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The shipping dispute cycle

Mark Taylor, Partner, Forensic and Investigation Services, UK, looks at the impact of the economic downturn on the shipping sector.

In the Mazars 2011 Litigation and Arbitration survey, we identified that the forecasted increase in disputes resulting from the economic downturn was yet to be seen. However, we noted that the shipping sector was behaving much more as one would expect. This global sector is apparently a copy book example of how the economic downturn manifests itself in worldwide disputes and I set out below my recent experiences of disputes in the shipping sector.

I first noticed an uptick in shipping disputes when it became apparent that there was a shortfall of cargoes on the US East Coast and I was appointed on a breach of contract matter. This was in relation to an eight year contract of affreightment (CoA) that was breached as the charterer no longer had cargoes to ship. With four years of the CoA left to run, the ship owner had suffered a significant loss of profits, and my assessment required detailed modelling of future incomes and costs, including forming a view on more unpredictable variables such as bunkering costs and demurrage. Mitigation was also a key consideration given the surplus of vessels available, but ultimately the doctrine of the lost volume seller prevailed.

As cargo availability dropped, so too did the demand for vessels. Consequently, charter rates plummeted. The first evidence I personally saw of this was breached long term charterparties. I am currently acting on one such dispute where the charterer refused to accept a vessel at the commencement of a seven year charter at a charter hire rate agreed at the peak of the market. The Turkish vessel owner was only able to achieve a market rate following the collapse of charter rates – a fall of about 40% which resulted in considerable loss of profits. As well as there being a dispute about the future market rates, I am also required to consider what an appropriate discount rate would be as damages are to be awarded before the end of the original charter term. Significant sums are at stake and such disputes are commonplace. As an aside, I note that specialty vessels are still very much in demand, with one of my cases being concerned about the lack of availability of specialist utility vessels and the delays caused when such vessels are not available.

The next category of disputes in which I have seen increases are shipbuilding disputes. It was indeed wholly predictable that a severe economic downturn would result in fewer new-builds. I am currently acting on a breach of contract dispute where a ship owner breached four shipbuilding contracts, each for an ultra-large container carrier, resulting in the shipbuilder facing a significant loss of profits. The impact of such a breach is far reaching and when I visited the shipyard in Asia it was quickly apparent how this breach, caused by a lack of demand by a European buyer, was having a major impact in the area, with huge workforces and entire communities affected.

In times of economic pressure profits must be found somewhere. Regrettably, some individuals will inevitably turn to pushing, and even crossing, boundaries to show a profit, resulting in allegations of manipulation, misrepresentation and fraud. In the shipping sector, the numbers tend to be big and frauds can be seriously damaging. As an example, in the mid 2000s, I was the expert for Abu Dhabi Investment Company in the case against ADX Shipping where it was found that ADX Shipping had fraudulently misrepresented a number of facts about its vessels when setting up a liner joint venture with ADIC, resulting in losses in the order of $100 million. Fraud cases are apparently again in the ascendancy, of which I have first hand experience with a new matter developing in Singapore.

Fraud isn’t the only way to push boundaries. I have recently acted on a case where shortcuts and recklessness were probably the cause of a commodity trader/shipper delivering an off-specification product to a petrochemical plant, resulting in near catastrophe and significant losses.

Ultimately, owners of shipping companies are seeing a fall in the value of their companies. In a recent dispute between shareholders in the USA and Scandinavia, it became apparent that there was a massive value expectation gap between the selling shareholders’ previous positive outlook and the current gloomy economic forecast which could not be bridged between the parties. Expert advice and an expert determination were required to resolve the parties’ differences, resulting in a much lower valuation than the selling shareholders had hoped for.

What now remains to be seen is whether this apparently predictable cycle of disputes on a global basis is reflected in other sectors.
The value of matrimony?

