

Using California Corporations Code Section 2000 to Resolve 50-50 Shareholder Deadlocks in Privately Held Corporations

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Introduction

All too frequently, in the absence of applicable buy-sell or other shareholder agreements, serious problems arise when two owners, each owning half of a private corporation, develop irreconcilable differences either personally or about the business. Often a breakup of the ownership becomes the objective of one of the equal shareholders, who either wants to sell out or force out the other shareholder. The principal factor that often motivates these business divorces, and also makes them more complicated, is that one owner may play a much more significant role than the other in the conduct of the business. Although California has a variety of laws dealing with deadlocked boards of directors, shareholder rights, and buy-outs in lieu of dissolution, the strategies in representing 50-50 shareholders are both subtle and complex, and implicate a whole range of laws and regulations, including corporate governance, fiduciary duty, valuation, and merger and acquisition law and practices.

This article will discuss strategies that can accomplish the separation of the ownership interests of 50-50 shareholders, with a focus on companies in which there is unequal participation in the business by the two shareholders. Some of the most effective strategies are complicated and sophisticated, and if managed poorly can expose parties to significant liability or losses. Because of this complexity, and because of the variety of interests and relationships involved in such 50-50 situations, there is no conventional approach to resolving such deadlocks.

Circumstances leading to dissolution

Fifty-fifty ownership can result from any number of business or personal circumstances, including an initial agreement between co-founders, accumulated ownership of interests, or inheritance. When the participation in or contributions to the business by the equal owners become too disparate, friction can result. This friction can reinforce the disparate contributions by causing the more active owner to take steps to minimize the involvement of the co-owner. As a result, resentment can develop for both owners: the more active owner may resent receiving only half of the profits while working harder and bringing more value to the business, while the less active owner may feel undervalued or pushed out and believe that his or her reduced influence in business affairs is adversely affecting the company.

Both owners can also feel under-compensated. The more active owner may expect and demand higher compensation for his or her contribution, and believe that the other owner deserves less or no compensation. The less active owner, who can or does control half of the board, may be unwilling to agree to higher compensation for the other owner or lower compensation for him or herself. The less active owner may also believe that the more active owner is taking excessive benefits and using company money for personal expenses. The less active owner may come to view the other owner as being abusive, violating corporate obligations to treat shareholders fairly, or otherwise taking improper advantage. Resentment can build for both parties.

In some circumstances, a less active owner may be satisfied with the other owner doing more of the work but nonetheless being obligated to share equally in all profits beyond whatever employment compensation is being paid. Further resentment may develop for the more active owner who perceives his or her contribution as the principal value in the business, which cannot fully be adjusted by any differential in employment compensation. In those cases, the more active owner may believe that the entire value of the business rests on him or her and that the other 50 percent shareholder is not fairly entitled to 50 percent of the profits. The less active owner may not view the other owner's contribution as being that significant, and believe that independent management could do a better job, possibly at a lower cost, so that both shareholders would simply receive equal dividends. The more active owner rarely agrees to step down.

These and other personal dynamics may lead to an impasse between equal owners if the board of directors is correspondingly equally divided. The superior court is empowered to deal with such an impasse by the appointment of a "provisional director." Although court appointment of a provisional director will enable a majority vote on items

that come before the board, it may not satisfy the sensibilities of the more active owner, who is constrained by having to answer to a provisional director who is in a position to control the board when the two owners cannot agree. Moreover, this judicially imposed tie-breaking vote is usually not healthy for the continued operation of the company. Unless the owners can resolve their differences, inevitably some other solution is required.

Impasse on basic business issues, differences in participation, personal resentment, compensation disputes, and the different perceptions of the equal owners can all lead to the desire by one or both of the owners to disengage from the company, to sell out to or buy out the other owner, or to sell the company to a third party. Differences are very likely to arise regarding what duties each shareholder owes the other in a sale situation, and who gets what and at what value. Not infrequently, the more active owner wants to buy out the other owner, but is unwilling to meet the requested price. The more active owner may also feel that equal division of sale proceeds obtained from a third party buyer is indefensible based on different past contributions; the other owner is not likely to agree to any unequal division.

