BUSINESS VALUATIONS

UNDER

CALIFORNIA CORPORATIONS CODE SECTION 2000

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1.0 **PREFACE**

1.1 This discussion paper raises and discusses relevant issues relating to the CPA's role in performing business valuations under California Corporations Code Section 2000. It is not intended to establish standards of practice or identify specific procedures that are required to be performed by CPA's in this situation.

2.0 **INTRODUCTION**

2.1 CPAs are frequently asked to render business valuation services under California Corporations Code Section 2000 ("Section 2000"). Section 2000 is the statute invoked by the corporation or a shareholder(s) seeking to avoid dissolution of a corporation when:

1) a suit for involuntary dissolution has been brought under Section 1800, or
2) proceedings for voluntary dissolution have been initiated under Section 1900.

The corporation or shareholder(s) seeking corporate dissolution is the "moving party" (seller).

The shareholder(s) seeking to avoid corporate dissolution is the "purchasing party" (buyer).

2.2 The appraisal process in a Section 2000 assignment is unique. The CPA will use appraisal concepts that are vaguely defined in the statute. The engagement, which involves multiple appraisers and multiple parties, causes communication and procedural issues that are often complex. This discussion paper addresses these and other nuances that affect the CPA when performing business valuation services in this setting.

3.0 **STATUTORY FRAMEWORK**

3.1 Sections of the California Corporations Code ("the Code") other than Section 2000 may be relevant to the CPA in performing a valuation under this statute. This discussion paper does not attempt to cover all relevant statutes. The CPA should rely on the court and attorneys for specific direction regarding the law. Notwithstanding this, the CPA should be generally familiar with three chapters of the Code when performing an engagement related to Section 2000:

1) Chapter 18 – Involuntary Dissolution
2) Chapter 19 - Voluntary Dissolution
3) Chapter 20 – General Provisions Relating to Dissolution

3.2 **Chapter 18** of the Code sets forth the statutory framework for the *involuntary* dissolution of a corporation. Section 1800 of this chapter is the statute that enables a party to file a complaint for involuntary dissolution. Essentially, the moving party seeking involuntary dissolution must have both the *authority* and *grounds* to file a complaint. Subsection (a) of Section 1800 sets forth the *authority* to file a complaint. Subsection (b) of Section 1800 sets forth the *grounds* to file a complaint.

3.3 In general, Subsection (a) grants the ***authority to sue*** for involuntary dissolution to the following persons:

1) One half or more of the directors in office.
2) Shareholders who: a) hold shares representing not less than 33 1/3 percent of the total equity of the corporation, *exclusive* of shares owned by persons who have participated in an alleged wrongful activity, or b) any shareholder of a close corporation (italics added).

3) Any shareholder, if the period for which the corporation was formed has terminated without extension.

4) Any other person expressly authorized to do so in the articles.

3.4 Subsection (b) sets forth the ***grounds to sue*** for involuntary dissolution:

1) Abandonment – The corporation has abandoned its business for more than one year.

2) Board deadlock – The corporation has an even number of directors who are equally divided and cannot agree to manage affairs to the benefit of the corporation.

3) Shareholder deadlock – The shareholders are so deadlocked that the business can no longer be conducted to the advantage of the corporation, or the shareholders have failed at two consecutive annual meetings to elect successor directors.

4) Pervasive fraud, mismanagement, abuse or unfairness – Those in control have been guilty of or knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority, or persistent unfairness toward any shareholder.

5) Unfairness in small corporations – In corporations with 35 or fewer shareholders, liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholder(s).

6) Corporate expiration – the period for which the corporation was formed has terminated without extension.

3.5 **Chapter 19** of the Code sets forth the statutory framework for the *voluntary* dissolution of a corporation. Section 1900 of this chapter sets forth the authority of a corporation to voluntarily elect to wind up and dissolve. In general, any corporation may elect to voluntarily wind up and dissolve by the vote of shareholders holding 50 percent or more of the voting power. In certain situations the court, upon petition of the corporation or certain other authorized parties, may take jurisdiction over the dissolution proceeding.