Nick Baker, Matrimonial Forensic and Investigation Services, UK and Nazreen Pandor, Senior Consultant, Forensic and Investigation Services, South Africa consider recent developments in matrimonial disputes.

Recent developments
Recent developments in UK case law have led to significant changes in the way that assets are divided between the separating parties in divorce cases. Courts are looking to achieve a fair solution in divorce settlements by recognising the specific contribution that both parties have made to the marriage over its term. In the landmark case of White v White (2000), a partnership model (divided fairly) rather than a needs model (determining the individual needs of the parties) was used and Mrs White received 40% of the family assets. This ultimately resulted in the sale of the family-run farm. Previously, the Court would not have ordered the disposal of a business. This case marked the most fundamental change in relevant laws since the 1970s.

Further significant cases have followed, including McFarlane v McFarlane (2006), in which the House of Lords ruled that the settlement should not just reflect the wife’s needs but should also, in certain circumstances, compensate her for her future losses. The recent case of Jones v Jones has provided an extra dimension in terms of the way that a party’s pre-marital or inherited assets are treated. In particular, the change in value of a party’s business interests over the course of the marriage must now be considered. This requires an understanding of the latent potential value (that is the potential worth of the business interests at the date of marriage, rather than its current value) and how this value may have changed over time. The legal landscape is demanding a much more precise and valuation focussed approach, rather than simply seeking to work out what one party’s needs are. Processes and considerations that are commonplace in other contentious valuations are now demanded in this sector. For example, the extent to which the historic profitability of the business has been affected by “one-off” income and expenses or by unusually high levels of management remuneration must be considered as well as whether the lack of recent valuations may require a restatement of net assets.

Valuations of businesses
Historically, our matrimonial valuation instructions only required us to conduct “overview” business valuations and focus on the calculation of a spouse’s reasonable needs (using the Duxbury model). We are now more frequently instructed to identify the financial resources of both parties and to consider, for example, the latent potential value of a business at the date of marriage and how this value may have changed over time. The legal landscape is demanding a much more precise and valuation focussed approach, rather than simply seeking to work out what one party’s needs are. Processes and considerations that are commonplace in other contentious valuations are now demanded in this sector. For example, the extent to which on whether the individual’s lifestyle is representative of their declared income; the changes arising from the landmark cases outlined above have also led to a change in the nature of our work.

Extracting funds from the business
Recent cases have shown that the Courts are now more willing than ever to make settlements which result in the disposal of part or all of the businesses concerned. Accordingly, we are increasingly asked to provide opinions as to how funds may be secured to effect settlements without jeopardising the ongoing viability of the primary businesses owned by one or more of the parties.

The international perspective
This change in focus regarding matrimonial forensics is not just manifesting itself in the UK. Our South African Forensic and Investigation Services team has worked on a number of high-profile cases where assets were concealed pending divorce actions. Over the last two years, with the recession affecting increasing numbers of people, reports indicate there has been a rise in senior-level executives heading to Court to argue they have been hit by the credit crunch and cannot afford a large-scale divorce settlement. Those who are already divorced are trying to obtain reductions in previously agreed maintenance orders. Whilst this may be true, there is increasing suspicion that some spouses are intentionally hiding their assets in order to protect them from forming part of the divorce settlement. The Mazars team have found that a wide variety of tactics are being used, including moving assets into trusts; undervaluing assets; not reporting cash transactions; purchasing assets under someone else’s name and delaying income until after the divorce.

Changes in working practice
While we are still regularly called upon to conduct the more “traditional” aspects of matrimonial forensic work, such as:
• assessing each party’s assets – this can include ascertaining whether or not former spouses have disclosed all assets in their financial statement, or in certain circumstances, whether they have laundered money or hidden income;
• investigating the true ownership of assets (for example, trusts or shares in overseas companies) that one party may be seeking to disguise; or
• assessing the income and outgoings of both parties and, where appropriate, commenting

Case Study – extracting funds from a business
We were instructed – on behalf of the wife – to value the share capital of a UK-based transport company for use in achieving a matrimonial settlement.