Strategies and remedies of the two owners

Absent a buy-sell or other contractual arrangement, if the parties cannot reach agreement for one to buy the shares of the other, or to sell the company to a third party, there are limited statutory mechanisms that may lead to one party selling to the other. Either shareholder can attempt to sell his or her 50 percent interest to a third party (generally an unlikely possibility and an unattractive buying opportunity under the circumstances); attempt to induce the other owner to purchase his or her 50 percent interest at an appraised or negotiated value; or compel a liquidation sale of the whole company. However, neither shareholder can compel the other to sell out by appraisal. Each 50 percent shareholder has the same available remedies, but the value and use of each remedy differs for each of them.

Less active owner's strategic choices

The less active owner may elect simply to continue to receive half of the profits while the other owner does more than half of the work. As a 50 percent shareholder who can or does control half of the board of directors, the less active owner is potentially in a position to control the salary and benefits of the more active owner, and to exert influence over a court-appointed provisional director to limit such compensation. In addition, the less active owner may also receive some salary for historic reasons, or as a result of providing services. As a party who controls half of the board, the less active owner may be in a position to extract a salary, whether earned or not.

However, if the less active owner wants a more active role but cannot get it, disagrees with business decisions, believes that the other owner is abusing his or her position, or otherwise wants to terminate the relationship, he or she may take steps that will result in being bought out by the more active owner, being bought out by a third party, or receiving half of the liquidation value of the company. The most direct resolution is a negotiated purchase by the other owner, if possible. While the less active owner cannot require the other owner to buy his or her shares, legal steps are available to enhance that possibility.

Any 50 percent shareholder has a statutory right to wind up and dissolve the corporation, which, one way or another, will result in money being paid to the party moving for dissolution, assuming that the company has any value. If the less active owner seeks a dissolution of the corporation as a matter of right, this sets into motion a number of possible outcomes. If no action is taken by the other shareholder, winding up and dissolution will result in the sale of the company as a going concern or the liquidation of the company in the form of a piecemeal sale of the assets, depending on the condition of the company. The winding up and dissolution will be conducted either by the board of directors (Corp C § 1903) or the superior court (Corp C §1904). The equal shareholders will divide the proceeds of sale equally.

If the 50 percent shareholder not moving for dissolution under Corp C §1900 wishes to avoid the winding up and dissolution of the company, that party may invoke Corp C §2000. Under §2000, the superior court oversees a valuation of the corporation to enable the shareholder not seeking dissolution to purchase at an appraised value the shares of the shareholder seeking dissolution. This valuation in lieu of liquidation is designed to yield, as nearly as possible, a value that would reflect what the shareholder moving for dissolution would obtain in the event the corporation were actually dissolved. The valuation is based on what Corp C §2000 calls the "fair value" of the

company, and not on a traditional "fair market value" appraisal (as "fair market value" is defined in Rev Rul 59-60, 1959-1 Cum Bull 237). In general, "fair value" will be somewhat less than fair market value, because a sale in dissolution necessarily has some distress aspects that are not present with a willing buyer and willing seller acting with full knowledge and without compulsion to buy or sell in connection with an ongoing business.

After the Corp C §2000 valuation is completed, the shareholder not seeking dissolution (i.e., the co-owner who has invoked §2000) may or may not elect to buy out the shareholder seeking dissolution at the appraised "fair value." The party who invokes §2000 but declines to purchase at the "fair value" will be liable for the expenses, including attorney fees, incurred in the §2000 proceeding by the party moving for dissolution. If the shareholder who invoked §2000 declines to buy out the shareholder seeking dissolution, the corporation's assets (or the corporation as a going concern) must be sold with the resulting net proceeds distributed to the shareholders in proportion to ownership.

