS TO BE TAKEN INTO ACCOUNT IN DETERMINING THE FINAL SHARE EXCHANGE RATIO...

- 4) The cover (ratio of after-tax earnings to dividends paid during the year) for the present dividends of the two companies. The fact that the dividend of one company is better covered than that of the other is a factor which will have to be compensated for at least to some extent.
- 5) In the case of equity shares, the relative gearing of the shares of the two companies. The 'gearing' of an ordinary share is the ratio of borrowings to the equity capital.
- 6) The values of the net assets of the two companies. Where the transaction is a thorough-going merger, this may be mere of a talking-point-than a matter of substance, since what is relevant is the relative values of the two undertakings as going concerns.

## FACTORS TO BE TAKEN INTO ACCOUNT IN DETERMINING THE FINAL SHARE EXCHANGE RATIO...

- 7) The voting strength in the merged enterprise of the shareholders of the two companies.
  - 8) The past history of the prices of the shares of the two companies.
- Combination of all or some of the methods of valuation may be adopted for the purpose of fixation of the exchange ratio of the shares of the two companies.
  - Book value method has been described as “more of a talking-point than a matter of substance.”

**BROOKE BOND LIPTON INDIA LTD**  
*(1999) (98 COMP CAS 496) (CAL.)*

- In a Scheme of amalgamation, if the ratio of exchange has been fixed by an experienced and reputed firm of chartered accountants, then in absence of any charge of fraud against them, court will accept such valuation and ratio of exchange.
- A mere allegation of fraud is not enough, it must be a proper charge of fraud with full particulars.
- No charge made or established in instant case

**DINESH VRAJLAL LAKHANI V. PARKE DAVIS (INDIA) LTD.  
(2005) (124 COMP CAS 728) (BOM.)**

- Court will not interfere only because the valuation adopted by the valuer may have been improved upon had another method been adopted.
- Court is neither a valuer nor an Appellate forum to re-appreciate the merits of the valuation
- Court has to ensure that the determination should not be contrary to law or unfair to the shareholders of the company which has been merged.



## ARUN KUMAR AGARWAL V. COFFEE LANDS LIMITED (1999) (97 COMPCASE 380) (KAR.)

### ○ Facts:

- 1) Three companies carrying on similar business were proposed to be amalgamated.
- 2) One of the shareholders of the transferee company objected the proposed ratio of allotment of shares and raised allegation on the Valuer.
- 3) Further, the Regional Director had raised objection that as a result of merger, the subsidiary company will be holding shares in the holding company which will result in violation of Section 42 of the Companies Act, 1956.

**ARUN KUMAR AGARWAL V. COFFEE LANDS LIMITED  
(1999) (97 COMPCASE 380) (KAR.)...**

○ Held:

- 1) It is best to entrust the simple job such as doing a calculation and evaluation of value of shares to the firms who are most familiar with the working and all other relevant facts of the companies concerned rather than to outsiders who would have to start from scratch.
- 2) Thus the Court held that there is no infirmity as far as 1<sup>st</sup> issue is concerned.

**ARUN KUMAR AGARWAL V. COFFEE LANDS LIMITED  
(1999) (97 COMPCASE 380) (KAR.)...**

- 3) Section 42 of the Companies Act, 1956 prohibits the holding of shares by a subsidiary company in its holding company. This issue was considered by Delhi High Court in case of Himachal Telematics Ltd and Himachal Futuristic Communication Ltd (1996) (86 Comp Case 325 ) wherein it was held that such an objection was inconsequential while considering a scheme of amalgamation.
- 4) The provisions that govern the scheme of amalgamation are independent provisions and that they are not limited by what is contained in Section 42 of the Companies Act in the matter of sanction of the Scheme of Amalgamation.

## **SUMITRA PHARMACEUTICALS AND CHEMICALS LTD.** *(1997) (88 COMP CAS 619) (AP)*

### ○ Facts:

- 1) The bulk drug division of the petitioner company was proposed to be transferred and merged with Nicholas Piramal India Limited.
- 2) Central Government raised an objection that the appointed date is April 1, 1995 and the valuation date is August 31, 1995.
- 3) ROC raised an objection that a separate application should be made u/s. 100 of the Companies Act, 1956 for reduction in share capital and that the same cannot be a part of the Scheme of Arrangement.

**SUMITRA PHARMACEUTICALS AND CHEMICALS LTD.**  
*(1997) (88 COMP CAS 619) (AP)...*

Held:

- That appointed date of implementation of scheme can be different from date of valuation.
- That separate application for reduction of capital is not required as long as Section 391(1)(a) substantially complied with and liabilities are also taken over by the Company.

