Breaking Up Is Hard to Do: A Primer on "Business Divorce" Litigation for Transactional Lawyers

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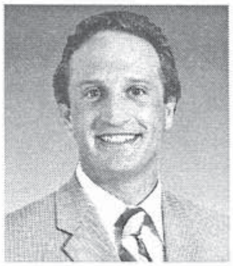

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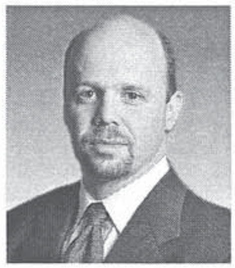

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INTRODUCTION

Breaking up a business in California can be difficult, in some ways not unlike dissolving a marriage—emotional, expensive, and contentious. "Business divorce" litigation can be especially unpredictable when there is no written agreement governing the break up and the default statutory rules control. This article is intended for transactional lawyers who are faced with helping their clients choose the right form of entity and drafting the agreement(s) that will govern that entity. The purpose of this article is to discuss some of the issues that arise in dissolution or buyout litigation under the default statutory schemes for each of the primary forms of entity in California—partnerships, limited partnerships, corporations, and limited liability companies—so that transactional lawyers might better understand what their clients may face if they do not alter the default rules by agreement. As discussed in more detail below, transactional lawyers should work with clients to negotiate and draft elegant and workable contractual mechanisms to resolve impasses, to allow individual owners to exit voluntarily or to be forced out of the business, and to value and divide up the business in a buyout or dissolution.

GENERAL AND LIMITED PARTNERSHIPS

A general partnership is probably the most basic form through which two or more persons can choose to operate a business or make an investment together. If two individuals are in business together and they haven't created some other form of entity, they are probably partners. A partnership is "an association of two or more persons to carry on as co-owners a business for profit." Corp C §16202(a). A joint venture is another label sometimes put on such an association, and joint ventures are governed by the same California law as partnerships.

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General Partnerships

The best way to handle disputes among partners—including disputes that may culminate in the breakup of the partnership—is to have a good written partnership agreement in place. Agree on the rules of the road before you start traveling together. Even if the business has already been formed and is underway, it's not too late to put in place a written partnership agreement. If the partnership is not governed by a written agreement, the Uniform Partnership Act of 1994 (RUPA) (Corp C §§16100–16962) will govern. Further, RUPA includes some provisions that are nonwaivable and therefore will apply regardless of what the partnership agreement might provide.

Turning to the statutory mechanisms that apply to general partnerships, there are two ways for a partner to "get out": (1) dissociation, meaning a partner exits (either voluntarily or involuntarily) but the partnership's existence continues, and (2) dissolution, meaning one or more partners force, or partners agree to, the termination of the partnership.

Dissociation

When California adopted RUPA in 2000, the most significant change in the partnership statutes was the introduction of the concept of dissociation. See Corp C §§16601–16603. In times past, the only way to force one's way out of a partnership (or to force another partner out) under the default statutory scheme was to dissolve the entity. RUPA's creation of the concept of dissociation provides a statutory means for a partner to voluntarily exit or be forced out without terminating the existence of the partnership.

Section 16601 provides that a partner "is dissociated from the partnership" on the occurrence of any of these events:

(1) The partnership's having notice of the partner's express will to withdraw as a partner or on a later date specified by the partner.

(2) An event agreed to in the partnership agreement that causes the partner's dissociation.

(3) Expulsion pursuant to the partnership agreement.

(4) Unanimous vote of the other partners if:

(A) It would be unlawful to carry on partnership business with that partner.

(B) There has been a transfer of all or substantially all of that partner's transferrable interest in the partnership.

(C) A partner that is itself a corporation has filed a certificate of dissolution, been suspended, or had its right to conduct business revoked.

(D) A partnership, limited partnership or limited liability company that is a partner has been dissolved and its business is being wound up.

(5) Judicial expulsion sought by partnership or a partner because:

(A) The partner engaged in wrongful conduct that adversely and materially affected the partnership business.

(B) The partner willfully or persistently breached the partnership agreement or a duty owed under §16404.

(C) The partner engaged in conduct that made it not reasonably practicable to carry on the business of the partnership with the partner.

(6) The partner (A) became a debtor in bankruptcy, (B) executed an assignment for the benefit of creditors, (C) sought, consented to, or acquiesced in the appointment of a trustee, receiver, or liquidator of all or substantially all of that partner's property, or (D) failed, within 90 days, to vacate or stay the appointment of a trustee, receiver, or liquidator of all or substantially all of that partner's property.