The less active owner can thus either accept the status quo of co-ownership, negotiate a sale if possible, or move to wind up and dissolve the company and be bought out for 50 percent of appraised "fair value" or whatever is received in a winding up and dissolution. No law prohibits either shareholder from buying the business as a going concern or buying assets of the company following a rejected §2000 appraisal, or following the exercise of Corp C §1900 if §2000 is not invoked.

Active owner's strategic choices

The more active owner has the same options as the less active owner, but different considerations. If the more active owner is unable to negotiate an acceptable resolution of differences or a buyout with the other owner, the more active owner's only mechanism for changing the status quo is to invoke Corp C §1900 to wind up and dissolve the corporation.

Should the more active owner elect to dissolve the company, he or she gives the other owner the opportunity to purchase the corporation in a §2000 proceeding. Thus, the owner who is more involved in the operation of the business must risk losing the business in order to obtain a business divorce.

Once the more active owner initiates dissolution, the other owner may elect to buy the company in order to operate it or to resell it. Should the less active owner have a strategy of buying the company and then immediately reselling or "flipping" the ownership, or just bringing in new owners, there will be problems attracting such buyers for the reasons described below.

The different relationships the two owners have to the business substantially effects whether or not the less active owner will exercise the right to buy the company at a §2000 appraised fair value if the more active owner elects to wind up and dissolve the corporation. First, the less active owner may have different personal objectives and interests, which may not include running the business. Second, the less active owner may no longer have (or may never have had) the skill, experience, or knowledge to run the business. Third, the less active owner may be unwilling to risk buying out the other owner, even at an appraised fair value, without the confidence that he or she can successfully run the business.

In evaluating a purchase of the company, the less active owner must also consider a number of important negative factors that are controlled by the other owner. Because of the nature of the Corp C §2000 sale, the more active owner has no obligation to provide the sorts of warranties, representations, and agreements not to compete that would be given in an ordinary voluntary sale of a going concern. Perhaps the most critical factor in the less active owner's decision to buy is the right (absent some prior agreement) of the more active owner immediately to compete directly with the old business once it is sold to the less active owner. The more active owner is under no legal obligation to remain in management or to perform the traditional functions of a selling owner in assisting in the transition to the new ownership. Thus, the less active owner, who may be less familiar with the business, will be assuming significant risks in buying out the more active owner through a §2000 proceeding. The reverse is probably not true for an active owner who buys through a §2000 process, because he or she is fully familiar with the business, is already running it, and may not be concerned about any serious competition from the less active selling owner.

The artificial nature of the Corp C §2000 valuation process also compounds the less active owner's problems. California courts have held that the court-appointed appraisers must assume for purposes of valuation that the selling shareholder will enter into a noncompetition agreement, even if it is not actually required or agreed to. One federal court, interpreting §2000, held that "the hypothetical sale method of valuation asks what hypothetical willing sellers would do to maximize their return." In that case the court concluded that the appraiser could find that the sellers would extend trade secret licenses controlled by the majority owners to a new buyer, even if the majority owners claimed that they would not do so upon sale. Although this fiction of a hypothetical seller will cause the company to be valued at a higher amount than it would be if the absence of a noncompetition agreement or other favorable post-sale agreement is assumed, the fact is that on sale by the more active shareholder to the other shareholder, there will be no noncompetition agreement or other post-sale agreement of the rights controlled by an individual unless compensation for such an agreement is negotiated.

Mart v. Severson also indicates that the appraisers should assume that the parties to the hypothetical sale will negotiate the other requisite terms to a sale agreement. These "requisite terms" referenced in *Mart* presumably include warranties, representations, and employment agreements, all of which may not in fact be given. However, because the appraisers apparently must assume these "requisite terms" of the sale, the valuation price presumably will be increased.