## **CIT v. MOTHERSON AUTO P. LTD** **(2015) (ITA No. 178/2001) (DELHI)**

- Issue:

Whether sum of money received by the Company on account of goodwill from its collaborator is exigible to tax.

- Held:

- There was sufficient basis for valuation of goodwill and the valuation cannot be held to be unreasonable or untenable in law and therefore the amount was not exigible to tax.
- Assessee enjoyed monopoly in respect of the product manufactured, the continuous functioning, had large volume of orders at hand when the collaboration took place and;
- Relied upon the decision in case of CIT v. B.C. Shrinivasa Setty (1981) (128 ITR 294) (SC)

## **DR. MRS. RENUKA DATLA V. SOLVAY PHARMACEUTICALS B.V. & ORS. (2003) (265 ITR 435) (SC)**

- Facts:
- In terms of a settlement, shares held by petitioners in 2 companies were to be purchased by Solvay and Mr. Vasant Kumar.
- Mr. Y.H Malegam, CA had to evaluate intrinsic worth of both the companies as going concerns and value the shares held by the Petitioners.
- Standard and generally accepted method of valuation had to be applied.
- Such valuation was final and binding on all parties to the settlement

## **DR. MRS. RENUKA DATLA V. SOLVAY PHARMACEUTICALS B.V. & ORS. (2003) (265 ITR 435) (SC) ....**

- Valuer considered 3 methods –  
Asset base, earning based, market based
- DCF was not applied in absence of any independent projections and the projections provided by parties substantially differing.
- Held:
- If the valuer applied the standard method of valuation, considered the matter from all appropriate angles without taking into account any irrelevant material or eschewing from consideration any relevant material, his valuation could not be challenged on the ground of its being vitiated by fundamental error.



## **DR. MRS. RENUKA DATLA V. SOLVAY PHARMACEUTICALS B.V. & ORS. (2003) (265 ITR 435) (SC) ....**

- The court sounded a note of caution observing that valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy.
- Even when finality attaches to the decision of the valuer, the court could still interfere if the valuation was made on a fundamentally erroneous basis, or a patent mistake had been committed by the valuer, or that the valuation was vitiated by a demonstrably wrong approach or a fundamental error going to the root of the valuation.
- In respect of projections, the valuer has chosen best possible method by capitalising past earnings and also considering maintainable profits.

## **G.L. SULTANIA AND ANOTHER V. SEBI AND OTHERS (2007) (5 SC 133) (SC)**

- The issue in the instant case was on valuation of shares by SEBI under the ‘Takeover Code’.
- Offer for takeover of Hindustan National Glass and Industries Ltd. by ACE Glass Containers Ltd and C.K. Somany.
- The petitioner argued that there was an under valuation of shares and the principles laid down by Hindustan Lever’s case did not apply to the facts of the case.

**G.L. SULTANIA AND ANOTHER V. SEBI AND OTHERS**  
**(2007) (5 SC 133) (SC)...**

- The court held that unless it is shown to the court that some well accepted principles of valuation has been departed from without any reason, or that the approach, adopted is patently erroneous or that relevant factors have not been considered by the valuer or that the valuation was made on a fundamentally erroneous basis or that the valuer adopted a demonstrably wrong approach or a fundamental error going to the root of the matter the court cannot interfere with the valuation of an expert.

## **BLUE STAR LIMITED, PETITIONER (2000) (1 CLC 682) (BOM.)**

- Facts:
- International software division (ISD) of BSL was transferred to BSIL. BSIL was a dormant Company and with the acquisition of ISD pursuant to scheme. BSL was to become active.
- The scheme provided for transfer of willing employees of ISD division to BSL.
- The employee shareholders/ creditors holding 3% shares raised an objection.

## BLUE STAR LIMITED, PETITIONER (2000) (1 CLC 682) (BOM.)....

- The court made the following observations and held as follows:
- It is true that the transfer of shares by one company to another company is primarily determined by the shareholders and therefore if the 99% of them are of the view that the valuation of shares are reasonable and fair, then the court should be slow to interfere with it.
- With regard to valuation again SC has held that there is no reason to presume that the shareholders did not know what they are doing. Principles in Hindustan Lever's case relevant