(7) For a partner who is an individual: (A) death, (B) appointment of a guardian or conservator, (C) a judicial determination that the partner has otherwise become incapable of performing the partner's duties under the partnership agreement.

(8) For a partner that is a trust, distribution of the trust's entire transferrable interest in the partnership.

(9) For a partner that is an estate or a personal representative of an estate acting as a partner, distribution of the estate's entire transferable interest in the partnership.

(10) Termination of a partner who is not an individual, partnership, corporation trust, or estate.

In the absence of a written partnership agreement that includes a provision governing the withdrawal or retirement of partners, Corp C §16601(1) is the key provision for an unhappy partner who wants out voluntarily. If there is no partnership agreement, or even if there is, a partner wishing to withdraw will almost always choose to dissociate in accordance with Corp C §16601(1). There is one exception: A partner cannot dissociate from a partnership of only two persons; dissolution is the only available exit from a two-person partnership.

Corporations Code §§16602 and 16103 provide that the right to dissociate cannot be taken away by agreement; a partner can always choose to no longer be a partner. The only limitation that a partnership agreement can place on the right to dissociate under §16601(1) is to require that the notice to be in writing.

PRACTICE TIP: Counsel should be careful not to accidentally dissociate a client. If counsel writes a letter that can be paraphrased as, "My client is sick of you guys and wants to be bought out," the client's partners may argue, and a court or arbitrator may find, that this statement constitutes dissociation. Because §16601(1) begins with the phrase "the partnership's having notice," what the partnership believed counsel's statement meant may be more important than what counsel or the client intended to communicate. Any communication that could be interpreted as an expression of "will to withdraw as a partner" could become a notice of voluntary dissociation under §16601(1).

Although a partner can always voluntarily dissociate, such a dissociation may later be determined by the court or arbitrator to be "wrongful." For example, a dissociation from a partnership for a definite term is wrongful if it takes place before that term expires. See Corp C §16602(b)(2). If a dissolution is wrongful, the remaining partners can pay the departing partner over time (rather than in a lump sum, as is usually required), and the partnership can deduct damages caused by the wrongful dissociation from the amount paid to the dissociating partner for his share. See Corp C §§16602(c), 16701.

While a partner can always dissociate voluntarily, forcing a partner out using §16601 is more difficult. Death and bankruptcy are easy, but if the situation is a problem partner that the other partners want to expel from the partnership against his or her will, the other partners must go to court and prove one of the three grounds found in Corp C §16601(5). (Although §16601(4) provides for expulsion by unanimous vote, that subsection applies only in limited circumstances.) For dissociation via judicial expulsion, in addition to the time and expense of litigation, the party seeking to dissociate another partner must prove that the partner engaged in wrongful conduct that materially harmed the partnership, or that the partner breached the partnership agreement or his or her fiduciary duties, or otherwise made it impracticable to carry on the business with that partner in the partnership. See Corp C §16601(5). This can be hard to do, especially if the partnership is profitable.

Dissolving the partnership and reforming a new entity without the problem partner may be the lesser of two evils and more attractive than paying that partner top dollar based on going concern value, in cash, with little time to raise money for the buyout.

Anytime a partner is dissociated, he or she must be compensated for his or her share of the partnership, less any damages caused by the dissociation if it is wrongful. Corporations Code §16701 sets forth the default mechanism to value and purchase the partnership interest of the dissociated partner and favors dissociated partners in at least two ways: (1) the partnership is valued as a going concern to determine the buyout price of the dissociated partner's interest, and (2) the buyout price must be paid in cash and cannot be paid over time (unless the dissociation was wrongful). These requirements are the reason why a notice of dissociation is often followed by a decision by the remaining partners to dissolve. Dissolving the partnership and reforming a new entity without the problem partner may be the lesser of two evils and more attractive than paying that partner top dollar based on going concern value, in cash, with little time to raise money for the buyout. Note, however, that under Corp C §16701.5, any partner that dissociated within 90 days of the dissolution is still treated as a partner for purposes of winding up the partnership's business.

As discussed above, if the dissociation was wrongful, Corp C §16701(f) and (h) provide some potential relief to the remaining partners by giving them the ability to pay over time and discount the buyout price by damages caused by the dissociation. However, a dissociated partner likely will not agree that he or she dissociated wrongfully. The potential for disagreement—and litigation—over whether the dissociation was wrongful, or over the buyout price or timing of payment, is much greater if the partners are relying only on the statutory mechanisms rather than on a detailed written partnership agreement.