Thus, when the less active owner is the buyer, the true value of the business when sold in liquidation after a §2000 valuation may be less than the appraised "fair value," which must be based on the assumption of a fictitious covenant not to compete and other beneficial sale terms. When the more active owner is the buyer, under §2000 these fictitious value concepts do not have the same impact, because the business will retain the value provided by the more active owner. Because of this fiction, the less active shareholder may be overpaying at "fair value." The court in *Mart* suggests that even though these fictitious benefits are properly assumed in the "fair value" appraisal, if the potential seller really wants to sell at fair value, the seller will negotiate such terms. However, if the potential seller is the more active owner, such a negotiation may be rejected for personal or strategic reasons.

The more active owner who has given the other owner the Corp C §2000 purchase opportunity has every incentive to persuade the appointed appraisers to set the highest "fair value" in a §2000 appraisal, so that he or she can receive the highest price possible from the less active owner, or discourage the less active owner from buying the company. A number of strategies can be used potentially to increase or decrease the "fair value," although the details of these strategies are beyond the scope of this article. Given these considerations, the more active owner may risk moving to dissolve the company, since the chance of the less active co-owner actually buying the business is relatively small. Thus, the more active owner's best strategy for gaining sole ownership and control of the company may be to dissolve it. Before such a bold decision is made, however, the more active owner should realistically evaluate whether the less active owner might buy the company to operate it or sell it to a third party, all in light of the strategies discussed below.

Active owner's purchase advantage in a dissolution sale

If the more active owner invokes the dissolution procedures of Corp C §1900 and the business is not bought by the other owner based on the Corp C §2000 "fair market" appraisal, or if §2000 is never invoked, the more-active owner is in a position to buy the company at a liquidation sale. A sale must occur because Corp C §1900 mandates that the company must be wound up and dissolved if not purchased at the appraised "fair value" by a party invoking §2000.

Once a company is in dissolution, Corp C § 1903 requires the board of directors to conduct the company's business for the purpose of winding up its affairs. Thus, the board is obligated either to sell the assets of the corporation piecemeal or sell the corporation as a going concern. It would violate the letter and spirit of the dissolution provisions simply to continue to operate the corporation without moving toward some form of sale. If the directors fail to move the dissolution forward, any shareholder holding over 5 percent of the stock can move to invoke court control over the process.

Moreover, once voluntary dissolution has begun, certain actions are required that have a negative effect on the continued conduct of business.

Although the Corp C §2000 valuation creates a hypothetical sale value that basically assumes normal motivation by the owners to sell the company, the self-interest of the more active owner who intends to buy the company in liquidation at the lowest possible price may induce different conduct during the sale process than assumed by §2000. For example, in a normal sale, the owners ordinarily will agree to some period of noncompetition. Selling owners ordinarily also will agree to cooperate in the transition to the new owners, which may include some period of continued employment by the selling owners. A buyer ordinarily requires and obtains extensive warranties, representations, and indemnities from a seller. While the §2000 valuation may assume some or all of these factors, the actual sale may not include any of them, making the company less attractive to possible third party buyers.

If the more active owner wants to buy the company in liquidation, he or she can drive down the purchase price of the company by making it unattractive to potential competing buyers. To achieve this, the active owner can legally refuse to agree not to compete, to assist in transition, or to provide any warranties, representations, or indemnities. Moreover, a potential third party buyer will be most interested in obtaining these types of concessions from the more active owner, who knows the most about the business that is being sold, and who will be a competitive threat to any new owner. Such concessions from the less active owner may be viewed as being of less value.

The less active owner may not be in a position to provide valuable assistance to a new owner, meaningful warranties, representations, or indemnities, or a noncompetition agreement that has significant value. Accordingly, the price of the company in a liquidation sale will be substantially reduced if the more active owner is interested in purchasing the company and decides not to promote or support the sale.

