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California Corporations Code Section 2000: A Solution to Corporate Dissolution

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Where there's a will, there is *sometimes* a way.

Such is the adaptation on the old adage when applied to California Corporations Section 2000 (Section 2000).

The intent of Section 2000 is to afford warring shareholder groups an alternative to flat-out dissolution. In some instances, the statute enables both parties to achieve their goals. However, the law of unintended consequences often rears its ugly head. This article describes Section 2000 and identifies some of the areas of controversy that arise with its application.

California Corporations Code Section 2000: An Overview

Section 2000 may be invoked as a defense to a lawsuit for involuntary dissolution, or in a proceeding for voluntary dissolution initiated by a vote of shareholders representing 50 percent of the voting power of the corporation. In either instance, the corporation or 50 percent or more of the voting shareholders may avoid dissolution by, according to the statute:

> "...purchasing for cash the shares owned by the plaintiffs 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 sale of the entire business as a going concern in a liquidation." Section 2000 (a).

If the parties are unable to agree on the "fair value," then the purchasing party must post a bond to cover attorneys' fees and reasonable expenses of a valuation, and the court will then stay the dissolution proceeding and appoint three appraisers to determine the fair value of the shares. Section 2000(b). The award of the appraisers, or a majority of them, is final and conclusive upon the parties when confirmed by the court. Section 2000(c).

Timing is key, too: The court issues an alternative decree calling for the corporation to be wound up and dissolved unless payment is made by the purchasing party within the time set by the court. If payment is made in a timely fashion, the moving parties are required to transfer their shares to the purchaser; however, if the purchasing party fails to make payment, it is required to pay the party invoking dissolution the reasonable costs of the appraisal, including attorneys' fees. *Id*.

The date of valuation is the date the involuntary dissolution action was commenced, or the date the proceeding for voluntary dissolution was initiated by the shareholders holding 50 percent of the voting power. However, the court may, upon a showing of good cause, designate a different date as the valuation date. Section 2000(f).

Preliminary Steps

What should shareholders do when faced with a Section 2000-triggering event? There are certain specific steps that can be taken to address such a situation.

Implement a Cost-Benefit Analysis

The first thing a corporation and/or its shareholders should do when confronted with one of the events triggering Section 2000 is assess the economic impact of invoking the code section. Due to confusion about the definition of "fair value" discussed below, and because the process is expensive (involving a three appraiser panel and potential attorneys' fee exposure), an initial evaluation should be made of the benefits of maintaining the corporation as a going concern. On the one hand, there may be significant benefits to avoiding dissolution,

such as avoidance of tax impacts, preservation of name recognition, goodwill, contracts and the like. On the other hand, in some instances it may make sense for the parties to shutter the business, and for those interested in carrying on to retool the business enterprise as a new entity going forward. At least one commentator has remarked of the code section, "Be careful what you ask for – you might get it."

Vet Your Potential Appraisers

Assuming a party elects to invoke Section 2000, one of the critical first steps is to conduct due diligence on the appraiser pool. The statute states that the court "shall appoint three disinterested appraisers," but in practice the moving party often selects an appraiser, the purchasing party does the same, and those two appraisers select a mutually acceptable third appraiser, with the court approval of this process constituting the "appointment."

Knowledge of the field of business conducted by the corporation is an obvious requirement. It is equally important to gauge the appraiser's familiarity with Section 2000. As discussed in the cases cited below, the court is required to disallow a valuation if it does not comport with the statutory requirements. Further, "fair value" is not the equivalent of "fair market value." Most appraisers are familiar with the "fair market value" standard; fewer are familiar with "fair value," which is a creature of statutory creation.

An important question to ask an appraiser candidate is whether he or she feels strongly about obtaining a unanimous opinion of value. The statute requires the court to confirm the "award of the appraisers, or a majority of them." Section 2000 thus anticipates that all three appraisers may not be in agreement on "fair value." However, certain appraisers have told this author that they will not finalize a report unless and until they have reached a unanimous opinion of value. While an appraiser might prefer such an approach to avoid getting embroiled in ongoing disputes or requests for further instructions/ clarification from the court, selecting an appraiser who signals that he or she considers it essential that all three panel members reach unanimity on the issue invites complexity, and potential delays, down the line.

Anticipate Procedural/Process Issues

Case law interpreting Section 2000 emphasizes the intended summary nature of the proceeding, and the intention to reach quick closure. In a contested proceeding in a jurisdiction with a crowded law and motion docket, things may not unfold as quickly as intended. With this in mind, shareholders should anticipate and address as many of the potential issues involving the appraisers as possible before the appointment hearing.