Dissolution

Corporations Code §16801 sets forth the events that trigger dissolution. A partnership at will can dissolve if at least half the partners decide to dissolve, *i.e.*, by majority rule. For a partnership for a definite term, the majority rule remains in effect throughout that term, in that the partnership will dissolve after a death or wrongful dissociation of a partner unless a majority of the partners vote to continue. An event that makes it unlawful to continue the business dissolves the partnership. Also, Corp C §16801(5) provides that a partner can file a lawsuit seeking judicial dissolution if (a) the purpose of the partnership is likely to be unreasonably frustrated, (b) another partner has engaged in conduct making it not reasonably practicable to carry on the business of the partnership, or (c) it is otherwise not reasonably practicable to carry on the business in conformity with the partnership agreement. In addition to having the burden of proving one of the grounds for dissolution set forth above, the partner(s) seeking dissolution must show that the partnership was harmed or is in danger of being harmed. These grounds are similar to the grounds for seeking judicial dissociation of one partner. Partners cannot eliminate, through a partnership agreement, the right of a partner to seek judicial dissolution on these bases. See Corp C §16103(b)(6).

One potential problem with dissolution under the default statutory rule is that, under Corp C §16803, all partners have equal rights to participate in winding up the partnership business in connection with a dissolution. If there is disagreement over how the winding up should be handled, which is likely if things have already deteriorated to the point that company is in dissolution, the only remedy is for a partner to ask the court to supervise the winding up process. See Corp C §16803(a). This process is unpredictable and can result in a court-appointed receiver managing the wind-up.

In addition, assuming that the partnership has been successful and has assets left over after satisfying liabilities, the Corporations Code does not allow in-kind distributions. Assets must be liquidated and only cash distributed. See Corp C §16807. Depending on the nature of the assets of the partnership, the need to distribute cash can be very tax-inefficient and can result in sales of assets at distressed values for less than their true value.

Valuation

In setting a buyout price for a dissociated partner's interest, Corp C §16701(b) expressly avoids using "fair market value" as the standard for valuation. The official comments to the uniform act on which the California partnership law was based stated:

> The terms "fair market value" or "fair value" were not used because they are often considered terms of art having a special meaning depending on the context, such as in tax or corporate law. "Buyout price" is a new term. It is intended that the term be developed as an independent concept appropriate to the partnership buyout situation, while drawing on valuation principles developed elsewhere.

Rather than fair market value, the dissociated partner's interest must be purchased based on *the greater* of either (1) the liquidation value of the partnership, or (2) the going concern value of the partnership. Corp C §16701(b). Both choices of valuation are "top down" in that the entire partnership is valued and then the dissociated partner's interest is purchased based on his or her percentage interest. No discount for illiquidity or having a minority interest is allowed.

"Liquidation value" in the context of partnerships does not mean a distressed sale value (which, as discussed below, is in contrast to valuation of a corporation in a buyout situation that does take into account the fact that the company or its assets are being sold under distressed conditions). See generally *Rappaport v Gelfand* (2011) 197 CA4th 1213. "Liquidation value" for a partnership is based on an assumption that the partnership is dissolved and wound up and its remaining assets distributed. If the partnership is one best valued as a collection of assets (*e.g.*, a real estate portfolio rather than an operating business), the liquidation value will be the sum of the fair market values of the properties minus quantifiable liabilities, divided by the partner's percentage interest. If the partnership would have a higher value as a continuing business, it must be valued as a going concern, *i.e.*, what a willing buyer would pay a willing seller for the partnership as a going concern, meaning that the goodwill of the business is included in the value. The remaining partners are entitled to reduce the going concern value based on the fact that the dissociated partner is no longer participating in the business, but the withdrawn partner will get the benefit of goodwill that he or she helped build for the partnership as a whole.

The practical problem with either method of determining the buyout price for a dissociated partner is that reality must be disregarded. Many if not most partners needing to sell a minority partnership interest would have to deal with discounts for illiquidity and minority interests, with little or no market available to sell their interests. Many if not most partnerships forced to dissolve would face potential distressed sale conditions and would be unable to capture full value for any goodwill of the business. Corporations Code

§16701 thus essentially provides a top-dollar buyout price for a partner who does not dissociate wrongfully, which is why, as discussed below, lawyers drafting partnership agreements should consider including contract terms governing buyouts and valuation.