The key element of the assignment was the valuation of the company in light of a recent downturn in its financial performance. This involved considering the liquidity, borrowing capacity and future income streams that could be derived by the company. We identified that the company had significant security (such as property and machinery) upon which borrowings could be secured.

Our work was largely based on projections and consideration of future prospects rather than a more simple historic revenue calculation. This is becoming the norm following the White v White case (prior to which many valuations were a much “broader brush”).

Our valuation was accepted by both parties and was used by the Court in determining the settlement value.

Summary
Recent case law has shown that family businesses are no longer automatically protected in divorce proceedings and that, in some cases, the value of a business at the date of marriage is as relevant to the final settlement as the value of that same business at the present time. A more detailed valuation approach is required, bringing matrimonial valuations in line with our standard approach to contentious valuation assignments.
Fraud alarm

Pavla Hladká, Director, Forensic and Investigation

Pavla Hladká considers whether fraud is rife because, unlike fire, there is no smoke to announce its presence.

Every company has multiple levels of controls to protect against, detect and recover from fire. Electrical appliance checks help prevent fires from starting; fire doors help prevent the spread of fire; smoke and heat detectors help detect fires; sprinklers and extinguishers help fight fires; and fire safes and insurance help recovery from fire. All of these measures cost significant sums, yet the absolute risk of fire is low. Of course, much of this is in place to save lives, but similar protection, detection and recovery options are available for tackling fraud – there just does not seem to be the corporate will to protect against what is a rife and costly fact of being in business.

Fraud is not a killer, but its impact can be devastating and the resulting shockwave hits many employees, families, suppliers, clients and even the market. As recent corporate incidents have shown, financial losses arising from fraudulent activity may lead to layoffs, plant closures or even business failures. Companies which survive a fraudulent event may still miss key business opportunities. The misappropriated capital might otherwise have been used to build new facilities, create employment or develop better products and services.

Companies appear reticent to spend a lot of resources, both physical and financial, on proactive fraud investigations. While companies are willing to spend money on fire insurance in the hope there will never be a fire, they appear to question the value of fraud controls, possibly because they are unaware of any such problems in the past.

Any Australian or Californian will know that a long, hot and dry summer increases the risk of a bush or forest fire. In terms of fraud, the current economic climate is equivalent to the summer of 2008 in California. The risk of fraud in organisations has dramatically increased in recent times due to the global financial crisis. Striving to achieve set goals and meet financial key performance indicators, companies may resort to dishonest practices – most often in the form of “creative accounting” and financial statement misrepresentations to report, for example, higher sales or better financial results.

Fraud investigations indicate that fraudulent behaviour particularly occurs in organisations when:

- There are no controls in place or controls are weak and inadequate;
- Employees are hired without previous checks on their honesty and integrity (pre-employment screening);
- Employees are inadequately managed or are pressured to achieve set financial goals;
- Employees who are trusted by the management have unresolved personal issues, especially of a financial nature, or suffer from an addiction to alcohol, drugs or gambling;
- The industry in which the organisation operates is naturally susceptible to corruption or corruption is common within it; or
- The organisation is experiencing problems – facing financial trouble, losing its market share, its services or products are becoming unsellable.

The reason for such actions may be due to a perceived need to present “improved” financial statements to shareholders, parent companies, banks, creditors and other key stakeholders. However, fraud of a similar nature can also be committed for a more focused gain – for example, certain components of employee compensation are frequently tied to the achievement of specific goals, and the employee may look for ways to show better-than-actual results.

Fire risk comes in many forms – devastating bush fires referenced above are external and cannot be controlled by, say, an individual home owner, but these are in stark contrast to a fire caused by a faulty electrical appliance left on overnight, which can be mitigated by having appropriate controls. However fraud committed from outside, such as by material and service vendors, customers, agents and other contractors, in the form of bogus invoices, double-billing for the same delivery, misrepresented quality or value of purchased materials and kickbacks offered to the organisation’s employees, can and must be controlled.

