Six Questions for Your Section 2000 Appraiser

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Section 2000 of the California Corporations Code (Section 2000) allows a shareholder that owns at least 50% of the voting power of a corporation in a voluntary or involuntary corporate dissolution proceeding to stay the dissolution and enter into an appraisal process. This gives the shareholder the option of purchasing the plaintiff's shares at an appraised value. The functionality and implementation of this valuable right thus depends on the appraised value of the plaintiff's shares. The statute describing the valuation assumptions is rather vague, and although supplemented by reasonable precedent guidance, valuation experts still seem to have wide latitude to interpret the statute's wording, often with a dramatic impact on the value conclusion. It would not be unusual for one company valuation to yield a value of $1 million, and another a value of $5 million. The results of the appraisal and subsequent buyout are often the reward for a lifetime of work for the selling shareholders, and they deserve a fair price for their shares and an unambiguous valuation process. Given that the fair value standard under section 2000 is quite different than other standards value appraisers commonly use, attorneys should be aware of the key assumptions appraisers must make in a section 2000 valuation. Discussed below are six key questions attorneys should ask an appraiser they are considering for a section 2000 engagement.

Question #1: Do You Interpret "Fair Value" Under Section 2000 to Mean Liquidation or Going-Concern Value?

Section 2000 provides that a defendant:

> may avoid the dissolution of the corporation and the appointment of any receiver by purchasing for cash the shares owned by the plaintiff or by the shareholders so initiating the proceeding (the "moving parties") at their fair value. The 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 a sale of the entire business as a going concern in a liquidation.[1]

The difference in the value of a company in liquidation (as the term "liquidation" is commonly interpreted in the valuation community) and its value as a going-concern is usually dramatic. Appraisers refer to this issue as the *premise* of value. For a valuation expert, a liquidation[2] of the company usually means a winding down of operations, an orderly or forced sale of the tangible assets, settlement of the liabilities, and the distribution of any remaining proceeds to the shareholders, net of expenses. Any intangible assets such as customer relationships, brand name, an established and trained workforce, custom computer software systems, and other types of goodwill are generally destroyed in the process. The value of the company as a going-concern is the sale of the entire business along with its normally considerable intangible assets. As stated, the difference between the two values is usually large. In aggregate, the companies listed on the Standard & Poor's 500 Index, for example, currently have an equity value (as a going-concern) approximately 5.7 times larger than their tangible book value (which is a reasonable proxy for the liquidation value of the total equity).

It should also be understood that valuation experts are very rarely involved in valuing companies in liquidation. The overwhelming majority of our practices relates to healthy companies. The only companies an appraiser would generally value under a liquidation scenario are those that are insolvent and cannot continue as a going-concern. It is perhaps because section 2000 valuations stem from a dissolution proceeding that the fair value standard is initially based off a liquidation premise. In the author's experience, however, companies that are in a section 2000 dissolution proceeding are usually far from insolvent and are usually healthy entities that have the ability to continue as going-concerns, albeit with some shareholder disagreements. To appraisers, section 2000's language creates conflict. Faced with the requirements imposed by the language of section 2000 and trying to be sensitive to the court's needs, valuation experts have sometimes valued companies as going-concerns, and sometimes on a liquidation basis. In *Trahan v. Trahan*,[3] a recent California Court of Appeal's case interpreting section 2000, the single appointed appraiser interpreted section 2000(a)'s language to mean a piecemeal liquidation, although the court in its ruling raised the possibility that a different value could have been ascribed to the company had the parties raised the issue.[4]

Luckily, appraisers are not left with the statute as their only guide. Cases interpreting the valuation requirements of section 2000 allow appraisers to value the company as a going-concern if they feel the company would be sold on that basis if the dissolution were allowed

to proceed. In *Mart v. Severson (Mart)*,[5] the California Court of Appeal said the following: "In other words, Section 2000 expressly requires that the going concern value of the corporation be reflected in the fair value price." The reason for this requirement is that "a liquidation does not necessarily contemplate that the assets will be sold piecemeal and the goodwill of the business sacrificed by a termination of the business." Marsh et al., 2 Cal. Corporation Law (4th ed. 2001 supp.) § 21.08[C] at 21-45. It may be possible to sell the entire business as a going-concern in liquidation. "If that is true, then the moving parties should be entitled to a value which takes into account that possibility, since such a sale of the entire business as a going concern could be made in the liquidation if the dissolution were permitted to proceed." *Id.*