Partnership Agreement Provisions

If partners retain a lawyer to draft a partnership agreement, there is a good chance that the lawyer will advise that they choose some form of entity other than a general partnership for their business. However, a general partnership can still be a useful entity in some circumstances, depending on the clients' relationships, business, and tax strategy. The following are suggestions for provisions that can and probably should be included in a partnership agreement to avoid the messiness that results if partners have no means other than the Corporations Code to break up or force out a problem partner:

- **Withdrawal**. The unfettered right to voluntarily dissociate under RUPA can lead to unpredictability and instability. Although a partner's right to dissociate cannot be taken away, a definite term for the partnership can be established. In that way, at least an early exit by a partner will be deemed a wrongful dissociation. Moreover, although RUPA prohibits limiting the right to withdraw, it is possible to define what makes a dissociation "wrongful" or to place contractual limits on how much and when a withdrawing partner gets paid, both of which can have the practical effect of discouraging dissociations and resulting in a less expensive and more predictable process when they occur.
- **Expulsion.** Although modifying or adding to the enumerated grounds for judicial dissociation under Corp C §16801 is an option, any such grounds will still require litigation and an evidentiary showing. Another option is to provide for dissolution on a unanimous vote of the other partners (which is only available in limited circumstances under RUPA) or on a super-majority vote of a specified percentage of the partners.
- **Valuation Upon Dissociation.** While the right to dissociate cannot be eliminated by contract, the right to receive going concern value can be eliminated and an alternative method of valuing the interest of a withdrawn or expelled partner can be provided. One option is a provision based on the concept of "You name the price, I decide if I am a buyer or a seller."
- **Winding Up.** To avoid confusion and conflict arising from the right of all partners to participate in winding up, counsel should consider specifying in the partnership agreement who will be in charge of winding up and should anticipate potential issues that might arise in winding up. For example, if the business of the partnership is one in which it is more efficient to make in-kind transfers of assets rather than to liquidate and transfer cash, that right should be created in the partnership agreement and an objective mechanism for valuing those assets included, so that there will not be a fight over whether a partner received too much or too little out of the dissolution.

Limited Partnerships

Limited partnerships are a popular alternative to general partnerships. The word "limited" provides a clue as to why: Control and management are more concentrated, liability of owners is not joint and several, and more rights can be created and taken away than for a general partnership. Although a transactional lawyer is more likely to choose a limited, rather than a general, partnership as a form of entity, limited partnership law borrows many of the same concepts described above for general partnerships.

California's current limited partnership law, the Uniform Limited Partnership Act of 2008 (Corp C §§15900–15912.07), is commonly called "Re-RULPA" because the uniform act on which it is based went through three iterations.

Dissociation

The dissociation provisions for limited partnerships have many similarities to the dissociation provisions for general partnerships in Corp C §16601. For example, Corp C §15906.01(b) essentially tracks the grounds for dissociation found in §16601, discussed above. One key difference, however, is that in a limited partnership "[a] person does not have a right to dissociate as a limited partner before the termination of the limited partnership." Corp C §15906.01(a). Another key difference for a limited partnership is that the right to dissociate by delivering a notice of express will to withdraw can be waived by agreement. Although a general partner always has the statutory right to dissociate voluntarily, no matter what the partnership agreement might say, a limited partner can agree to waive that right under the terms of the partnership agreement. See Corp C §§15901.10, 15906.01. If the dissociation events are not altered by agreement, limited partners can be dissociated from the partnership for all of the same logical reasons as general partners, such as death or bankruptcy. The ability of limited partners to expel each other is less meaningful in the context of a limited partnership. In a general partnership, absent an agreement to the contrary, any partner can bind the partnership and participate in management, making it much easier for a problem partner to cause trouble and, more importantly, for the other partners to dissociate the problem partner if he or she is misbehaving. In a limited partnership, however, the limited partners have surrendered control over management to a general partner, and therefore have far less opportunity to engage in conduct that would satisfy the grounds for dissociation under Corp C §15906.01(b)(5) and justify the cost of litigation.

Corporations Code §15906.03 provides grounds on which the *general partner* is dissociated. Interestingly, a general partner can choose to dissociate voluntarily. See Corp C §15906.03(a). The right of a general partner to dissociate cannot be waived by agreement. Corp C §15906.04(a). However, the dissociation can be wrongful. For example, breaching a contract to serve as general partner for a specific term, or until certain conditions are satisfied, constitutes wrongful dissociation. Moreover, as Corp C §§15906.05(b) and 15906.07 make clear, dissociating as general partner is not the type of quick exit that is likely to insulate that general partner from liability. A dissociated general partner loses control over the partnership but remains liable as a general partner for its management, as well as liable for potential damages caused by the general partner's dissociation.