Finally, Corp C §2000(a) mandates that the corporation be valued for a cash sale only. This is consistent with the statutory scheme that applies to liquidation, which ultimately can only result in a cash sale unless a majority of the shareholders agree to accept some other form of consideration, such as the stock of an acquiring company. As a result, if the more active shareholder wishes to acquire the company, he or she must be prepared to pay cash in a §2000 or §1900 sale unless the selling shareholder will accept other consideration. At the same time, the cash requirement further reduces the marketability of the company, because a purchase by a third party using stock, debt, or some form of earn-out over time, is not available if either shareholder refuses to agree to those terms and requires all cash. Refusal to accept consideration other than cash is another strategic option that may possibly further reduce the number of available buyers and therefore presumably reduce the price.

The net result of these factors is that if the more active shareholder wants to buy the company, that shareholder legally may take, or refuse to take, certain actions that will make the company unattractive to most buyers (other than himself or herself), except at a highly reduced price. By depressing the price, the more active shareholder may enhance his or her own bargain purchase opportunity, because the board of directors must still favor the highest price, no matter how low it is. At the same time, the less active owner may recognize that the ability of the active owner to drive the price down in an open market sale means that it would be better to accept some negotiated buyout than to run the risk that the company will sell (to a third party or the other owner) for a fraction of the value that could be achieved in a sale by motivated owners. Finally, the more active owner must be careful to avoid certain significant legal risks while attempting to gain the pricing advantage.

Risks and complications of a bargain purchase by active owner

If the more active owner invokes Corp C §1900 for dissolution of the corporation with the goal of ultimately being the purchaser, potential conflicts arise if the more active owner remains on the board of directors or as the chief executive of the company if and when it is offered for sale. Because a more active owner interested in buying has no assurance that he or she will be the high bidder, this potential buyer faces a dilemma. On the one hand, the buyer always wants the lowest price. On the other hand, if the more active owner is not the low bidder and the company is sold to a third party, the desired price is the highest possible price. These two positions cannot be reconciled. If the more active shareholder wants to assure the highest price, he or she should act like a motivated seller. The highest price can generally be achieved only with a full array of the "requisite terms," including noncompetition agreements, employment agreements, warranties, representations, and indemnities. The more active owner may demand from the less active owner separate compensation for providing these "requisite terms," and in this way attempt to obtain differential compensation to re-fleet earlier contributions. Agreeing to this special compensation may actually be in the interest of the less active owner if the result is a higher net sale amount going to the less active owner. A demand by the more active owner for special compensation for providing "requisite

terms," if rejected, may make it impossible to obtain maximum value. However, legally depressing the price to obtain a bargain purchase calls for an entirely different strategy.

The board of directors is obligated to the shareholders generally to obtain the maximum sale price for the corporation. As a potential buyer, the more active owner acting as a director may be confronted with conflicting positions regarding how the company should conduct itself to maximize the sale price. These conflicting positions arise notwithstanding the active owner's strategic and legal refusal to provide noncompetition and employment agreements or warranties, representations, or indemnities that would enhance the sale price. Inevitably, if it has not occurred already, a tie-breaking director will be selected by the two owners or by the court to serve on the liquidating board. The active owner's position as an active buyer will cause the power of governance to shift to the tie-breaking director.

While trying to be a buyer at a low price, the more active owner, who is also managing the business, must act with extraordinary care to avoid a successful claim by the less active owner for breach of fiduciary duty. It is important to note that no case in California has held that one 50 percent shareholder has a fiduciary duty to the other 50 percent shareholder based solely on such share ownership. Nor does a fiduciary duty arise "in the course of arm's-length buyout negotiations between two equal shareholders of a corporate enterprise," even when one shareholder relies on the other to "paint the truest picture possible of where the company is right now." Thus, the active shareholder assumes a fiduciary duty to all shareholders only as a result of being a director or officer of the company.

Because the more active owner is more responsible for the continued operation and success of the company, it is difficult for that person to remove him or herself completely from management of the company during the sale process. This is particularly true if the active owner hopes eventually to own 100 percent of a business that has continued to flourish during the sale period, which can become quite extended. It is difficult for a business to continue to operate at its normal profitable level while going through an adversarial sale process. The longer the process takes, the greater the potential damage to the business. Thus, careful decisions must be made regarding what matters should be voted on by the board. This also presents complications in the selling process, where the active owner may also be a bidder. Difficult decisions also must be made about how and to what extent the chief executive or director who is also a competing buyer should participate in the process.