It is sometimes the case during the dissolution proceedings that the defendant will ask the appraisers to interpret the statutory language as requiring the piecemeal liquidation of the company, even though the company is profitable, growing, healthy, and solvent. It is unlikely, though, that the same defendants would allow such destruction in value of their interest if the dissolution proceedings were seen through to their ultimate end. As I hope is evident, attorneys practicing in this area would be well advised to understand how appraisers interpret section 2000's language regarding the premise of value.

Question #2: Will You Incorporate a Forced Sale Environment into Your Analysis? If so, How?

The commonly used standards of value for company appraisers are "fair market value" and "fair value." Both definitions assume hypothetical willing buyers and willing sellers. Case law makes it clear that most California courts would prefer section 2000 appraisers to simulate the sale environment as if the dissolution proceeding were completed. Quoting the *4-C Electronic Packaging* opinion,

> Since the moving parties have initiated a dissolution proceeding pursuant to which the corporation will be liquidated unless the other shareholders buy them out … [it is apparent] that the moving parties should not be entitled to more than the liquidation value of their shares, i.e., what they would receive if their objective is obtained.[6]

It is also clear from the description of the actual "winding up" of the corporation in California Corporations Code sections 1805(c) and 1903(c)[7] that the sale environment under the dissolution proceedings is one of a forced seller. However, there does not appear to be any material time constraints on either the section 2000 proceedings or the actual sale process.[8]

In *Mart*, where I was one of the appraisers, we told the court that our 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, for an unattractive company in a poor economy with few potential suitors, or a tight timeframe (or a combination of the four), the impact could be dramatic. Quantifying the impact for appraisers posses a significant challenge because appraisers generally do not have access to forced sale transactions to use for comparative purposes. 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 several years visiting superior courts across the state. Ultimately though, the court in *Mart* affirmed our valuation of the subject company under a forced sale environment assumption. *Mart* broke new ground on this issue as it was never addressed in previous precedent cases.

Question #3: Will You Adjust Your Valuation to Reflect Cash Transactions Only? If so, How?

It is quite clear from the statutory guidance that the company is to be valued assuming all cash consideration for the shares. To quote section 2000 again, the defendant "may avoid the dissolution of the corporation and the appointment of any receiver by purchasing *for cash* the shares owned by the plaintiff…."[9] [Emphasis added]. The language of section 2000 was derived from former section 4658[10] which also was clear:

> In any such suit [for involuntary dissolution] the holders of 50 percent or more of the outstanding shares of the corporation may avoid the appointment of a receiver or the dissolution of the corporation by purchasing the shares of stock owned by the plaintiffs for their *fair cash value.* [Emphasis added]

Again, this is a subtlety that is often over-looked by appraisers, but one that can have an impact on the conclusion.

The cash consideration assumption is one that would primarily impact the transaction method in the appraisal. In this method, sales of entire companies are reviewed in order to ascertain the appropriate terms of sale for the subject company. It is very

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2 *Connecticut v. American Electric Power Co., et al.*, 406 F. Supp. 2d 265 (S.D.N.Y. 2005).

3 *Comer v. Murphy Oil Co.*, 2009 WL 3321493 (5th Cir. Oct 16, 2009) (No. 07-60756); 2006 WL 1066645 (No. 05-0436) (S.D. Miss. Aug. 30, 2007).

4 *California v. General Motors, et al.,* U.S. Dist. LEXIS 68547 (2007).

5 *Native Village of Kivalina v. ExxonMobil Corp., et al.,* No. 08-1138 (N.D. Cal., Filed Feb. 26, 2008).

6 *Connecticut v. American Elec. Power Co., Inc.,* 2009 WL 2996729 (2d Cir. Sep 21, 2009).

7 *Comer v. Murphy Oil Co.,* 2009 WL 3321493 (5th Cir. Oct 16, 2009).

