So You Want to File a Dissenting Shareholder Action? Think Twice and Understand the Risks to Both Parties in a Corporation 2000 Proceeding

Jim Andersen, CPA/CFF/ABV, ASA

Shareholder disputes continue to run rampant, not only in California, but throughout the United States. What is particularly disconcerting to me is the total lack of understanding that shareholders have as to what the outcome, damage to the business and the overall cost of a proceeding may be. This article will address many of the issues and concerns and hopefully provide guidance to shareholders contemplating such a proceeding.

Corporate Code Section 2000 and its related subsections Sections 1800 and 1900 have many ambiguities. What makes these related code sections even more confusing are the following:

- A lack of clarity and understanding of what the "fair value" definition truly means.

- Case law is very limited with no case law at all that addresses current tax law, particularly the built in gains conundrum of highly appreciated assets in C corporations.

- The selection of the three disinterested appraisers and how that process truly works.

- Who pays the fees to the attorneys, appraisers, etc?

In addressing the above I will start with the "fair value" definition and try to differentiate it from traditional "fair market value".

"Fair Value" as defined in California Code Section 2000 "shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation." Some guidance is provided in the Mart v Severson matter where one of the appraisers told the court that his interpretation of fair value meant a "tainted" sale environment, one where the seller was not willing, but forced. In general, this can only have a negative, or at best neutral, impact on the ultimate sale price. For an attractive company in a good economy with many suitors and a reasonable marketing period, the impact will not be material. However, this becomes particularly problematic for an unattractive company in a poor economy with few potential suitors. The impact with that fact pattern could be dramatic.

What even complicates things more is the lack of meaningful information for utilization of the market approach as to one of the three approaches to valuing a company. The overwhelming majority of the sales in appraisers' transaction databases occur between a willing buyer and willing seller. Of particular interest to appraisers would be access to sale prices of companies that were dissolved under California Corporations Code sections 1800 or 1900. There is not, however, any available data, nor could it be readily assembled short of spending years visiting superior courts across the state.

In differentiating "Fair Value" vs. "Fair Market Value" we must first understand what fair market value is. Revenue Ruling 50-60 defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Let's consider the critical elements found in the traditional definition of fair market value that are not present in a Section 2000 proceeding. First, a willing seller is not involved. In a corporate dissolution the seller is involuntarily disposing of the assets of the company. Second, the seller is under a compulsion to sell, specifically because of the pendency of the dissolution proceeding; this is entirely opposite from the provisions of Revenue ruling 59-60 that contemplate that the seller is not under any compulsion to sell. Third, the involuntary seller under a compulsion to sell pursuant to Section 2000 does not have the luxury of waiting for a top offer; the sale must be completed under the adverse conditions of a corporate dissolution conducted in accordance with California law.

Let's look at some of the case law that exists in a California Code Section 2000 proceeding. The various cases have been regurgitated many times: Brown, Abrams, Ronald, Mart, Trehan, etc. The "take a ways" from the limited case law are as follows:

- Liquidation value is not the standard-you must consider the possibility of selling the business as a "going concern in liquidation", a totally different concept than pure liquidation.

Many of my colleagues and I deem this to be a "quick sale" concept. Depending on the type of business being valued it may be a little less than fair market value or it could be liquidation value. Facts and circumstances are different for every proceeding, with liquidity of the business and barriers of entry being forerunners in the valuation decision making process.

• Minority discounts are not allowed. The business is valued in whole with the selling shareholder receiving a pro rata share of the overall value in cash.

• Discounts for lack of marketability are "it depends". Marketability is a totally different concept than lack of control. You can deal with the marketability issue in a couple of different ways, either through risk considerations in your discount rate or through a separate calculation.

• The Abrams case addresses the fact that an inherent covenant not-to-compete must be considered in the valuation process.

What has not been addressed via case law and is the "new hot topic" in Corporate Code Section 2000 proceedings is built in gains tax considerations in C corporations.

Prior to the repeal of the General Utilities doctrine by the Tax Reform Act of 1986, corporate taxes could usually be avoided on appreciated assets via appropriate distributions of the assets. After 1986 and the repeal of the General Utilities doctrine, such "tax free" distributions were not permitted, and the sale of an appreciated asset would trigger a corporate-level tax, thus significantly changing how built-in-gains taxes were considered when valuing a corporation.

Currently, the primary method remaining for a C corporation since the 1986 repeal of the General Utilities doctrine to avoid the corporate-level tax on appreciated assets is to convert to an S corporation and hold the assets for 10 years before selling them.

Under the fair market value standard appraisers have opined that the built-in gains tax must be considered since the repeal of the General Utilities doctrine in 1986. Underlying this opinion is the premise that a willing buyer would be cognizant of the potential tax liability it would face and, therefore, would consider such a tax liability when determining the value it would be willing to pay for the acquisition of the stock of a C corporation. While the courts have recognized that the built- in gains tax should be considered in valuing a corporations stock, how those taxes should be recognized varies based on the facts and circumstances of each case with case law indicative of some consideration for when the taxes may actually be paid and adjusting the liability accordingly.

What differentiates the handling of the tax situation in a Corporate Code Section 2000 proceeding under the fair value standard v the fair market value standard is the absolute certainty that the corporate tax would have to be considered on a dollar for dollar basis since any potential tax planning considerations would not be available because of the "date certain" timing and immediacy of the 2000 proceeding.
Final comment: this appraiser's view is that full dollar for dollar adjustment is warranted on all cases that have potential built in gains ramifications. What will be interesting is when case law on a disputed case ultimately brings this issue to fruition.

The last two issues that I would like to discuss relate to the selection process for the three disinterested appraisers and who pays the fees in the proceeding.

I have seen the selection of the appraisers handled in a number of ways. The court may take control and review various appraiser resumes and just go ahead and choose three, hopefully qualified, valuation analysts. Or, and more often than not, each side will pick its own appraiser and the two appraisers will chose a third. Finally, both sides may agree to waive the three appraiser process and stipulate to one neutral appraiser. I have worked under all three of these scenarios and the one that I personally would never agree to in the future is being a "party of one". In that instance, the side that didn't like my report went out and hired a rebuttal appraiser anyway and the case went to a full blown two day hearing. My personal preference is having both sides pick their own appraiser with the appraisers then agreeing upon a neutral. The reason? The appraisers have typically been at a higher level, the attorneys are usually more experienced in Corporate Code Section 2000 proceedings, and the gamesmanship is usually easier to monitor.

The fee situation can be handled in two ways. The more traditional method is having the moving party pay his or her own fees while the corporation typically pays for the fees of the party exerting his or her 2000 rights. I have also seen the corporation agree to pay the fees for both parties, more often negotiated in advance in 50-50 shareholder proceedings.

In summary, a Corporate Code Section 2000 proceeding should be a last resort to resolving corporate conflict. While on the surface it may appear that the shareholder exercising his or her rights to block the dissolution has the advantage, this may not always be the case. The cost of the proceeding to all parties is extensive, the damage that is done to the work force can be crippling, and the purchase of the business interest by the purchasing party is an all cash deal.

The moral of the story? A well crafted buy/sell agreement with an agreed upon valuation method determined in advance is a more palatable solution than a six or seven figure dissolution proceeding!