Major financial fraud is often committed by an organisation’s top management and may amount to millions of Euros. Besides senior managers, financial fraud can also be committed by accounting and finance employees, IT staff, sales and purchasing, payroll employees, and others. It is almost impossible to find a professional activity or position where fraudulent behaviour can be completely ruled out.

Special attention should be given to two types of organisational fraud in particular: (i) internal control override by management and (ii) collusion between employees of the targeted organisation and third parties (mostly customers, agents and contractors, in the form of reporting on work already done, claiming non-reimbursable expenses, submitting false invoices etc.).
**In order to confront fraudulent behaviour, an organisation has to:**

- Accept that fraud exists and could occur;
- Acknowledge the importance of fraud awareness;
- Deal with human factors by hiring honest people and keeping them honest via deterrents to fraud;
- Deal with the environmental factors by implementing adequate and enforced controls, policies and procedures, including following up on all dishonest acts. They should incorporate, among other things, the following basic elements:
  - Create and support a strong ethical environment (corporate culture);
  - Introduce and observe a clear and effective segregation of duties within the organisation;
  - Define and limit conflicts of interest; and
  - Continually monitor and control activities.

Organisation and third parties (mostly representatives of suppliers or customers). Every survey of occupational fraud to date has indicated that the most frequent types of fraudulent behaviour are corruption (for example, accepting and offering bribes), conflicts of interest and economic extortion; fraudulent financial statements, such as incorrect revenue recognition, cost manipulation, fictitious revenues, misrepresentation of financial information and improper asset valuation; and asset misappropriation, including inventory overestimations, fraudulent cash disbursements, embezzlement, larceny and skimming.

Unlike fire, which most of us never experience, fraud is present in every organisation. We have to accept that no company or person is immune to fraud. A company, agency or individual that thinks it is invulnerable to fraud is, in fact, the most susceptible to fraudsters. Too often, complacency is the fraudster’s best ally. If fraud produced smoke as does a fire, management would be horrified to see the number of smouldering computers and files quietly smoking around the office.

No organisation’s fire plan is to “wait and see” – it is equally foolhardy to have a laissez-faire fraud plan. Forensic investigations in 2011 have unfortunately corroborated the rising trend of fraud committed in organisations. Companies therefore have a duty to strengthen their fraud prevention and detection control systems and to intensify internal reviews. For the same reason, external auditors should pay increased attention to the fraud-risk issue when conducting statutory audits.

There is no special recipe, checklist or manual for detecting fraud. No such thing exists and no such thing is truly capable of being developed to address all forms of fraud. One of the options available for fraud detection is a fraud investigation, sometimes called a forensic audit, performed by an external forensic team. Forensic auditing is considered a unique specialty that involves the use of auditing techniques developed for the sole purpose of detecting fraud. The primary objective of a forensic audit is to prove or disprove a suspicion that fraudulent behaviour has occurred. If the forensic auditor finds that the suspicion was justified, their task is to – where possible – quantify the loss suffered, establish the motive of the fraud and the manner in which it was committed, identify the individuals involved and concerned, determine their responsibility and, in particular, obtain evidence proving the scope and extent of the fraud.

Forensic accountants and/or fraud examiners use techniques and proven procedures to detect both major financial fraud and seemingly insignificant fraudulent conduct whose investigation may then prevent further damage and increased financial losses in the company. In addition to fraud investigations, forensic accountants can help organisations in their anti-fraud efforts by introducing preventive measures, setting effective internal controls and subsequently assisting in their implementation.

Fraud is unavoidable, and for those in business, it is an occupational hazard. We are always mindful to ensure that a company does not spend more money preventing and detecting fraud than it may possibly lose as a result of fraud, but we are aware that the costs and long-term effects of fraud are many. Companies that are victims of fraud not only bear the cost of the fraud itself (to the extent that they are unable to recover funds), but also the costs of investigating the fraud, of clearing up the problem and of ensuring there is no recurrence.

