Business Divorce:
I Love You — Not

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When marital partners have irreconcilable differences, either party can end the marriage through "no fault" dissolution. But for California business owners—whether corporate shareholders or limited liability company owners—getting out when conflicts arise can be difficult.

In my experience, the most typical situation is one where a corporation was organized by one family or by a group of two or more friends, but the shares have passed to their descendants, whose interests widely diverge from each other. Frequently, one faction has effective control of the corporation and the other faction either wants more money distributed or wants to convert their ownership to cash. Although the limited liability company form of entity is much newer, similar problems can arise. In either case, if the parties did not establish a buy out mechanism while they were friendly, they must look to the statutes for answers when a dispute arises.

Each situation is different. This article examines general principles involved where owners of a California corporation are in conflict. Part 2 will cover conflicts involving California limited liability companies.

When unhappy shareholders own shares having at least 50% of the voting power in a corporation, dissolution is an available, but sometimes complicated, remedy. When an unhappy shareholder cannot muster 50% of the shareholder votes, dissolution may still be possible in some circumstances.

Shareholders holding at least 50% of a corporation's voting stock may file with the Secretary of State a voluntary election to wind up and dissolve under Corporations Code Section 1900[1], thereby beginning the process. The shareholders need no reason for commencing dissolution—it is essentially a "no fault" dissolution. Where that process may lead is discussed below.

Unhappy shareholders who together own at least one-third of the outstanding shares can file a complaint for dissolution with the Superior Court under Section 1800, but there are very limited grounds. The most frequent grounds are:

(a) Corporation has an even number of directors and the board is deadlocked, creating a situation where the business can't be managed profitably or the property and business are in danger of being impaired or lost, and the shareholder factions are unable to elect an uneven number of directors to break the deadlock;

(b) Those in control have been guilty of, or knowingly countenanced, persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders, or the corporation's property is being wasted;

(c) If the corporation has 35 or fewer shareholders, liquidation is reasonably necessary to protect the rights or interests of the complaining shareholders.

Unhappy shareholders who own less than one-third of the shares may still have the right to force dissolution. The complaining shareholders, in counting up to one-third, may exclude from the denominator shares owned by persons who personally participated in any of the transactions described in item (c). Thus, a small minority being abused by a large majority may have enough shares to force dissolution. In all other circumstances, unhappy shareholders owning less than one-third of the shares must find other remedies or accept their powerless minority status.

Commencing dissolution under Section 1800 or 1900 is only the first step. Dissolution is a radical approach to separating the parties. Generally, dissolution will result in the corporation being subject to income taxes as if it had sold its assets. If the corporation files its income tax returns as a C Corporation, then the shareholders will also be taxed on any gain realized when the assets are distributed or sold and the proceeds distributed to them—a so-called "double tax" situation. If the corporation is an S Corporation, the corporation's gain is passed through and taxed to the shareholders, but the shareholders will have no second tax, except that if the corporation recently converted to an S Corporation, the double tax problem may remain to some degree. The party commencing the dissolution (the "moving party" under section 2000) should be prepared to pay capital gain taxes as the price of getting out, as well as a reduc-

1 Section references are to the California Corporations Code.

tion in the value received due to taxes on the gain recognized by the corporation upon dissolution if the corporation is not an S Corporation. The other party or parties will not be eager to accept the tax burdens of dissolution, and this may provide an incentive for them to negotiate a buyout at a price close to what the moving party would receive in a dissolution.

The fact that the parties might negotiate a purchase price does not mean that they will. They may have radically different views as to value, even though they may be influenced by the standards of Sections 1800 and 2000 described below. If the parties cannot agree on a price, then the moving party must wait to see if the corporation or the other shareholders (called "the non-moving parties" in Section 2000) exercise the right under Section 2000 to avoid dissolution by purchasing, for cash, the shares of the moving party at "fair value." Fair value must be determined on the basis of liquidation value, but taking into account the possibility of a sale of the entire business as a going concern in a liquidation. Whether a business can be sold as a going concern or should be valued strictly on the basis of liquidation is often a source of conflict.

Courts have interpreted "fair value" to be something less than fair market value because of the assumption that a sale would occur over a short period of time in a liquidation context. However, the courts have held that no minority discount is to be applied, that a covenant not to compete from the departing shareholder is to be presumed in valuing the business, and that taxes that might be incurred in liquidation are to be ignored because there will be no liquidation if the moving party's shares are purchased. If the parties do not agree on fair value, the nonmoving parties may petition the Superior Court to stay the dissolution proceedings and determine the fair value of the shares, which is accomplished through appraisers appointed by the Court. Usually, each side appoints one appraiser and the two appraisers appoint a neutral. Experience has shown that appraisers can vary widely in their opinions, but in general the appraiser appointed by the moving party will find a higher value than the appraiser appointed by the nonmoving parties and the neutral will be somewhere in the middle. However, the final value must be confirmed by the court and reported case law indicates that the courts will scrutinize the valuations; the neutral appraisal may not govern the outcome.

When a value has been set by the court, the non-moving parties will have a limited period in which to complete the purchase and if they fail to do so, dissolution will be ordered and the non-moving parties will be liable for the moving party's costs.

The forgoing is only a general description of issues involving moving for dissolution of a California corporation. The process is complex and requires a careful analysis of risks. The unique facts of each situation will affect the desirability of pursuing remedies under the described statutory remedies, or other remedies.

In Part 2 of this series, I will cover conflicts involving California limited liability companies.

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