8 Complaint, page 2, paragraph 5.

9 *In re Deseret Power Electric Cooperative*, PSD Appeal No. 07-03 (EAB Nov. 13, 2008).

10 http://www.reuters.com/article/pressRelease/idUS100101+24-Mar-2009+BW20090324.

11 http://yosemite.epa.gov/ee/epa/incsave.nsf/437c451fb25915d5852564db00579f01/402588e6ace4772b85256636004fc574!OpenDocument.

12 Over a Dozen Years of RECLAIM Implementation: Key Lessons Learned in California's First Air Pollution Cap-and-Trade Program, p. III-I-3, South Coast Air Quality Management District, June 2007.

13 Over a Dozen Years of RECLAIM Implementation: Key Lessons Learned in California's First Air Pollution Cap-and-Trade Program, II-2-8, 9, South Coast Air Quality Management District, June 2007.

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common in smaller transactions for the seller to provide financing to the buyer by taking a note back for a portion of the total consideration or to agree to an "earnout" or other delayed payment. In larger transactions, it is very common for buyers to use their own shares as consideration. In general, both seller financing and stock consideration are thought to have an upward influence on the transaction price. Seller financing has that effect because it is often established at attractive terms, and share consideration works to enhance the purchase price because buyers may be less sensitive to price using shares instead of cash, particularly if the buyer believes their shares may be over-priced by the market. In both circumstances, the comparable transactions should be discarded from the analysis unless a reliable adjustment can be made to eliminate the impact of non-cash consideration on the purchase price.

Question #4: How Will Your Valuation Incorporate Liquidation Costs, if at All?

In keeping with the guidance that fair value under section 2000 should incorporate assumptions consistent with what would have occurred if the dissolution were allowed to proceed,[11] the appraisers should incorporate all liquidation costs into their analysis. Although the question of incorporating liquidation costs into the analysis has not been addressed specifically by the courts of appeal, it seems reasonable to conclude they should. This is another nuance that is usually not recognized by section 2000 appraisers because it is not usually considered in traditional valuation standards of value. Costs will be incurred assuming either a piecemeal liquidation or a going-concern sale. In a piecemeal liquidation, legal, accounting, auctioneers', and other costs will likely be incurred. In a sale of the company as a going-concern, additional advisors outside of attorneys and accountants are likely to be required, in addition to an investment banker or business broker. Although not as material to the conclusion as the premise of value (liquidation or going-concern), selling or dissolution costs for smaller companies can be over 5% of total value.

Question #5: Will Your Valuation Incorporate any Marketability Discounts, Minority Discounts, or Control Premiums?

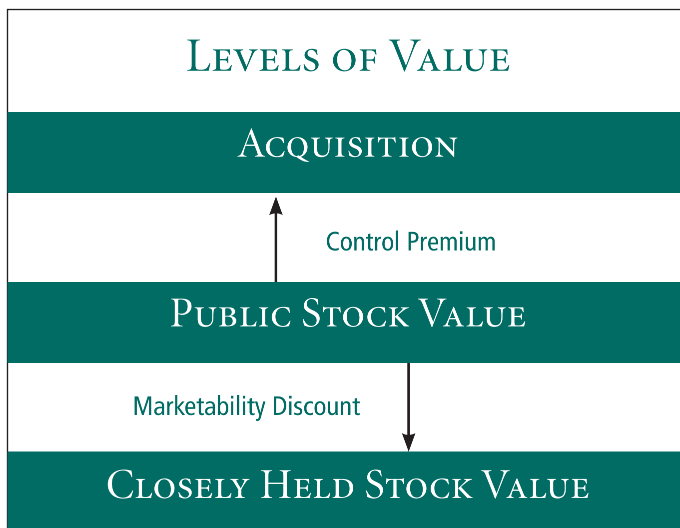
Discounts and premiums in corporate valuation are an area of significant interest to company owners and advisors. Unfortunately, it is also an area that sees its fair share of confusion around terminology and concepts. For the sake of some clarity while discussing the issue in a section 2000 context, the following is a brief review of the basic principles of discounts and premiums. In general, for any valuation there are three key points to know: i) What is the size of the interest being valued; ii) Does the company have an actively-traded market for its shares; and iii) What is the starting "level of value"?

