Are Valuation Discounts Appropriate in LLC Member Statutory Buyouts?

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Prior to 2010, most of the dissolution and buyout cases that were decided by the California courts of appeal involved corporations, with plaintiffs seeking buyouts under California Corporations Code § 2000. Given the rise in popularity of limited liability companies (LLCs), there have been an almost equal number of LLC buyout cases since 2010. The LLC buyout option language in California Corporations Code § 17707.03 is similar to § 2000. However, the language is not precise from an appraiser's perspective and could lead to a lower value being attributed to an LLC member's interest than would be determined under the § 2000 language. In addition, LLCs are often more complex to value accurately because of their unique tax status, *i.e.*, they are not taxed at the entity level.[1] These factors raise some difficult valuation issues, which have been the subject of much dispute in the valuation community and, more significantly, in the courts, for the better part of two decades.

Review of Corporate and LLC Buyout Statutory Language

In general, the statutory buyout language for corporations and LLCs is very similar under the Corporations Code and allows for the cash buyout of a party requesting dissolution. One of the differences between the corporate and LLC statutes, however, relates to the size of the interest that will qualify its holder to seek a judicial dissolution. Under the corporate statute,[2] shareholders holding at least 33 1/3 percent of the common shares are required.[3] The LLC statute, however, provides that "any member or members" may seek dissolution.[4] The reduction in the required size of the interest is a significant improvement in the rights of small LLC interest holders as compared with small corporate interest holders. The grounds for dissolution appear similar from a non-attorney perspective, with deadlocked management or persistent and persuasive fraud on the part of the controlling interest holders stated in both sections.[5]

Much more significant from a valuation perspective, however, is the difference in the language describing the value at which the plaintiff's interest can be purchased. Under the corporate buyout language, value is defined as *fair value*, which "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."[6] Guidance from the courts has been helpful in interpreting this language as generally requiring the valuation of the company as a going concern, considering the value of any intangible assets such as customer relationships and brand names, *if* the appraiser believes the company would be sold on that basis.[7] Of course, if the company is not solvent or is consistently unprofitable, it would likely be valued based on the liquidation value of its assets, net of its liabilities. The LLC buyout statute[8] requires the purchase for cash of the moving party's interest at *fair market value*, with no further clarifying language. The addition of the word *market* may not carry much significance to the casual observer, but to a valuation expert *fair market value* is a term of art and, absent any further instructions, can lead to a value materially lower than fair value.

Fair Value versus Fair Market Value

The addition of the word *market* to the term *fair value* has the impact one might expect—it requires a focus on what the interest would sell for in the open market. Fair market value is one of the most widely used standards of value in the valuation community and is defined by the Internal Revenue Service "as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both parties having reasonable knowledge of the relevant facts."[9] Professional governing bodies for appraisers have similar definitions of fair market value.[10] Absent any further instruction from the courts, this means that the LLC interest buyout price should reflect what the holder could sell the interest for in the open market. Minority interests in private companies are very difficult to sell, especially interests in companies in which there may be some mismanagement or mistreatment of minority shareholders. What could be realized in a sale of a minority interest is usually dramatically less than the interest's pro rata share of the value of the whole company.

In valuation terminology, the difference between (i) the interest's pro rata share of the entire value of the company, and (ii) the value of the interest that could be realized in an open market sale, reflects two discounts: a discount for lack of control (sometimes also referred to as a minority discount) and a discount for lack of marketability. These two discounts together are material; combined, they are usually in the range of 40% to 60%. The discount for lack of control reflects the fact that the minority interest holder does not control the company and therefore cannot choose its strategic direction, determine dividend policy, or enjoy many of the other benefits of corporate control. The discount for lack of marketability reflects the lack of a ready market for the shares, unlike securities that trade on public exchanges such as the New York Stock Exchange.

An Open Issue at the Court of Appeal

The meaning of the term *fair market value* under the LLC buyout statute was at issue in the unpublished case of *Khnkoyan v. Missakian* (*Khnkoyan*).[11] In that case, the minority shareholders sought dissolution of two California limited liability companies under former California Corporations Code § 17351(b)(1), which had identical language to the current LLC statute. The dispute was decided by an arbitrator, and the arbitrator's decision was confirmed by the Superior Court of Los Angeles County. The arbitrator allowed both minority and marketability discounts in valuation of the interests and relied on valuation textbooks describing those discounts in determining fair market value.