The business may be sold in a number of ways, including sale of the assets, or sale of some or all of the business as a going concern through negotiation, auction, or a brokered sale. Brokerage may be conducted by a business broker or investment banker. A variety of sale strategies are available.

If the majority of the board elects a competitive sale through brokerage, any shareholder as a potential buyer stands to be excluded from participating in the preparation of the sale materials or in the selling process. Because both shareholders are potential buyers, regardless of any nonbinding declaration of noninterest in purchase they may make, the burden of overseeing the preparation of sale materials and the sale may fall on the independent director or any special consultant that the board may retain. That consultant may be the broker or investment banker, or may also be a separate party.

If the active shareholder is a potential buyer, his or her nonparticipation in preparing sale materials may negatively affect the quality of those materials. The active shareholder as the most senior corporate executive normally would actively assist in the sale, providing key information and leading presentations to possible buyers. This traditional executive role must somehow be reconciled with also being a potential buyer. The active shareholder must be careful, however, not to act in some way, as an officer or director, that can be construed to undermine the sale process, or claims of breach of fiduciary duty may arise.

In particular, following the notice of voluntary dissolution under Corp C §1900, the more active shareholder who is an officer or a director will be in a vulnerable position regarding any corporate activity he or she undertakes. In what may be a very contentious environment—especially if the more active owner takes legally permitted actions that may depress the sale price—the less active shareholder may scrutinize the other shareholder's corporate activities to find grounds for a breach of fiduciary duty claim in order to obtain some leverage in the process. Under these circumstances, the more active shareholder will be well served to assure that any significant corporate actions are reviewed and approved by a majority of the board. This may be a frustrating process when one of the initial reasons for the dissolution is disagreement about the conduct and direction of the business. In the most extreme

circumstances, the more active shareholder should consider resigning as an officer or director in order to be an aggressive purchaser without fiduciary duty exposure. However, resignation will limit his or her influence over the sale process and diminish control over the continuing conduct of the business.

Assuming that the board of directors is seeking to fulfill its obligation to maximize shareholder value by maximizing the sale price, the more active shareholder as an officer or director may be excluded from most or all of the selling process, except as a potential buyer. The board must also decide whether it will negotiate with interested bidding parties, including the more active shareholder, following an initial bidding round. The sale process and the extent of participation in that process by the more active shareholder have serious implications for the ultimate outcome of the sale. Whatever procedure the board selects may influence whether third parties seriously enter the bidding process. This all may be complicated further if the less active shareholder wants to maximize value or simply deprive the other shareholder of ultimate ownership regardless of the cost.

Possibility of a negotiated sale between the shareholders during the selling process

The difficult situation described above may cause the equal shareholders to negotiate a sale between them, taking into account some or all of the following possible values and factors present: (1) the fair market value of the company; (2) the highly depressive affect on the sale price caused by the legal noncooperation of the more active owner; (3) the risk to the more active owner of a claim for breach of fiduciary duty; (4) the risk to the more active owner of losing the purchase to another buyer; (5) the generally negative effect on the company's operations of the forced sale process and management dislocation; and (6) a contentious board situation with a court appointed tie-breaking director. Consideration of all of these factors, taken together, may enable the disputing parties to establish a realistic value for the company under the circumstances.

Conclusion

Unless sometime during the sale process the parties negotiate a mutual resolution of ownership, the separation of interests of equal 50-percent shareholders through dissolution and sale is fraught with risk and complication for both sides. The more active shareholder stands either to purchase at a bargain, or to sell at less than full value. The less active shareholder is unlikely ever to obtain the kind of fair market value available in a sale by motivated owners. A comprehensive understanding of corporate and fiduciary law, as well as valuation, is essential to guiding an owner successfully through this process and optimizing that owner's outcome.