Fraud is on the rise and it is therefore necessary to encourage the fight against fraudulent activities and financial misconduct. Fighting fraud through education, prevention, detection and, ultimately, the prosecution and punishment of fraudsters, should be seriously considered by every company’s management and incorporated into the company’s business strategy.
Can Hong Kong build on role of regional peacemaker

A 90% settlement rate suggests a strong case for Hong Kong mediation.

By Annie Chan, Partner, Forensic and Investigation Services, Hong Kong.

At the close of December 2010, the Mediation Information Office of the Hong Kong International Arbitration Centre (HKIAC) revealed that mediation cases in Hong Kong had shown good results, with a 90% settlement rate. The majority of cases involved Hong Kong parties, but a number of cases also originated from outside the territory.

Despite two years having passed since the collapse of Lehman Brothers and some markets beginning to take on a more positive outlook, 2010 saw a noticeable increase in the number of commercial disputes in Hong Kong. This is likely to have caught the eye of legal practitioners and regulators, but it has also expedited the development of mediation in Hong Kong.

With mainland Chinese parties involved in an increasing number of international disputes, plus cross-border business transactions between Taiwan, Hong Kong and the mainland continuing to grow, Hong Kong is well placed to fill the role of a neutral venue in dealing with commercial disputes.

As an Alternative Dispute Resolution (ADR) mechanism, mediation is increasingly becoming the accepted alternative to courtroom litigation. The voluntary process introduces an impartial party to assist in reaching a settlement acceptable to all. Compared to litigation, this is a route that offers greater flexibility in terms of settlement, is often seen as more practical – and saves time and money.

The Civil Justice Reform came into effect in April 2009. The objective is to enhance effectiveness in the justice system and to facilitate the early settlement of disputes by means of mediation. The Practice Direction on Mediation became effective on 1 January 2010 and there has since been a growing number of disputes resolved by mediation.

The announcement of the Practice Direction to promote mediation has caused concern amongst some lawyers as to the impact on law firms, but the judiciary is clearly in full support of mediation. The Honourable Mr Justice Lam has been quoted as saying Hong Kong has developed a new dispute resolution culture and that mediation is viewed as a platform for litigants to develop a new mindset and to focus their attention on solving disputes using ADR.

How successful can mediation be?

This relative success for mediation and the continued economic growth in and around China asks the question: is Hong Kong becoming the place for international business to conduct ADR?

Secretary for Justice, Mr Wong Yan Lung SC, has been quoted as saying that Hong Kong’s highly qualified arbitration professionals, a mature and trusted legal system based on common law, and our openness to professionals worldwide, all point to a positive answer.

His belief is strengthened by the fact that Hong Kong arbitral awards are enforceable in more than 130 contracting states linked to the 1958 New York Convention, and are also enforceable in China by virtue of a separate arrangement signed by Hong Kong’s Department of Justice and the Supreme People’s Court in 1999, facilitating reciprocal enforcement of arbitral awards.

As the only common law jurisdiction in China to enjoy a high degree of judicial independence, Hong Kong has retained its competitiveness amongst neighbouring countries. It could also be said that the Closer Economic Partnership Agreement has played a role in nurturing Hong Kong’s relationship with China. This may have helped Hong Kong position itself as a venue for settling commercial disputes involving international parties.

If we use arbitration as a barometer for mediation, the signs look even more positive. The HKIAC recently celebrated its 25th anniversary. HKIAC handled 624 dispute cases in 2010, most of them international in nature, which puts Hong Kong, in terms of caseload, in second place in Asia.
Alternative Dispute Resolution in the South African Companies Act

Gillian Bolton, Partner, Forensic and Investigation Services, South Africa

After a somewhat lengthy and complicated gestation process, South Africa’s new Companies Act of 2008, which replaces the former Companies Act of 1973, finally came into effect on 1 May 2011.