The plaintiffs appealed, claiming that the trial court should have looked at the intent of the operating agreement, which prohibited use of these discounts in appraisal of a member's interest.[12] Further, the plaintiffs pointed to the corporate buyout case, *Brown v. Allied Corrugated Box Co.* (*Brown*),[13] where the court of appeal observed:

> As a practical matter, there is no question but that the lack of control inherent in plaintiffs' minority shares would substantially decrease their value if they were placed on the open market. . . . It has been noted, however, that the rule justifying devaluation of minority shares in closely held corporations for their lack of control has little validity when the shares are to be purchased by someone who is already in control of the corporation.[14]

In the end, the court in *Khnkoyan* decided not to resolve the discount issue on grounds that the arbitrator's decision was not judicially reviewable. But the court did say that the "question whether the arbitrator's appraisal of the plaintiffs' shares should have included discounts for minority interest and lack of marketability is a close one."[15]

This statement of course leaves appraisers uncertain regarding whether to apply discounts in statutory LLC buyouts. Almost certainly the issue will arise again. When trying to determine if discounts are appropriate for a minority interest, appraisers will look first to instructions from the courts, either directly or in case precedent. Absent court guidelines, most appraisers will look to the definitions of value accepted within their professional organizations, as apparently happened in *Khnkoyan*. A more insightful appraiser, however, will consider the context of the valuation. To an appraiser, the context of the valuation can be much more important than the definitions of value employed in shareholder oppression and appraisal cases—lawmakers don't always appreciate the material differences in value that can arise from a small wording change.

Context Matters

To valuation experts, the *Brown* court's statement that discounts are not relevant when a majority is purchasing shares from the minority does not ring completely true. Outside of a dissolution proceeding or a sale or merger environment, the majority will usually try to purchase the minority's shares as cheaply as possible. The controlling shareholder is under no obligation to pay the highest price. The seller's only other option is to sell the shares to another investor who would become a minority shareholder and therefore would pay only the discounted value. The majority knows this and will use it in negotiations. Conversely, the seller knows the shares will have more value in the hands of the majority buyer and will use this knowledge to try and get a higher price than the discounted value. The ultimate price will be determined by the motivations, needs, capacity, and negotiating leverage of the parties.

More important in the LLC dissolution buyout context are the two other arguments against discounts presented by the *Brown* court. First, the *Brown* court indicated that allowing the discounts would not be fair. The court reasoned that the statute allowing minority shareholders to seek dissolution is in place to protect them from an unscrupulous majority. To permit discounts to the value of minority interests would allow "the very misconduct and unfairness which provoked the minority shareholders to seek involuntary dissolution . . . [to] be used to further oppress them. This, the statutory scheme before us cannot be read as condoning."[16] What is viewed as fair, however, can be different from person to person; the concept of fairness therefore does not provide a firm foundation for arguments against discounts in the buyout context.

The more practical and compelling reason the *Brown* court gave for not discounting the shares is that if the dissolution proceeding were allowed to proceed to its end, and was not interrupted by the buyout process, all of the shareholders would receive exactly the same amount per share.[17] In such a situation, the majority and minority shareholders would be working together to maximize the sale price of the entire company. If the California legislature believes that it is good public policy to give minority shareholders the ability to dissolve a company for good cause, the legislature has thereby given them the right to receive their pro rata share of the whole. To require a discounted buyout value diminishes minority shareholder rights under the Corporations Code. If this result is good public policy for corporate shareholders, the same should hold true for members of limited liability companies.

LLC Tax Status

One of the reasons LLCs are so popular is that they pay no entity-level tax.[18] Income is instead passed through to the members who pay individual income tax on their respective shares of LLC income. Although LLCs are very attractive in comparison to C corporations, which pay taxes at both the entity and shareholder level, the unique tax status of LLCs presents a challenge to valuation professionals and the courts. The difficulty arises because most of the valuation data from the stock market and transaction databases used to value companies is derived from C corporations.[19] Applying this information to an LLC entails an implicit assumption that the LLC is a C corporation—which obviously it is not. The question becomes what, if any, impact the tax status of the LLC would have on its value. This question is likely to surface in the future in LLC dissolution buyout cases.

Even if the minority interest being valued in a buyout case is an LLC interest, it may not necessarily be valued as an LLC interest by the appraisers. In corporate buyout valuations under California Corporations Code § 2000, the question before the appraisers is: What will the company as a whole sell for? If the valuation guidelines for corporations are held to apply in the LLC buyout context, the appraisers need to look at the likely buyers of the whole company and whether those buyers would consider the pass-through tax status of the LLC. A buyer's motives can be difficult to determine with any certainty. In general, however, in the case of smaller business entities that are likely to be formed as LLCs, buyers are more likely to be individuals or else pass-through entities that pay for acquisitions based on the pass-through tax status of the entity being acquired.