All valuation methods result in an indication of value at some "level of value" described in Figure 1. It is only when the appraiser needs to adjust the level of value that valuation experts apply premiums or discounts. In general, majority or controlling interests are sold for the highest amount per share, represented in the "Acquisition" box in Figure 1. Controlling interests, whether they are in public or private companies, tend to have the same amount of marketability through the investment banking market, and they bring with them complete control over the subject company's operations and assets.[12] Minority interests in public companies, on the other hand, have almost no control of the corporation associated with it but have actively-traded shares (the "Public

Stock Value" in Figure 1). If a valuation approach yielded an indication of value at the "Public Stock Value" box of Figure 1 and an appraiser was valuing a 100% interest in a company (control), he would likely add a control premium in order to arrive at the correct "level of value." The inverse of a control premium (In Figure 1 going from the "Acquisition" box to the "Public Stock Value") is called a minority discount.

At the bottom of the "levels of value" ladder is the minority interest in a private company (the "Closely Held Stock Value" in Figure 1). Minority shareholders in private companies suffer from virtually no market for their shares (and often sale restrictions), as well as a lack of control over business operations or assets. Again, if a valuation method resulted in a "Public Stock Value," an appraiser would apply a marketability discount[13] to reduce the value to the "Closely Held Stock Value." In general, marketability and minority discounts only apply to going-concern valuations. With all that said, appraisers are often asked to ignore the size and marketability aspects of a particular share interest and value it on a certain basis, i.e. value a minority interest in a private company (lowest value per share) on a controlling basis (highest value per share) as a shareholders' agreement or statutory language may require it in the interest of equity.

Figure 1



In a section 2000 context, the courts of appeal have been quite clear that no discounts should be applied. The primary argument presented is that allowing discounts would not be fair to plaintiffs because it would penalize them further for their minority position when the intent of the statutory framework is to alleviate the potential for misconduct by the majority. In *Brown Allied Corrugated Box Company*[14] the court wrote under sections 4658 and 4659 of the former California Corporations Code:

> Under the valuation approach adopted by the majority commissioners and confirmed by the trial court, however, a controlling shareholder, especially an unscrupulous one, could avoid the proportionate distribution which would follow from an involuntary dissolution simply by invoking the buy-out provisions of former Corporations Code sections 4658… and 4659…. According to that approach, the minority shares would then have to be valued in relation to what they would bring on the open market, with an appropriate reduction for the fact that they do not give their purchaser control of the corporation…. Thus, the very misconduct and unfairness which provoked the minority shareholders to seek involuntary dissolution could, in this manner, be used to further oppress them. This, the statutory scheme before us cannot be read as condoning.

The court further clarified: "Had plaintiffs been permitted to prove their case and had the corporation then been dissolved, it is clear that upon distribution of the dissolution proceeds each of the shareholders would have been entitled to the exact same amount per share, with no consideration being given to whether the shares had been controlling or noncontrolling." Given the court's guidance, section 2000 valuations done on a going-concern basis should indicate a controlling (Acquisition box Figure 1) level of value[15] with no discounts for lack of control or marketability.

Question #6: If the Seller Has Not Signed a Non-Compete Agreement, Will You Assume One Has Been Signed in Your Appraisal?

In private company transactions, it is customary for the sellers to sign covenants not-to-compete, and it is highly unlikely a buyer could be found for a company if the primary shareholders didn't sign non-compete agreements. The primary shareholders are usually the most senior executives and have the ability to build a competing business, so they must be prevented from competing; otherwise, they may seriously damage the value of the subject company. However, in most section 2000 disputes, covenants not-to-compete have *not* been signed by the shareholders.

