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PERSPECTIVE

Guidance for boardroom disputes in the courtroom

By Bernard M. Resser
and Vera Serova

Whether a company's business is good or bad, disputes arise in the boardroom between business owners. Unfortunately, these boardroom disputes sometimes end up in the courtroom. Until now, when that happened, certainty was lacking regarding the available remedies and how they are carried out, particularly when the internal dispute arises in the increasingly popular form of business entity known as a limited liability company. A recent appellate court opinion that is now certified for publication resolves some open questions about how membership interests in LLCs are valued under California law when a dissenting member is bought out.

In California, like many jurisdictions, a dissenting shareholder of a closely held corporation may initiate an involuntary dissolution of the corporation if the shareholder suspects fraud, abuse of authority by the directors or majority shareholders, or another enumerated basis for dissolution. Corp. Code Section 1800 (b) (1)-(5). In that event, the corporation or the holders of 50% or more of the voting power of the corporation have a choice: to allow the dissolution, defend against the alleged basis for the dissolution, or avoid dissolution by purchasing for cash the shares of the unhappy shareholder at their "fair value." Corp. Code Section 2000(a). Unless the parties agree on what that fair value is, the court appoints three disinterested appraisers to ascertain it. Corp. Code Section 2000(c). This procedure, known as "statutory buy-out" has been codified in California Corporations Code Section 2000 for many decades.

With the popularization of a newer form of business entity, the LLC, California adopted the Revised Uniform Limited Liability Company Act, effective in 2014, that includes a similar statutory buyout provision for LLCs. Section 17707.03 of the California Corporations Code allows a dissatisfied member of an LLC to seek its involuntary dissolution. Like a corporate dissolution, this statute offers a choice to either allow the dissolution, defend against the alleged basis for the dissolution, or avoid dissolution by purchasing the dissenting member's interest. However, unlike Section 2000 that directs the purchasing parties to tender the "fair value" of the dissenting shareholder's shares, the purchasing LLC members must pay "fair market value" for the dissenting member's interest. (Another difference between Section 2000 and Section 17707.03 is who may exercise that choice. Under Section 17707.03 the other members may initiate the buyout process. Corp. Code Section 17707.03(c) (1). Under Section 2000 only the company or a holder of 50% of the voting interests may do so. Corp. Code Section 2000(a).)

Is "fair market value" different from "fair value?" The legislative history does not shed any light on the difference between these standards or explain why California chose one standard for corporations and another for LLCs. Nor does it offer any methodology for assessing either value. So when a boardroom dispute ends up in the courtroom, the parties' lawyers, and the valuation professionals, must look elsewhere for guidance. One point of contention in statutory buyout proceedings is whether a discount for lack of control (DLOC) should apply to the valuation of the dissenting, minority shareholder's shares

or a dissenting member's minority interest in an LLC.

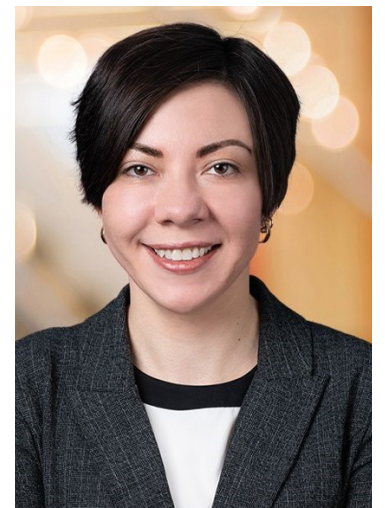
Case law developed under Section 2000 holds that the "fair value" of a minority shareholder's shares in a corporation under section 2000 typically does not include discounts for lack of control or lack of marketability. The court in *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477 (1979), interpreted the legislative intent behind that section as permitting the dissenting shareholder to receive the exact same amount per share in the buyout as the plaintiff would have received had the case been proven and the corporation dissolved. Moreover, because Section 2000 allows only the corporation itself or the holder of at least 50% of the voting shares to buy out a dissenting shareholder's shares, the *Brown* court reasoned "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 pur-

chased by someone who is already in control of the corporation."