Given an individual or pass-through entity buyer, the next question the appraiser faces is how much more, if anything, will be paid for this company in comparison to a C corporation. This question, as it turns out, has puzzled courts and valuation experts for decades. In a case involving an S corporation (another type of pass-through entity), the Tax Court dealt with the issue by not taxing the entity at the entity level and applying valuation measures from C corporations to the untaxed income. This approach resulted in a value premium relative to an identical C corporation of about 60 to 70%.[20] This methodology, however, ignores the reality that tax rates for individuals on LLC income and C corporation dividends are quite different. C corporation shareholders pay much lower taxes on dividends than LLC members pay on income, and this difference offsets much of the entity-level tax advantage of LLCs. The Delaware Court of Chancery has demonstrated the firmest grasp of all of the issues surrounding the valuation of pass-through entities and has developed a simplified approach that indicates a lower premium than the method adopted by the Tax Court.[21]

Final Thoughts

Despite the case precedents disallowing discounts in corporate buyouts under California Corporations Code § 2000, it is possible that, by use of the term *fair market value* in California Corporations Code § 17707.03, the legislature intended appraisers and the courts to apply discounts in LLC buyouts. If so, appraisers will provide discounted values. It would save time and reduce appraiser and legal costs, however, if (i) the legislature clarified its position on discounts in the statute, or (ii) courts provided instructions to appraisers regarding application of discounts at the outset of a valuation. In addition, courts are likely to see disparate methods used by appraisers to address the tax status of LLCs that dramatically impact value conclusions. Hopefully, California courts will look to the analysis and reasoning of the Delaware Court of Chancery when the issue comes before them.

Endnotes

1 U.S. Department of the Treasury. Internal Revenue Service. (2014). *Publication 3402* (Cat. No. 27940D). Washington, DC: U.S. Government Publishing Office.

2 Cal. Corp. Code § 1800(a).

3 This amount is adjusted to recognize convertible preferred shares and can also be measured as a percentage of equity. In the event that the grounds for dissolution are "persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders" (Cal. Corp. Code § 1800(b)(4)), the denominator used to calculate the required percentage is reduced by the shares held by those in control of the corporation. Cal. Corp. Code § 2000(a).

4 Cal. Corp. Code § 17707.03(a).

5 Cal. Corp. Code § 1800(b)(3) and (4); Cal. Corp. Code § 17707.03(b)(4) and (5).

6 Cal. Corp. Code § 2000(a).

7 *Mart v. Severson*, 115 Cal. Rptr. 2d 717, 725 (Cal.Ct. App. 2002).

8 Cal. Corp. Code § 17707.03(a).

9 26 C.F.R. § 20.2031-1(b) (2015).

10 National Association of Certified Valuators and Analysts. (2001). *International Glossary of Business Valuation Terms*. Retrieved from http://www.nacva.com/content.asp?contentid=166#terms_F.

11 *Khnkoyan v. Missakian*, No. B248125U, 2014 Cal. App. Unpub. LEXIS 1527 at *2-8 (Cal. Ct. App. Mar. 3, 2014).

12 The plaintiffs had originally sought an appraisal of their shares under the terms of the operating agreement, but later dismissed that action and sought appraisal under former Cal. Corp. Code § 17351. Since the operating agreement provisions where clear that no discounts should be applied, the plaintiffs likely regretted their decision to proceed under the statute. The members of the LLCs could also have made it clear when drafting the operating agreement that the framework for value (i.e., no discounts) also applied in circumstances when a dissolution buyout was sought under the statutory provisions. Although, from a non-attorney perspective, this may not be possible as the current Cal. Corp. Code § 17701.10 states that the operating agreement may not "[v]ary the power of a court to decree dissolution in the circumstances specified in subdivision (a) of Section 17707.03 *or the provisions for avoidance of dissolution in subdivision (c) of Section 17707.03*," which includes the definition of value (emphasis added).

13 91 Cal. App. 3d 477 485-86 (Cal. Ct. App. 1979)

14 *Id.* at 486.

15 2014 Cal. App. Unpub. LEXIS 1527, *7.

16 91 Cal. App. 3d at 487.

17 *Id.*

18 See *supra* Note 1 for default taxation of multi-member LLCs as partnerships. Partnerships are not taxed, but their income "passes through" to their partners. See U.S. Department of the Treasury. Internal Revenue Service. (2015). *Partnerships*. Retrieved from https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Partnerships.

19 If stock market and transaction information can be found for other pass-through entities, the valuation assignment can be handled without any adjustment for tax status.

20 Gross v. Commissioner, T.C. Memo 1999-254 (U.S. Tax Ct., July 29, 1999).

21 *See, e.g., Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290, 327 (Del Ch. 2006), and *Owen v. Cannon,* No. 8860-CB, 2015 Del. Ch. LEXIS 165, at *67 (Del. Ch. June 17, 2015), both of which were S corporation cases.