In addition, limited partners can file a lawsuit to expel a general partner on the same grounds applicable in general partnerships: wrongful conduct, breach of the partnership agreement or a duty to the partnership, conduct that makes it not reasonably practicable to continue the partnership business, along with damage or risk of damage to the partnership. See Corp C §15906.03(e). Re-RULPA also has the same provisions to address a general partner who dies, becomes bankrupt, or otherwise is divested of control or put out of business.

Dissolution

The statutory provisions governing dissolution of a limited partnership look a little like those for a general partnership. See Corp C §15908.01. But there is one big difference: there is no dissolution by majority vote unless the general partner approves. See Corp C §15908.01(b).

Just as in the case of a general partnership, a limited partner can apply to the court for a decree of dissolution. The grounds for judicial dissolution, however, are limited to proving that it is not practicable to carry on the business of the partnership in conformity with the partnership agreement. Corp C §15908.02(a). A limited partner can sue to *dissociate* a general partner for wrongdoing but, unlike a general partner of a general partnership, cannot sue to dissolve the partnership because of a general partner's misconduct.

If a limited partner does sue for judicial dissolution, the limited partnership statutes reach across from partnership to corporation law to borrow the concepts found in Corp C §2000, the statutory buyout option applicable to corporations (discussed in more detail below). In a judicial dissolution action, the other partners, if they want to continue the business of the partnership, can avoid dissolution by electing to buy out the partner(s) who sought judicial dissolution. Corp C §15908.02(b). The procedures for purchasing the limited partner interests are very similar to those under Corp C §2000 discussed below.

Provisions to Avoid or Reduce Conflict

The drafting concepts discussed above for general partnership agreements also apply to limited partnerships, and there are additional provisions that may be considered, as follows:

- **Waiver of Dissociation Rights.** If counsel is representing a client setting up a limited partnership, that client almost certainly will not want limited partners to have the right to dissociate by notice. Voluntary dissociation is messy for most limited partnerships, so it should be prohibited by agreement.
- **Withdrawal and Buyout.** Although the right to unrestricted voluntary dissociation should be eliminated, there should probably be some contractual mechanism for limited partners to withdraw and be bought out. If there is no exit, an unhappy limited partner is likely to pursue litigation as the only way out. Moreover, partners die, get divorced, or go bankrupt—situations that force the partnership at a minimum to value and potentially to purchase that partnership interest involuntarily. Better to have a mechanism in place that sets values and provides for a manageable buyout over time.

CORPORATIONS

Turning next to corporations, readers should note that this article does not address public corporations. The laws governing public corporations are complex, but "breaking up" can be as simple as calling one's broker to sell one's stock (although removing a difficult shareholder can be much more difficult). The following discussion is limited to privately held corporations organized under California law.

The corporation is perhaps the most popular form of business entity, but in many ways it is the least flexible. For example, the potential exit mechanisms from a corporation under the default statutory scheme are limited. Unlike a partnership, a limited partnership, or, as discussed below, a limited liability company (LLC), there is no way to dissociate or expel a shareholder in a corporation under the default statutes. Similarly, it is difficult for a shareholder in a privately held corporation to exit voluntarily without consent of the other shareholders. Moreover, a shareholder without a market for his or her shares cannot voluntarily dissociate and force the corporation to buy his or her shares. Rather, when a dispute breaks out among shareholders in a California corporation that cannot be resolved and a shareholder wants out, the only remedy available under the default statutes is to dissolve the corporation.

There are two ways to dissolve a corporation, voluntary dissolution and involuntary dissolution. Which remedy is available depends on the shareholder's ownership percentage, as discussed further below.

Voluntary Dissolution

If a shareholder owns 50 percent or more of the corporation's stock (or if a group of shareholders owns 50 percent or more in the aggregate), the shareholder (or shareholder group) can initiate a voluntary dissolution simply by filing a written notice with the California Secretary of State. See Corp C §1900. Once the form is filed, the corporation is wound up and liquidated, unless the remaining shareholders exercise their buyout option under Corp C §2000 (discussed in more detail below). Interestingly, although the owners of 50 percent or more of the shares can initiate a voluntary dissolution, Corp C §1902 provides that once the notice of dissolution has been filed, the consent of a majority of the shareholders is required to halt the dissolution process and resume operating the corporation as a going concern. In other words, a 50 percent shareholder can start the dissolution process, but that same 50 percent shareholder will be unable to stop the process without consent of one or more other shareholders.