3.6 While Chapters 18 and 19 set forth the law regarding dissolution of a corporation, **Chapter 20,** section 2000, sets forth the law for *avoiding* dissolution under those statutes. **Section 2000** of this chapter is an important section for a CPA providing valuation services in this context. It sets forth the judicial procedures that enable a corporation, or the holders of 50 percent or more of the voting power of a corporation, to avoid dissolution by purchasing the shares of the moving parties. While the CPA may perform services in an action filed under Chapters 18 and 19, it is the valuation services required by Section 2000 that are the focus of this paper.

3.7 Section 2000 is invoked by a defendant corporation or shareholder(s), the purchasing party, to avoid a threatened dissolution of the corporation pursuant to Section 1800 or 1900. By properly invoking Section 2000, the dissolution proceeding will be stayed. If the parties cannot agree on the fair value of the moving party's shares, and the purchasing party posts a bond, the statute states that the court will appoint three disinterested appraisers to appraise the fair value of the shares owned by the moving party. This appointment is contingent on the purchasing party giving a bond to pay the reasonable expenses of the moving party if the purchasing party does not buy the moving party's shares at the value confirmed by the court within the time specified by decree.

3.8 Much of the difficulty in appraising shares of stock in a Section 2000 engagement lies in the definition of "fair value" set forth in the statute. Paragraph (a) of Section 2000 states that, "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 the sale of the entire business as a going concern in a liquidation." This statement presents two premises that may be viewed as contradictory in the appraisal profession: going concern value and liquidation value. While some of the ambiguity has been clarified by appellate cases (see Section 7.0), interpreting "fair value" in the context of current valuation theory is one of the factors that makes valuing a business under Section 2000 difficult.

3.9 As indicated in the paragraphs above, the legal issues surrounding Section 2000 valuations are complex. These issues, and the vagueness of appraisal guidelines, may give rise to disputes in the valuation process. The CPA is advised to study relevant literature, including Chapters 18, 19 and 20 of the Code, and pertinent case law. When necessary, the CPA may consider seeking additional guidance from the court.

4.0 VALUATION CONSIDERATIONS

4.1 The lack of a clear definition of the valuation premises and standard of value in the statute have complicated valuations pursuant to Section 2000. It is important for the CPA to understand commonly accepted definitions in the business valuation profession before accepting an assignment in this area. It is also important for the CPA to become familiar with the appraisal terms used in the Code. The following sections present valuation premises and standards of value commonly used by the business valuation profession, followed by valuation premises and standards of value used in the Code.

4.2 Valuation Premises - Appraisal Profession. When valuing a business, the CPA typically determines the premise of value the company will be valued under: Going Concern or Liquidation. This "premise" of value forms a conceptual framework for the assignment. "Premise of value" is defined in the *International Glossary of Business Valuation Terms* (see Appendix A)[1] as "an assumption regarding the most likely set of transactional

[1] The International Glossary of Business Valuation Terms (See Appendix A) is the result of a unified effort by the five principal business valuation organizations (AICPA, ASA, CICBV, NACVA, and IBA) to develop a standard glossary whose meanings are clearly established and consistently applied throughout the business valuation profession. Note: The reader is cautioned that the Glossary is non-authoritative and continuously evolving. No

circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation." The premise of value should not be confused with the standard of value. A "standard of value" is the specific type of value used by the CPA in an appraisal situation. Standard of value is defined in the *International Glossary of Business Valuation Terms* as "the identification of the type of value being utilized in a specific engagement; e.g. fair market value, fair value, investment value." Standards of value are covered in Section 4.3 of this paper. A discussion of the two main premises of value in the business valuation profession is presented below:

1) **Going Concern** – When valuing a business under a going concern premise, the CPA generally assumes that the business will continue to operate into the future and has the inherent ability to do so. The *International Glossary of Business Valuation Terms* defines **going concern** as "an ongoing operating business enterprise." The same source defines **going concern value** as "The value of a business enterprise that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems and procedures in place."