The precedent cases have spoken very clearly on the issue and resoundingly ask the appraisers to assume hypothetical covenants not-to-compete have been signed by the shareholders, regardless of whether they have been signed by the plaintiff or defendant. In *Mart*, the court stated: "The appraisers did not consider whether Mart has already executed a covenant not to compete nor did they require that such a covenant be executed." [16] The court went on to

state: "The appraisers applied section 2000 properly by assuming that a hypothetical willing seller of Bay World would execute a covenant not to compete with the corporation...."[17] The court in *Abrams v Abrams - Rubaloff & Associates, Inc* also addressed the issue very clearly: "We think the appraisers properly considered a hypothetical covenant not to compete in evaluating a sale of the business as a going-concern."[18] Finally, the court of appeal in *Brown* echoed the same sentiment regarding the possibility of future competition by the current shareholders: "Plaintiffs were entitled here to their proportionate share of the entire corporation, including whatever goodwill intervener Brown had established. Any implied threat by Brown to leave the company and destroy its goodwill should consequently not have been considered."[19] This hypothetical assumption would only apply to a going-concern valuation. In a piecemeal sale of the assets, it is highly unusual that a buyer of equipment or furniture would require or receive a non-compete agreement.

Given that the seller is receiving the value of his or her interest based upon a hypothetical non-compete agreement being signed, it is only equitable from an economic perspective that one be signed as a condition of the actual sale. Section 2000 does not specifically address the issue of the terms of the actual sale contract, but *Mart* did address it:[20]

> [Section 2000] does not govern or even address covenants not to compete or any other term of the sale pursuant to which the purchasing party can buy out the shares of the moving party. Section 2000 authorizes the court to set only one term of the contemplated sale—the price. Once the fair value price for the corporation is set, the parties must negotiate the remaining sale terms.[21]

From a practical perspective, the seller should be reasonable in negotiations regarding the terms of the actual sale and ensure it is within market norms. If the terms of the sale, including the non-compete agreement, are overly advantageous to him or her, the seller may soon find themselves observing market norms if the buyer declines the option to purchase the shares and allows dissolution proceedings to be completed.

Conclusion

Section 2000 valuations are quite different from traditional valuation standards such as fair market value and fair value. Most valuation experts are not aware of the numerous nuances of section 2000 fair value appraisals, some of which can have an enormous impact on the valuation conclusion. Attorneys would be well advised to thoroughly vet their potential appraisers on the issues discussed to ensure they have read section 2000 and precedent cases. Doing otherwise risks receiving a value conclusion that is inconsistent with the statute's intent and potentially punitive to either the seller or the buyer. Given the size of the stakes for the parties, they deserve appraisers with a clear understanding of the task at hand. ■

Endnotes

1 Cal. Corp. Code § 2000(a).

2 In the valuation industry we unfortunately have different names for the same concepts, and sometimes similar names for different concepts. The liquidation value of a company has nothing conceptually to do with a liquidity discount. Liquidity discounts are applied to minority interests in private companies under certain circumstances.

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

4 "Nor did appellants argue in the court below that there was a possibility of sale of the entire business as a going concern in a liquidation. Appellants do not contend on appeal that the appraiser erred in failing to value the corporation as a going-concern in a liquidation. Indeed, appellants specifically disavow any such claim on appeal. Any error in this regard has been explicitly waived by appellants." *Supra*, at 71.

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

6 *Ronald v. 4-C's Electronic Packaging, Inc.,* 168 Cal. App. 3d 290 (1985). See also, 2, Marsh, Cal. Corporation Law (2d ed 1981), § 20.22 at 638.

7 Both sections read almost identically, in pertinent part from 1903(c): "When a voluntary proceeding for winding up has commenced, the corporation shall cease to carry on business except to the extent necessary for the beneficial winding up thereof and except during such period as the board may deem necessary to preserve the corporation's goodwill or going-concern value pending a sale of its business or assets, or both, in whole or in part. The board shall cause written notice of the commencement of the proceeding for voluntary winding up to be given by mail to all shareholders… and to all known creditors and claimants whose addresses appear on the records of the corporation."

8 However, Judge Kriegler in *Cotton v. Expo Power Systems, Inc.,* 170 Cal. App. 4th 1371 (2009) found 5 years to be too long between the valuation date and the actual purchase of the shares.

9 Cal. Corp. Code § 2000(a).

10 Former Cal. Corp. Code § 4658.

11 *Id.*

12 Some valuation experts believe that private companies sell for less than publicly-traded companies in a merger or acquisition because their shares are not traded on an exchange. Although the data suggests that private companies do sell for less, it is likely

due to factors other than marketability. It is unlikely that an acquirer of a public company would pay more for the shares simply because they were liquid because once purchased, they would not be publicly-traded any longer.