Involuntary Dissolution

General Principles

If one or more shareholders seeking to dissolve the corporation own less than 50percent, they are not able to initiate a voluntary dissolution. If, however, a shareholder owns at least 33-1/3 percent of the shares of the corporation, he or she can seek involuntary dissolution under Corp C §1800 by filing a verified complaint seeking that remedy. One-half or more of directors acting together may also seek involuntary dissolution. Procedurally, an involuntary dissolution is a special proceeding (as distinct from a civil action) and is governed strictly by Corp C §1800 and interpreting case law. The provisions of the Civil Code and Code of Civil Procedure applicable to civil actions only apply in a dissolution proceeding to the extent they are expressly incorporated in Corp C §§1800–1809.

Required Showing

Although an involuntary dissolution may be initiated simply by filing a verified complaint, to actually force a dissolution and liquidation the complaining party must make a showing at trial (or on summary judgment) of one of the following: (1) the corporation has abandoned its business for more than a year; (2) the corporation's directors *or* shareholders are deadlocked, *and* the deadlock has damaged the corporation or there is a danger it could do so; (3) "those in control of the corporation" (*i.e.*, the controlling shareholder(s)) have engaged in waste of corporate assets or wrongful conduct; or (4) for a corporation with 35 or fewer shareholders, dissolution is reasonably necessary for the protection of the rights or interests of a shareholder. See Corp C §1800(b)(1)–(5). As in the case of partnerships, these "wrongful conduct" grounds for dissolution can be difficult to establish if the corporation is profitable. For a corporation doing well, courts are reticent to substitute their judgment for that of a majority shareholder in the absence of extreme misconduct.

In addition to the grounds set forth above, which are available to a shareholder (or shareholder group) owning 33-1/3 percent of shares, any shareholder may obtain involuntary dissolution on a showing that "the period for which the corporation was formed has terminated without extension." Corp C §1800(a)(3), (b)(6).

Problems With Involuntary Dissolution

Involuntary dissolution is an unattractive option for exiting a corporation, although it may be the only option for minority shareholders if there is no buy-sell agreement. In addition to involving costly litigation in which the shareholder seeking dissolution must make a difficult evidentiary showing, involuntary dissolution is extremely unpredictable and risky for several reasons. First, if the proceeding goes all the way to trial, it is a proceeding in equity in which the court sits as the trier of fact and there is no right to a jury. Accordingly, the court has virtually unlimited discretion. Second, as discussed below, a party seeking involuntary dissolution may lose control of the proceeding if the other shareholders exercise their buyout option under Corp C §2000.

Statutory Buyout Option

General Principles

When faced with a notice of voluntary dissolution or a lawsuit for involuntary dissolution, Corp C §2000 creates an option for the shareholders who have not sought dissolution to buy out the shareholder(s) seeking dissolution and continue operating the corporation as a going concern. A shareholder can invoke Corp C §2000 at any time prior to actual liquidation of the corporation. If the remaining shareholders do not exercise their buyout option under §2000, the corporation will be dissolved, either as a matter of course in a voluntary dissolution, or, in an involuntary dissolution, on a successful judgment establishing one of the enumerated statutory bases.

Effect of Invoking Corp C §2000

Invocation of Corp C §2000 results in the creation of a new special proceeding that supplants the previous dissolution lawsuit or proceeding. Practically speaking, this means that once the new proceeding has been initiated, it will ultimately result either in the buyout of the party seeking dissolution at an appraised price or in the actual dissolution and liquidation of the corporation. In other words, once a shareholder invokes Corp C §2000, he or she cannot later dismiss that proceeding, but rather is locked in to either buying out the shareholder seeking dissolution at the appraised price or allowing the corporation to be dissolved. This consequence prevents a party from invoking Corp C §2000 to preview the appraised buyout price but then dismissing the proceeding if he or she does not like that price. Given its finality, invoking §2000, while a powerful tool, should be carefully considered, and an expert on that section should be consulted before doing so.

Battle of the Appraisers

Once §2000 has been invoked, three appraisers are either agreed on by the parties or appointed by the court. Although §2000 dictates that the court will appoint all three appraisers, pending court approval the parties can and often do agree to proceed otherwise, *e.g.*, when each side engages its own appraiser and then those appraisers agree on the third. The appraisers are officers of the court, tasked with reviewing the books and records of the corporation and, if they choose, interviewing the shareholder(s) or other relevant persons, in order to estimate the "fair value" of the corporation. Once §2000 is invoked, the dissolution proceedings that preceded the invocation are stayed and any pending discovery is stayed and replaced by requests for information by the appraisers. The parties have no right to discovery in a §2000 proceeding, although the appraisers can request information from the parties and third parties.