2) **Liquidation** - When valuing a business under a liquidation premise, the CPA generally assumes that the business will not continue to operate into the future, and that the company's individual assets will be sold or otherwise disposed. The *International Glossary of Business Valuation Terms* defines **liquidation value** as "the net amount that can be realized if the business is terminated and the assets are sold piecemeal." Liquidation can be either "orderly" or "forced". The *International Glossary of Business Valuation Terms* defines **orderly liquidation value** as "liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received." The same source defines **forced liquidation value** as "liquidation value at which the asset or assets are sold as quickly as possible, such as at an auction."

4.3 <u>Standards of Value – Appraisal Profession.</u> In addition to determining the appropriate premise of value for an appraisal, the CPA must determine the appropriate standard of

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attempt will be made to update this discussion paper for future modifications made to the Glossary. The reader should contact the Management Consulting Division of the American Institute of Certified Public Accountants for the most current version.

value. It is important to understand that the CPA's value conclusion for a company may differ depending on both the premise of value and/or the standard of value applied. A discussion of three prominent standards of value in the business valuation profession is presented below:

1) **Fair market value** - The *International Glossary of Business Valuation Terms* defines fair market value as "the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." One of the distinguishing factors of fair market value is that both the buyer and seller are generally assumed to be unknown and hypothetical.

2) **Investment value** - The *International Glossary of Business Valuation Terms* defines "investment value" as "the value to a particular investor based on individual investment requirements and expectations." One of the distinguishing factors of investment value is that both the buyer and seller are generally assumed to be known and specific.

3) **Fair value** - The term "fair value" is a statutorily created standard of value that is relevant in certain appraisal assignments, including Section 2000 valuations. Since statutes vary by jurisdiction, there is no universal definition of this term in the business valuation profession. In the context of Section 2000, fair value is discussed in Section 4.4. Relevant cases that provide further insight into the intended definition of fair value in the context of Section 2000 are discussed in Section 7.

4.4 Valuation Premises and Definitions - California Corporations Code. The preceding sections discuss valuation premises and standards of value as defined by the appraisal profession. In attempting to understand Section 2000, it is useful to analyze the appraisal terms set forth therein. A summary of terms contained in Section 2000 of the Code is presented below:

1) **Fair value** - "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))

2) **Liquidation value** - The fair value definition of Section 2000(a) refers to liquidation value, but does not define it there or in any other area of the Code. In Section 172 of the Code, "liquidation price" is defined as the "amounts payable on shares of any class upon voluntary or involuntary dissolution, winding up or distribution of the entire assets of the corporation, including any cumulative dividends accrued and unpaid, in priority to shares of another class or classes." Unfortunately, this definition provides little clarification of the term "liquidation value" in the context of a premise of value to be used in a Section 2000 appraisal.

3) **Going concern in a liquidation -** The fair value definition of Section 2000(a) refers to "going concern in a liquidation" but, as with "liquidation value," provides no definition of what that means.

4) **Beneficial liquidation** - This phrase, used in Section 2006 of Chapter 20 of the Code, is not defined. This section of Chapter 20, one of the general provisions relating to dissolutions, states that "distribution may be made either in money or in property….and shall be made as soon as reasonably consistent with the beneficial liquidation of the corporate assets."

5.0 VALUATION APPROACH

5.1 Issues raised by the lack of a clear value definition - Section 2000 defines fair value in a way that may present a theoretical contradiction for appraisers. One of the primary issues is the phrase, "going concern in a liquidation." This phrase introduces two premises of value which create unique valuation issues.

5.2 Understanding valuation terms in the statute - Ultimately, it is the court's responsibility to interpret the meaning of the terms set forth in Section 2000. Notwithstanding this, the CPA should attempt to generally understand the terms contained in the statute. One source available to the CPA is relevant case law (see Section 7 of this paper). Another source is the statute itself. While it is important to read the statute, it is also important to keep in mind the primary reason a Section 2000 valuation is being performed: to stay the dissolution of a corporate entity and to ensure that the moving party receives “fair value” for his or her shares. It may be useful to consider how an involuntary dissolution would be carried out if Section 2000 was not invoked. Code Section 1805, quoted below, speaks of the involuntary dissolution process:

> Code Section 1805: *“When an involuntary 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.”*

Thus, even when a company is being liquidated under Chapter 18 of the Code, the preservation of goodwill or going concern value should be considered; immediately ceasing operations and selling assets piecemeal is not a foregone conclusion.

