

September 21, 2010

***Valuation of Minority Interest in an
Involuntary Dissolution Proceeding***

Presented by:

Kathryn Andrews, Esq.

Thoits, Love, Hershberger & McLean

blog: thoitslaw.com/blog

email: kandrews@thoits.com

direct: (707) 534-7780

SPEAKER'S BACKGROUND

- **Biz Attorney** with experience in formations, professional corporations, equity and debt financing, acquisitions, start-ups, and franchises
- **Board** Member of local nonprofit *CONNECTIONS – A Forum For Women In Business*
- **Member** of the SCBA, Women in Law, Sonoma County Alliance
- **Speaker & Author**

Share Valuation & Involuntary Dissolutions

- Why are we here?
 1. Hot Topic
 2. Complex
 3. Misunderstood

I. SETTING THE STAGE INVOLUNTARY DISSOLUTIONS (Ch 18, Cal Corp Code)

- a. **AUTHORITY** required to file a complaint to dissolve a corporation
 - i. ½ of the directors
 - ii. shareholders who own at least 33.33% interest
(33.33% determined after excluding shares owned by person who has allegedly participated in wrongful activity)
 - iii. any shareholder of a “close” corporation

I. INVOLUNTARY DISSOLUTIONS **(Ch 18, Cal Corp Code)**

b. GROUNDS to file a complaint to dissolve a corporation

- i. abandonment
- ii. board deadlock
- iii. shareholder deadlock
- iv. persuasive fraud, mismanagement, abuse, or unfairness
- v. unfairness in small corporations (35 or less shareholders)
- vi. corporation expiration

II. VOLUNTARY DISSOLUTIONS **(Ch 19, Cal Corp Code)**

VOTE of shareholders holding at least **50%**
voting power

III. *AVOIDING* DISSOLUTION (Ch 19, Cal Corp Code)

- a. **§2000 Cal Corp Code can be invoked by the corporation or the “majority” or “50%” shareholder(s) seeking to AVOID dissolution**

- b. **Requires vote of shareholders holding at least 50% voting power (“purchasing party” “defendant” or “majority shareholder”)**

III. *AVOIDING DISSOLUTION* **(Ch 19, Cal Corp Code)**

- c. **Unique appraisal process of “moving party’s” or “plaintiff” “minority” shares:**
 - i. **If**, parties cannot agree on “fair value” of moving party’s shares;
 - ii. **And**, purchasing party posts bond (to pay reasonable expenses, including attorneys fees of the moving party, in case share purchase is not consummated);
 - iii. **Then**, the court will stay the dissolution proceeding, ascertain and fix the fair value of the moving party’s shares.

IV. COURT PROCEDURE

- a. Appoint 3 disinterested appraisers - to appraise the “fair value” of the shares owned by the moving party;**
- b. Award of the appraisers, or of a majority of them, when confirmed by the court, shall be final and conclusive upon the parties;**
- c. Issue court decree providing that unless payment is made for the shares within the time specified in the decree, the corporation shall be wound up and dissolved**

IV. COURT PROCEDURE

- d. If, purchasing party does not make payment for the shares within the specified time, judgment shall be entered against them and the surety on the bond for the amount of the expenses (including attorneys fees) of the moving party;**

- e. interest can accrue after decree date until payment is tendered**

V. CAL CORPORATE CODE § 2000

- a. Requires the purchasing party to **purchase for cash** the shares owned by the moving party at their **“fair value”**

- b. **FAIR VALUE** shall be determined “on the basis of the **liquidation value as of the valuation date**, but taking into account the possibility, if any, of the **sale of the entire business as a going concern in a liquidation”**

VI. QUERY WHAT IS “FAIR VALUE”?

- a. **Courts look to independent appraiser for guidance**
- b. **Business appraisers look to attorneys for guidance**
- c. **Even CPA’s look to attorneys for guidance**



AS ATTORNEYS WE MUST BE PREPARED TO PROVIDE BUSINESS APPRAISERS AND COURTS WITH APPRAISAL GUIDANCE IN AN ACTION BROUGHT UNDER CAL CORP §2000

VII. APPRAISER VALUATION PREMISES

- a. **GOING CONCERN** premise – assumes that the business is going to continue and has the ability to do so

- b. **LIQUIDATION** premise – assumes that business is going to cease operating and individual assets will be sold or otherwise disposed

VIII. PROMINENT APPRAISER STANDARDS OF VALUATION

- a. **FAIR MARKET VALUE – value of business in an arm’s length transaction between hypothetical willing and able seller and buyer**
 - i. In an open and unrestricted market
 - ii. Where both have reasonable knowledge of relevant facts

- b. **INVESTMENT VALUE – value of a particular investor based on individual investment requirements and expectations (assumes a known buyer and seller)**

VIII. PROMINENT APPRAISER STANDARDS OF VALUATION

- c. **“FAIR VALUE” – value standard created by statute**
 - i. Relevant cases provide further insight into definition of “fair value” in the context of §2000

IX. STATUTE IS CLEAR AS MUD

- a. **What is the value of a “*going concern in liquidation*?”**

- b. **Here is what we do know:**
 - i. PROCEDURE - for avoiding dissolution is set forth in §2000

 - ii. VALUATION DATE – is typically the date the dissolution action was filed by the moving party (unless the parties stipulate to a different date)