From a practical perspective, the appraisal process often becomes a "battle of the appraisers," with the parties submitting letter briefs and supporting evidence to the appraisers to attempt to drive the value of the company in their respective client's favor. Although it is possible to influence the appraisers' opinions, the appraisal process is largely out of the control of the parties, unpredictable, contentious, and expensive.

Once the appraisers have reached a conclusion, they issue a report or reports to the court, in which they recommend a "fair value" for the company and, in turn, for the shares of the party seeking dissolution, and explain how they arrived at that value. The appraisers need not reach a uniform conclusion as to "fair value," and in some cases each appraiser may reach a different conclusion. Whether they issue a uniform decision as to value or three different opinions, the appraisers' report conclusions are submitted to the court, which then performs a de novo review. The court may approve the report of the appraisers in whole or in part, may modify it in any way, or may reject their findings entirely and either assign its own value or remand the matter for a further appraisal. The absolute discretion of the court to disregard the appraisers' report adds yet another layer of unpredictability to the §2000 process.

"Fair Value"

Corporations Code §2000 provides that a shareholder seeking dissolution may be bought out for the "fair value" of his or her shares. "Fair value" is defined by §2000 as "based on the liquidation value as of the valuation date but taking into account the possibility, if any, of a sale of the entire business as a going concern in a liquidation." Importantly, "fair value" is not "fair market value," *i.e.,* the amount that a willing buyer would pay a willing seller if both have full knowledge of all relevant circumstances. See IRS Rev Rul 59–60, 1959–1 Cum Bull 237. Rather, "fair value" is "liquidation value," *i.e.,* what the corporation would be worth if it were actually dissolved and sold in a liquidation. Accordingly, the value of the company must be discounted in a §2000 valuation to simulate as closely as possible the conditions of an actual liquidation, including but not limited to taking into account the fact that the sale is made under distress rather than at the leisure of the seller. (This is a key difference from the statutes governing partnerships. In a partnership dissociation, the fact that the dissolution sale would be under distress circumstances cannot be considered.) Accordingly, as a general rule, "fair value" results in a lower buyout price being paid to the shareholder seeking dissolution than would be the case under a "fair market value" analysis. This is, however, an oversimplification—the concept of "fair value" is esoteric and complex and involves numerous strategy considerations that are beyond the scope of this article.

One of the major issues that arises in a §2000 "fair value" appraisal is that the appraisers must determine whether the corporation should be valued based on a piecemeal sale of its assets (*i.e.*, a net asset valuation) or whether it should be valued as a going concern. Corporations Code §2000 requires that the appraisers "tak[e] into account the possibility, if any, of a sale of the entire business as a going concern in a liquidation." In other words, if there is a real possibility that the entire company could be sold as a going concern in an actual liquidation, the appraisers must take that into account. The statute does not, however, offer guidance regarding how the appraisers should determine whether a going concern sale is possible or, if so, how to take this fact into account. These issues, like the rest of the §2000 appraisal process, are usually hotly contested, and their ultimate resolution is sometimes difficult to predict.

PRACTICE TIP: A §2000 valuation may be highly unfavorable for a shareholder in a closely held, service-oriented corporation, *i.e.*, one in which the owners of the corporation are, themselves, the primary assets of the business. Such businesses do not generally have significant assets that can be liquidated, so liquidation value will be very low. But going concern value may also be very low, even in a successful business, because, in the absence of an enforceable employment contract, the shareholder seeking dissolution cannot require that the shareholder opting for a buyout continue working for the corporation after the hypothetical sale. Before taking the dissolution route, attorneys and shareholders should think carefully about whether the business would attract a good price on the market if the opposing shareholders choose not to continue working for the company.

Modifying the Rules by Agreement

The analysis above assumes that there is no buy-sell agreement or other written agreement among the shareholders that addresses dissolution or buyout of a shareholder. California law generally allows for such agreements, and shareholders can and, in many instances, should consider modifying the default rules discussed in this article when they form a corporation.

- **Valuation.** The shareholders of a corporation may want to specify a different method of calculating the value of the company in a §2000 proceeding to provide more predictability than the default "fair value" appraisal process and to tailor the valuation to the nature of the business and its assets.
- **Dissociation.** Shareholders should consider creating the right to force a shareholder to sell his or her shares under certain circumstances and dictating a method of valuing those shares that differs from default statutory scheme, *e.g.*, by allowing for a payout over time and on reasonable terms. If counsel represents a minority shareholder, especially in a closely held corporation for which there is little to no market in which the corporation's stock can be sold, counsel may also want to consider including a provision that allows a shareholder to voluntarily exit and requires that the corporation to purchase his or her shares based on an agreed valuation mechanism.
- **Avoid 50/50 Corporations.** Once relationships deteriorate and one or more shareholders are ready to attempt to dissolve a corporation, 50/50 corporations are extremely problematic. Even if one shareholder's conduct is wrongful and damages the corporation, he or she cannot be forced out under the default statutes. In practice, the stalemate leads to protracted, expensive litigation.
- **Minority Shareholders.** The default statutory scheme does not give minority shareholders a right to exit the corporation. As a result, once discord arises that cannot be settled, no option exists but litigation. A contractual mechanism allowing for an exit by a shareholder on reasonable notice and for a fair price may avoid litigation.