5.3 <u>Minority interest discounts</u> - The court's interpretation of the law in Section 2000 valuations is that minority interest discounts are not appropriate. The logic for this is that if the dissolution were allowed to occur, the moving party would receive his or her pro-rata interest of the sales price and the issue of control would be irrelevant. For a more detailed discussion of this concept, see Section 7.

5.4 <u>Marketability discounts</u> - Section 2000 has no specific discussion regarding the applicability of a marketability discount. The authors are aware of no appellate cases that directly address this issue. The applicability or inapplicability of some form of marketability discount may depend on the facts and circumstances of the case. Appraisers should use caution and judgment when considering the use of a marketability discount.

5.5 Other issues - The appraiser should be aware of other issues that may exist in Section 2000 appraisals. Determining how these considerations should be handled may require stipulations from the parties, written instructions from counsel, and/or rulings from the court. The following are examples of some of these issues:

1) How should multiple business lines be handled? Could some lines be liquidated while others would be sold on a going-concern basis?

2) If the business is to be sold as a going concern, is there a time frame stipulated? How long should the appraiser assume the business will be exposed to the market?

3) Should the appraiser assume that a hypothetical buyer exists for a going concern business?

6.0 ENGAGEMENT CONSIDERATIONS

6.1 Section 2000 assignments pose unique engagement considerations for the CPA. The existence of multiple parties, multiple attorneys, and multiple appraisers, all working in the context of litigation, can make tasks such as communication and information gathering a challenge. The CPA should obtain an understanding of procedural issues such as these before commencing work. The CPA should also take care to ensure that the client relationship has been properly defined in a Section 2000 engagement. The CPA may be appointed by the court, yet paid by one or more of the litigants. From a procedural perspective, these issues and others make Section 2000 assignments among the more challenging valuation engagements in which a CPA will be involved.

6.2 Some of the more common engagement issues the CPA should clarify prior to commencing work are:

1) Valuation date: typically this is the date the dissolution action was filed unless one party has persuaded the court to designate a different date;

2) Whether the CPA will be allowed to communicate with the other appraisers;

3) Whether restrictions exist on oral and/or written communication with the appraisers or any party;

4) Whether the documents provided to one appraiser will be copied to all appraisers;

5) Whether the report should be written or oral;

6) Whether the appraisers should issue a joint report;

7) The fee arrangements, including retainers, balances due and fee caps;

8) Whether specific assumptions are to be made in appraising "fair value".

6.3 The CPA may be appointed by the court in a Section 2000 assignment or selected by the parties. It is beneficial to have these issues clarified, preferably in a court order. If these issues are not addressed in an order, the CPA is advised to seek written clarification prior to commencing work.

6.4 Although an engagement letter is not required by law, canons of ethic, or standards of practice, it is generally good business practice to have one. Typically, the engagement letter should identify the clients, the scope of the assignment, limitations on the assignment and the fee arrangement.

6.5 Some practitioners prefer to use the court order in lieu of an engagement letter. An engagement letter, however, may be desired even when a court order has been issued. If the court order is relied upon, the CPA is advised to insure that the order adequately addresses issues such as scope, fees, timing, communication, administrative procedures, client definition, etc. If these topics are not adequately covered, it may be advisable to issue an engagement letter that accurately defines the engagement. The CPA is advised to review AICPA Consulting Services Practice Aid 95-2 for further discussion of this issue.

7.0 **RELEVANT CASE LAW SUMMARY**

7.1 Following is a summary of pertinent case law for Section 2000, which gives guidance in this type of valuation engagement. Copies of the cases are included in Appendix E.