X. §2000 CASE LAW HOLDINGS

a. ***Brown v Allied Corrugate Box Co.***

91 Cal. App. 3d 477 (1979)

- i. “Fair value” of minority interest should NOT include any devaluation or **discount**, typical in “*fair market valuations*” for lack of control in other contexts
- ii. **Minority shareholder** who brings an action for the involuntary dissolution **should not**, by virtue of the majority shareholder’s invocation of the buy-out remedy provided under §2000, **receive less than he would have received had the dissolution been allowed to proceed** (liquidation value is pro rata w/out discount)
- iii. **Goodwill** is an asset of the corporation

X. §2000 CASE LAW HOLDINGS

b. ***Abrams v Abrams-Rubaloff & Associates, Inc.***
114 Cal. App. 3d 240 (1980)

- i. 50:50 shareholder involuntary dissolution action is governed by §2000, **and not by the provisions of the Code of Civil Procedure**
(except when such provisions are expressly made applicable, thus plaintiff was not entitled to a full evidentiary hearing)
- ii. §2000 contemplates a **summary proceeding**, and with good reason, for if the party seeking the appraisal is dissatisfied with the valuation, he may then choose to proceed with dissolution

X. §2000 CASE LAW HOLDINGS

c. ***Mart v Severson*, 95 Cal. App. 4th 521 (2002)**

- i. Appraisers applied §2000 properly by **assuming that a hypothetical willing seller the corporation would execute a covenant not to compete** (with the corporation after the sale)
- ii. **Discounting the value of the corporation because of the threat of future competition** by one of its shareholders (as the trial court did in this case) **unfairly deprives** the moving party of the **true value of his stock**

X. §2000 CASE LAW HOLDINGS

d. ***Trahan v Trahan, 99 Cal. App. 4th 62 (2002)***

- i. Appraiser's determination of the **fair value as the value upon piecemeal sale of the assets** as of the date the moving shareholders elected to dissolve the corporation **was supported by substantial evidence**, even though that determination **did not take into account completion and performance of outstanding contracts**, *because appraiser found that the corporation could not be sold as a going concern*

(in fact, the appraiser in this case, determined that the value of the outstanding contracts was a *negative* amount)

X. §2000 CASE LAW HOLDINGS

e. ***Dickson v Rehmke*, 164 Cal. App. 4th 469 (2008)**

- i. in the context of a limited liability company governed by Cal Corp Code §17351 (counterpart to §2000)
- ii. Held that (i) plaintiff does not waive his right to appeal when he accepted tendered money for his interest in the company, and (ii) the statute charges the court to ascertain and fix the “fair market value” of the membership interests (i.e., **the award of the appraisers does not bind the trial court; the court is free to select among conflicting opinions or decide the matter de novo**).

X. §2000 CASE LAW HOLDINGS

f. Cotton v. Expo Power Systems, Inc.

170 Cal. App. 4th 1371 (2009)

i. **Pending litigation should be consideration in assessing the fair value**

ii. Reversed and remanded to the trial court with directions to:

Obtain an appraisal taking into account the effect of the pending litigation on the fair value of the corporation

- OR -

Allow the corporation to complete the claim currently being litigated before the trial court again attempted to fix the value

X. §2000 CASE LAW HOLDINGS

g. Veyna v Orange County Nursery, Inc.

170 Cal. App. 4th (2009)

- i. Purchasing party **must tender the fair value of the shares** in accordance with the terms of the trial court decree, even if any appeal is perfected in order to avoid dissolution
- ii. Appellate court was kind enough to **extend the payment date** beyond the date set forth in the trial court decree (because the appellate decision was rendered subsequently; thus purchase party has one week to come up with \$12M and change)

(appellate court did not review the merits of the appeal)

X. §2000 CASE LAW HOLDINGS

h. Go v Pacific Health Services, Inc.

179 Cal. App. 4th 522 (2009)

Purchasing party's **objection to stay §2000** proceeding and decree because moving party's involuntary dissolution action has not been litigated (and is asserted to be groundless) is **denied**, because:

1. Invocation of §2000 is **optional**
2. §2000 is a "**special proceeding**" (rather than a civil action)
3. Objective of a §2000 buy-out is with **minimal expenditure of time and money** (that would otherwise be spent in litigation, in order to preserve the corporation)

X. MARSH'S CAL CORP LAW ON §2000

- i. “In virtually all cases where this right is exercised, the corporation will be one which is **closely held** and there will be **no actual market value or any actual cash sales by which the market value could be determined**. Therefore, the value to be determined must necessarily be a constructed or hypothetical market value at which the hypothetical willing seller would sell and the hypothetical willing buyer would purchase.” *Section 21.08[C]*

X. MARSH'S CAL CORP LAW ON §2000

- ii. “The moving party has initiated a liquidation proceeding and the **Drafting Committees believed that the moving parties should not be entitled to more than the liquidation value of the shares** (i.e., that which they would receive if their objective was accomplished). Having said that, the liquidation does not necessarily contemplate the assets being sold piecemeal. **It may be possible to sell the business as going concern. And if so,** then the moving party should be **entitled to a value which takes into account that possibility (including a pro rata distribution)**, since such a sale could be made in the liquidation if the dissolution were permitted to proceed. *(In this regard, the valuation differs radically from an appraisal of such minority shares in an estate tax proceeding.)*” *Section 21.08[C]*

TAKE AWAYS

- **INFORM** biz clients at formation & funding
- **BENEFITS** of buy-sell & shareholder agreements
- **VALUE** of communication and fair practices re: minority shareholders

THANK YOU!!!