For example, the statute says the court shall "prescribe the time and manner of taking evidence, if evidence is required." Section 2000(c). However, the appellate courts have made it clear that due to the summary nature of the proceeding there is no right to discovery. *Abrams v. Abrams-Rubaloff and Associates, Inc.*, 114 Cal.App.3d 240, 247-248. Therefore, if a party wants to obtain information or otherwise participate in the information sharing process, he or she should call this to the court's attention prior to or at the appointment hearing.[1]

In practice, appraisers will often convene meetings with the parties, either jointly or separately, with counsel often given the opportunity to be present or at least to observe, but the statute imposes no rights or obligations in this respect. Therefore, it is good practice for a party to vet suggested procedures with his or her "appointed" appraiser in advance. Issues to consider include:

- Whether counsel for the parties should be allowed to attend information-gathering meetings conducted by the appraisers
- Banning *ex parte* communications once the three appraiser panel is convened
- Imposition of deadlines for various stages
- Process for seeking court instructions in the event questions from the appraisers arise during the assignment

"Fair Value"

The statutory definition of "fair value" has been the source of much confusion. It is not the same as "fair market value," and clients need to be aware of this distinction from the outset. 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 sale of the entire business as a going concern in a liquidation." Ca. Corporations Code Section 2000(a).

The most important point clients need to understand: Straight "liquidation value" is less than standard "fair market value." The requirement that the appraiser take into consideration the possibility of a "sale of the entire business as a going concern in a liquidation" raises

[1] Similarly, there is no requirement that the appraisers' report be verified, nor does a party have a right to cross examine the appraisers on their findings. *Id.* In cases where questions have arisen, it does appear to be common practice for the court to issue a series of questions or requests for clarification to the appraisers. See, e.g., *Cotton v. Expo Power Systems, Inc.* 170 Cal.App.4th 1371, 1379 (2009); *Mart v. Severson, supra*, 95 Cal App.4th 521, 527.

the possibility that the seller may realize more than a piecemeal liquidation price. However, on top of this, the appraisers will still consider costs of liquidation and the fact that the buyer is required by statute to pay all cash in a short period of time.

Additional nuances articulated by cases interpreting Section 2000 have provided some guidance (in the abstract, at least) about factors that will or will not be considered. Some of these factors benefit the potential buyer, while others benefit the seller. As a result, perceptions of unfairness can exist on both sides in a Section 2000 matter. For example:

- The appraisers cannot apply a "minority discount" to the shares being appraised. *See, Brown v. Allied Corrugated Box Company, Inc*., 91 Cal.App.3d 477, 487 (1970); *Ronald v. 4-C's Electronic Packaging, Inc*., 168 Cal. App.3d 290, 298-299 (1985).
- The appraisers are required to assume the selling shareholder will enter into a covenant not to compete as part of the valuation, even though in reality the seller may not actually do so. *See, Mart v. Severson*, 95 Cal.App.4th 521, 531; *Brown, supra*, 91 Cal.App.3d. at 487-488. The imposition of this hypothetical condition has a potentially unfair impact on the purchasing company/ shareholder, since they are paying for something they may not get. The appellate court in *Mart* tried to explain away this unfairness by pointing out that the purchaser is not required to pay the price determined by the appraisers, because it could opt instead to proceed with dissolution under Section 2000. *Mart, supra*, 95 Cal.App.4th at 535. However, this ignores the fact that Section 2000 imposes a penalty on the purchaser who elects not to proceed with the buy-out, by requiring it to pay the appraisers' fees (which can run in the six figures) and the seller's attorneys' fees under Section 2000(c).
- The tension between the term "liquidation value" (which generally equates with a piecemeal sale of assets) and "the possibility, if any, of the sale of the entire business as a going concern in a liquidation" creates a great deal of ambiguity, and often with results that do not immediately seem fair. For example, in *Trahan v. Trahan*, 99 Cal.App.4th 62 (2002) the appraiser (a single appraiser appointed by stipulation of the parties) attributed a negative value to the company, even though the company was party to several hundreds of thousands of dollars in unperformed construction and maintenance contracts. The appraiser reasoned that the statutory term "liquidation value" required her to conclude the contracts would not be completed, and even if they were, the costs of completion would need to be considered. The court applied a strict interpretation of the statute, and found the appraiser correctly determined the value as of the statutory valuation date. This finding was sustained on appeal.

However, the appellate court noted that the moving party could have sought an alternate valuation date as authorized by Section 2000(f). Had it done so, the appellate court opined, the appraiser could have considered the value of the contracts, reduced by administration/winding down costs, as part of the value.

- A shareholder derivative claim will affect share value, and it must be considered by the appraisers in determining fair value. *Cotton v. Expo Power Systems, Inc*. 170 Cal. App.4th 1371, 1381-1382 (2009).

Counsel should anticipate areas of expertise or appraiser comfort levels with parameters unique to the assignment before they are selected or proposed. Against this backdrop, the appraisers will render their ultimate conclusion. At that point, as long as the purchasing party meets the payment deadline, dissolution is avoided. If the purchasing shareholders elect not to proceed, they must pay for the costs of the appraisers and opposing counsel who were required as a result of the process.

Conclusion

Section 2000 is intended to offer a win-win situation in the event of shareholder disputes. Often the implementation strays from initial expectations. However, the process does enable a small business to continue operating despite unanticipated shareholder friction.

The best practice for any small corporation is to have a buy-sell agreement in place that anticipates shareholder differences, and enables a party to exit at the appropriate time without friction and disputes concerning value. As practitioners, more often than not attorneys inherit cases in which the parties on both the buy and sell side have failed to implement a buy-sell agreement, making it necessary for counsel to make the best of an imperfect situation. Section 2000 offers an option in some of those instances.

The bottom line: Shareholders should go into the Section 2000 process with open eyes, sufficient advance planning and experienced legal counsel.

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