13 Marketability discounts are sometimes also referred to as liquidity discounts but also mistakenly referred to as minority discounts.

14 *Brown v. Allied Corrugated Box Company*, 91 Cal. App. 3d 477 (1979).

15 Of course, the valuation must be further adjusted for the issues already discussed.

16 *Mart*, 95 Cal. App. 4th at 531.

17 *Id.*

18 *Abrams v. Abrams-Rubaloff & Associates, Inc.*, 114 Cal. App. 3d 240, 249 (1980).

19 *Brown*, 91 Cal. App. 3d at 488.

20 *Mart*, 95 Cal. App. 4th at 532. Judge Haerle necessarily had to address it because the absence of a signed a non-compete agreement was the reason the trial court requested the appraisers to value Bay World on a liquidation basis.

21 *Id.* at 532.

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their Operating Agreement addresses capital account maintenance, a requirement to make liquidating distributions in accordance with positive capital account balances that includes a Qualified Income Offset provision. To be safe, the Operating Agreement should specifically reference these tax requirements, although many agreements simply provide a general reference to compliance with the Internal Revenue Code and Treasury Regulations.

ii. Substantiality

Meeting an economic effect test will not automatically cause the IRS to respect a special allocation of loss entirely to A. It is also necessary to show that the allocation affects the amount of money partners will receive independent of tax consequences, i.e., that the allocation is "substantial."[25] Substantiality can most easily be thought of as avoiding allocations that have only a short-term impact (such as allocating a loss in one year, matched by a gain in a subsequent year, so that there is no overall economic impact—so-called "transitory" allocations) or avoiding allocations that are only of tax character (such as allocating tax exempt income to one member and an equal amount of taxable income to another member—so-called "shifting allocations"). [26] From an economic effect point of view, these types of allocations are acceptable but have tax abuse potential, thus these types of allocations are closely scrutinized to make sure that they are not simply a tax "scam."

By far, this issue comes up most often in potential "transitory allocations," i.e. allocations that offset over two or more tax years. In a transitory allocation, the IRS does not deem the economic allocation in year one to be "real" because the allocation is so short-lived or illusory that the receiving member is not treated as actually taking the risk of allocation. While substantiality is a "facts and circumstances" test, if there is a strong likelihood that the LLC will offset the special allocation by a reversing allocation—a so-called "charge back" allocation—within five years, then the allocation is presumed to be insubstantial.[27] For example, an allocation of gross rent loss in year one and a matching allocation of gross rent income in the following year would violate this rule.[28]

If loss is allocated to A in 2009, the allocation will be transitory if there is a strong likelihood that A will have a special allocation of income in a future tax year.[29] If a reverse allocation is made five years after the original allocation, it will not be considered transitory.[30] Finally, the "value equals basis" rule may automatically grant substantial economic effect status for depreciation deductions even over a period of more than one year.[31]

In our example, members A, B, and C should carefully examine past special allocations of income to A, and they should anticipate that A will not receive a special allocation of income during the next five years. In addition, they should analyze the detrimental tax effect to B and C of the allocation of loss to A. The allocation of loss to A in 2009 may have a detrimental effect because B and C could carry the loss forward to future years.

iii. The Problem of Non-Recourse Debt

Another consideration that may affect an LLC's decision on loss allocation is whether the loss involves a non-recourse liability. As a very broad concept, a "non-recourse deduction" involves a loss or deduction on property secured by a non-recourse debt.[32] A "non-recourse debt" generally means that the lender may only obtain the property securing the debt and may not involve the personal assets of the LLC members when collecting a debt.[33] California law generally provides such treatment for LLC members.[34]

Nevertheless, because LLC members are generally not responsible for LLC debts, they have no economic risk of loss for non-recourse liabilities. This means that they cannot use the substantial economic effect test in relation to the allocation of a non-recourse deduction.

To address this concern, the IRS created the concept of "partnership minimum gain."[35] In essence, minimum gain is the amount by which the non-recourse liabilities secured by