## WHO CAN CHALLENGE VALUATION ?

- Generally, shareholder's and creditor's approvals not interfered with by courts, in the absence of fraud or malafides and the Scheme being not oppressive of minority and the principles of valuation on proper material and justifiable assumptions followed.
  - Navjivan Mills Co. Ltd and Kohinoor Mills Co. *Ltd (1972) (42 Comp Cas 265) (Guj)*
  - Sumitra Pharmaceuticals and Chemicals Ltd., *(1997) (82 Comp Cas 619) (AP)*
  - Anup Kumar Sheth v. RIL *(2010) (154 Comp Cas 278) (Bom.)*
  - German Remedies Limited *(2005) (125 Comp Cas 615) (Bom.)*

## WHO CAN CHALLENGE VALUATION ? .....

- Minority Shareholders- if scheme or exchange ratio unfair
- Creditors- if scheme unfair to them
- Central Government – if scheme against public interest or contrary to law
- MCA General Circular no. 53 dated 26-07-2011 requires all RD/ ROC's representing CG to file written statement of objections to the HC, as to :
  - Whether valuation report submitted and ratio as per GAAP
  - Where foreign entity involved, permission from regulatory authority obtained
  - Whether compliance of FEMA/ RBI guidelines done
  - Whether Scheme circumvents law

## WHO CAN CHALLENGE VALUATION ?....

- Income-tax Department - If any tax fraud or illegality involved
- SEBI – No right to be heard in the petition and no right to appeal against the order of the company court. SEBI's role as Regulator- either accept the valuation or reject the valuation and not required to pass reasoned orders.



## INTERNATIONAL COURTS – JUDICIAL REVIEW

- Courts reluctant to interfere with expert valuation
- Valuation being contract/ agreement between parties, if they agree on mode of valuation, it cannot be disturbed.
- Bad faith or fraud, bias or other impropriety affecting fundamental fairness of the appraisal must be demonstrated.
- Error or difference in professional judgement not enough.
- For e.g. see – *Singer & Fridelander Ltd. v. John D. Wood & Co.* (1977) (2 EGLR 84)

## MANAGEMENT REPRESENTATION LETTER (MRL)

- MRL is an important piece of documentation
- The Valuer takes representation from the management regarding information that the client's management provides to the Valuer for the valuation assignment
- Information provided through all modes of communication, including oral communication should be included in MRL.
- The content of the MRL depends on the nature and terms of the engagement and should be modified appropriately according to the requirements of the engagement.
- MRL is signed by a senior member of the management responsible for providing information to carry out the valuation.
- It is a good practice to issue the signed report only upon receipt of a signed MRL.

## MANAGEMENT REPRESENTATION LETTER (MRL)...

- MRL may be standard in most cases.
- One has to be careful not to miss out on certain common points like details of the historical, current and projected financial information, interest rates, details of surplus assets and contingent liabilities, details of accumulated losses, tax computations, and explanation provided on certain key assumptions in the financial model such as on strategic or expansion plans, documents, records and information.
- The management may also represent that it is not aware of any material misstatement of any fact or any other information that should be disclosed in the course of the valuation.
- The MRL serves to avoid any misunderstanding or misrepresentation and also protects the Valuer in case the valuation is challenged at a later stage by any party.

## VALUATION REPORT

- The form of the valuation report will depend upon the nature of engagement, its purpose, its findings and the needs of the decision-makers who receive and rely upon it.
- Reports should be carefully prepared, to communicate the results and identify the information relied upon in the valuation process.
- The report should effectively communicate the methods considered and approaches used along with the reasoning for using a particular approach, as well as present the supporting documentation in a simple and concise manner.

## VALUATION REPORT...

- The Valuer should indicate in the valuation report the restrictions on the use of the report (which may include restrictions on the users of the report, the uses of the report by such users, or both).
- The report should cover the standard of value such as Fair Market Value, Fair Value, Investment Value or Intrinsic Value; and the valuation premise such as liquidation or going concern.
- The type of report issued by the Valuer depends on various factors such as the type and purpose of engagement, the level of reporting detail agreed to between the two parties and users of the report.

## VALUATION REPORT...

- For instance, a report prepared under a governing law or regulation, would detail the relevant portions of the accounting standard or law under which the valuation has been carried out, along with its applicability in the engagement.
- A detailed report for other engagements includes the following:
  - 1) Introduction to the business being valued, analysis of the subject entity and related non-financial information;
  - 2) Analysis of the industry to which the entity belongs;
  - 3) Financial statement/information analysis;
  - 4) Date of valuation;

## VALUATION REPORT...

- 5) Valuation approaches and methods considered and used;
- 6) Sensitivity analysis or scenario analysis if relevant;
- 7) Conclusion of value;
- 8) Caveats and scope limitations or exclusions;
- 9) Appendices.

THANK YOU