Until recently, there was no appellate court precedent in California on the meaning of "fair market value" under Section 17707.03 and whether it is different from "fair value" as interpreted by the courts under Section 2000, including in *Brown*. Instead, parties to such disputes were left to litigate the meaning of Section 17707.03 in each trial court. Parties attempting to settle such disputes were also without guidance on this material element to the valuation of a dissenting member's membership interest. This made it all the more difficult for boardroom disputes to avoid the courtroom.

The recent 2nd District Court of Appeal decision *Cheng v. Coastal LB Associates*, 2021 DJDAR 9883 (Sept. 22, 2021), fills that void and ascribes different meanings to "fair market value" and "fair value." The *Cheng* court held that considerations articulated in *Brown* do not apply to fair market value of an LLC

Bernard M. Resser and Vera Serova are trial attorneys who handle company internal disputes for business clients at Greenberg Glusker LLP in Los Angeles.



member's interest. Application of a DLOC to the valuation of a dissenting member's interest under section 17707.03 is proper when supported by substantial evidence.

The statutory buyout proceeding in *Cheng* involved an LLC, the primary asset of which was real estate. Bernice Cheng, a member with a 25% interest in the LLC, initiated an involuntary dissolution action, and two of the other members (her sisters, Caroline Cheng Jones and Diane Cheng) elected to buy out Bernice's interest. The appraisers valued Bernice's interest at \$623,979, including a 27% "discount applicable to a minority interest." The trial court confirmed the appraisal. Bernice appealed arguing that the minority discount should not apply to the fair market value of her 25% membership interest under section 17707.03. Bernice argued the same rule should apply to LLCs and corporations, citing *Brown's* holding that a DLOC should not

apply. The Court of Appeal rejected Bernice's argument and affirmed the valuation that included a DLOC.

The *Cheng* court distinguished *Brown*, holding that valuation standards prescribed under Section 2000 for corporate shares do not apply to membership interests in LLCs under Section 17707.03. In particular, the *Cheng* court held that a DLOC is proper when determining the fair market value of a minority membership interest in an LLC. In so ruling the Court of Appeal stated: "Fair market value includes discounts reflected in the market." "Had the Legislature intended to apply a 'fair value' standard to purchases of membership interests under section 17707.03, it would have done so expressly in the statutory language." Unlike fair market value, the Court of Appeal reasoned, fair value "does not consider market-related factors that could affect value in the particular hands of a specific owner" and "considers only

'the proportionate interest in a going concern.'" That is not a proper standard for valuation of an LLC interest under Section 17707.03, the *Cheng* court emphasized.

The Court of Appeal noted that California has largely adopted the definition of "fair market value" from IRS Revenue Ruling 59-60 that defines FMV 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 the relevant facts." The Revenue Ruling 59-60 requires consideration of applicable discounts. The Court of Appeal concluded that application of a 27% minority discount to Bernice's interest in the LLC was supported by substantial evidence, including customary principles of appraising interests in real estate-holding entities and valuation studies involving

restricted stock transactions.

Because this ruling is well-reasoned and consistent with cases decided in other jurisdictions, treatises, articles and rules of statutory construction, the authors — who have had to litigate this issue without the benefit of *Cheng's* guidance — concur in the result. But regardless of where one comes out on the virtues of this ruling, *Cheng* provides much-needed guidance regarding the available statutory buyout remedy in disputes involving limited liability companies. The publication of *Cheng* will help parties in such cases avoid unnecessary litigation over the DLOC issue in trial courts, reduce the burdens on appellate courts, and even assist parties in reaching settlements before resorting to court proceedings.

Cheng should result in fewer boardroom disputes ending up in our courtrooms and more certainty about appropriate outcomes when they do. ■