7.2 Brown v. Allied Corrugated Box Company, 91 Cal.App.3d 477 (1979). At issue in this case was the value of a closely held corporation which manufactured corrugated cardboard containers and boxes. The decision states that minority shares should not be devalued for lack of control in a Section 2000 valuation. The court set forth several arguments against such a devaluation. One argument: "...the rule justifying the 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." The court noted that the valuation is part of the court-supervised involuntary dissolution process wherein the minority shareholder is protected from inequitable distribution at the hands of the majority. Further, the court stated that in a dissolution the minority shareholder is entitled to the same amount per share as the majority shareholder, and in the instance where the majority elects to purchase the moving party's shares pursuant to Section 2000(a), the moving party should not receive less than would have been received had the dissolution been allowed to proceed. The *Brown* decision also provides a discussion of corporate goodwill. In *Brown*, the majority appraisers devalued the business on the basis that the purchasing party was primarily responsible for cultivating customers and, in effect, was the owner of the resultant goodwill. The court rejected that approach and unequivocally stated "the goodwill of a business conducted by a corporation is the property of the corporation alone…" In reliance on Jones v. H.F. Ahmanson & Co., 1 Cal.App.3d 93 (1969) , the court noted a controlling shareholder has a fiduciary duty to the minority shareholder. The court held that in developing a clientele through his use and control of the corporation's assets, the purchasing party was deemed to be acting for the benefit of all the shareholders, not just himself. Plaintiffs were entitled here to their proportionate share of the entire corporation, including whatever goodwill the purchasing party had established through his use and control of the corporation's assets. Any implied threat by the purchasing party to leave the corporation and destroy its goodwill was consequently disallowed.

7.3 <u>Abrams v. Abrams - Rubaloff & Associates, Inc., 114 Cal.App.3d 240 (1980)</u>. This matter involved the valuation of a talent agency in which 100 percent of the management services were provided by the plaintiff and the defendant. Each were 50 percent shareholders. There is a brief discussion of the appraisal method upon which two of the three appraisers agreed. It was determined that the corporation's contracts with artists were of value to a third-party buyer only if a covenant not to compete was assumed as part of a sale transaction. Therefore, the court confirmed the appraisers' imposition of a hypothetical covenant not to compete in evaluating the sale of the business as a going concern. In addition, the court did not allow the fair value of the shares to be reduced by alleged income tax consequences. The holding of *Abrams* is that appraisers are required to consider the manner in which the parties to a hypothetical sale are most likely to maximize their return in determining the value of the business.

7.4 <u>Ronald v. 4-C's Electronic Packaging, Inc., 168 Cal.App.3d 290 (1985)</u>. The primary issue in this case was whether the majority of the appraisers were correct when they valued the shares using the price-to-earnings ratio method based on certain publicly-traded corporations. The court held that there is no established market for closely held stock, and therefore sole reliance on the price-to-earnings ratio method is improper. The case also referenced In re Marriage of Hewitson, 142 Cal.App.3d 874 (1983), in which the court concluded that "if an active market existed for the stock, its market value could be determined, but if none existed then its investment value should be determined." *Ronald v. 4-C's* is also commonly cited for its suggestion that the appraiser consider all the implications of Revenue Ruling 59-60 in a Section 2000 valuation.

8.0 CONCLUSION

8.1 Valuing a business under California Corporations Code Section 2000 presents unique challenges for the CPA. The Code establishes the law but does not adequately define the complex appraisal terms and concepts contained in it. CPAs should be aware of this and the unique issues that arise in these engagements by studying relevant materials and, depending on the structure of the engagement, having early and frequent communication with the attorneys and/or the Court.

APPENDICES

A. International Glossary of Business Valuation Terms

B. California Corporations Code Chapter 18

C. California Corporations Code Chapter 19

D. California Corporations Code Chapter 20

E. Section 2000 Court Cases

- Brown v. Allied Corrugated Box Company
- Abrams v. Abrams - Rubaloff & Associates, Inc.
- Ronald v. 4-C's Electronic Packaging, Inc.