Reflecting the Department of Trade and Industry’s vision of reforming the South African corporate environment so as to promote economic development and competitiveness, the Act introduces a number of fundamental changes to the corporate landscape.

These include a number of new regulatory bodies, differences as regards the categorisation of companies and the registration process, safeguards for the rights of minority shareholders, and the codification of the previous common law duties of directors.

As a matter of general principle, and in keeping with the “comply and explain” approach of the new Act, provision is also made for Alternative Dispute Resolution (ADR), an approach informed by the King III Code of Corporate Governance (King III).

King III requires a company’s directors and executives to try to resolve any disputes that may arise in the most cost-effective manner possible, while also keeping the interests of ongoing relationships to the fore. In recognising the importance of ADR, King III recommends, in the first instance, mediation or conciliation. Failing this, arbitration should follow, with appropriate provision being made for this contractually.

Consequently, one of the ways in which a person (as defined by section 157 of the Act) can try to address an alleged contravention of the Act or to enforce any provision of a company’s Memorandum of Incorporation or rules, or a transaction or agreement contemplated by the Act, is by means of ADR (as provided in Part C of the Chapter).

Section 157 defines a person as:
- a person as contemplated by the particular provision of the Act, or
- someone acting on behalf of any such person, or an affected group or class or an association acting in the interest of its members, or
- any person, who, with the leave of the Court, is acting in the public interest.

Class actions are therefore permitted in South Africa for the very first time.

Part C of the Act - entitled Voluntary resolution of disputes - provides that, as an alternative to going to Court or to the Companies and Intellectual Property Commission (CIPC), a person who would be entitled to apply for relief or file a complaint in terms of the Act, can refer a complaint for resolution of the matter by mediation, conciliation or arbitration to:
- the Companies Tribunal, or
- an accredited entity as defined (discussed below).

The parties involved are, however, formally required to participate in any such process in good faith.

An accredited entity is defined as a juristic person or association of persons accredited by the CIPC or an organ of state or entity under public regulation that is mandated to perform mediation, conciliation or arbitration and which has been appropriately designated, possibly conditionally, by the Minister.

If the ADR process results in resolution of the dispute, the accredited body involved is empowered to record the resolution in an order, which, with the parties’ consent, can also be made an order of Court. This may also include an award for damages without having to go to Court in such regard.

In terms of the approach to Court, the Court has various powers as regards the consent order, including ordering the proceedings to be closed to the public, if the confidentiality of the parties so requires.

It is clearly early days for the implementation of the new Act but we await with interest the referral of disputes for resolution by ADR. There has already been some delay in the process of accrediting entities for ADR purposes, but as soon as the tething troubles have been resolved, we are ready to assist clients wanting to make use of such a process.

Hong Kong has recently enacted a new Arbitration Ordinance, making arbitration law more user-friendly to the international business community.

Hong Kong’s additional plan to establish the Investor Education Council (under the watchful eye of the Securities and Futures Commission) and the Financial Dispute Resolution Centre are further indicators that Hong Kong is prepared to pro-actively seek out resolution methods for all manner of disputes.

A positive course for mediation

Hong Kong’s mediation growth charts a positive course for the future. It offers businesses from Greater China and beyond, a fair, trusted and internationally supported arena, in which to secure enforceable resolutions to commercial disputes.

Indeed, the Hong Kong Government is making a strong case for greater transparency in the financial world and is setting international examples.

Civil Justice Reform in Hong Kong has spurred the growth in mediation, but it is Hong Kong’s own reputation for fairness, its quality legal system and its diligence in seeking out resolutions across the board, that can take mediation in Hong Kong to the next level.
Please get in touch...

Our Forensic and Investigation Services practice is structured globally on a regional basis.

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