LIMITED LIABILITY COMPANIES

This article concludes with a discussion of dissociations and dissolutions in limited liability companies (LLCs). Significantly, LLCs are governed by an entirely new statutory scheme that became operative on January 1, 2014, known as the Revised Uniform Limited Liability Company Act (RULLCA). The most significant change is the addition of provisions allowing for voluntary dissociation and judicial dissociation of members, akin to those for partnerships. See Corp C §§17706.01–17706.03. Previously, as in the case of corporations, there was no statutory mechanism for expelling a member. RULLCA represents a partial evolution of California LLC law away from its roots in the law governing corporations and towards the law governing partnerships. As in the case of limited partnerships, most of the rights provided by statute can be modified, limited, or eliminated by agreement. See Corp C §17701.10.

Although LLCs now resemble partnerships in that a member can be judicially dissociated, the statutory scheme governing dissolution of LLCs is closer to that governing dissolution of corporations. In the absence of an operating agreement stating otherwise, a member owning *more than* 50 percent of the membership interests can voluntarily dissolve the LLC simply by filing a form with the Secretary of State. See Corp C §17707.01(b). (In contrast, a 50 percent shareholder can voluntarily dissolve a corporation, but voluntary dissolution of an LLC requires consent of a majority of the membership interests.)

As in the case of corporations, members owning 50 percent or less of the interests in an LLC may obtain involuntary dissolution by making a showing either that it is not reasonably practicable to continue the business, dissolution is necessary to protect the interests of members, management is deadlocked, or those in control have engaged in or countenanced fraud or mismanagement. See Corp C §17707.03. Unlike a corporation, however, any member of an LLC may seek involuntary dissolution; there is no 33-1/3 percent ownership threshold for LLCs as there is for corporations. Corp C §17707.03. If one or more members seek dissolution of an LLC, voluntary or involuntary, the other member(s) may exercise a statutory buy-out right that is very similar to Corp C §2000, but is governed by Corp C §17707.03(c).

Although the appraisal and buy-out process for LLCs is similar to that for corporations, there are a few important differences. First, a corporation is appraised based its "fair value" under §2000, which is *not* the equivalent of fair market value, for the reasons discussed above. An LLC, however, will be appraised based on fair market value; therefore, none of the discounts applicable to "fair value" apply because those discounts arise from the fact that "fair value" is defined by §2000 as based on a distressed "liquidation value" rather than a transaction involving a willing buyer and seller. Neither the legislature nor the courts have explained this difference between the LLC statute and §2000.

Second, when the remaining members in an LLC exercise their buyout option in response to a member seeking dissolution, the LLC statute expressly provides that a subsequent dismissal by the member who filed the lawsuit for involuntary dissolution does not stop or affect the buyout proceedings. Corporations Code §2000, however, does not directly address such a situation.

The statutes governing LLCs involve the same expense, risk, and unpredictability as litigation under the default schemes governing partnerships and corporations. In addition, there is an added layer of uncertainty in "business divorces" of LLCs because RULLCA was only recently enacted, and to date there are few cases interpreting it. Fortunately, of all the California entities, LLCs offer the most flexibility for the parties to modify the statutory scheme, including the statutes governing dissolutions, dissociations, and buyouts. There are few LLC statutory provisions that cannot be modified by agreement. See Corp C §17701.10(c)–(d). The same drafting considerations discussed above for corporations and partnerships are applicable to LLCs.

CONCLUSION

Each of the popular forms of California business entities has statutory mechanisms that allow for forced exits, whether through dissociation or dissolution. These statutes, however, often lead to costly, protracted, and unpredictable litigation that is largely out of the parties' control. Although some of the statutes applicable to dissociation and dissolution cannot be waived by agreement, there is no prohibition on replacing the valuation mechanisms provided by the statutes for dissociations and dissolutions. Good buy-sell provisions, such as terms defining when a buyout or dissolution takes place and price and payment terms, are the best preventive measures to avoid litigation or to minimize the risk and expense of such litigation if it does occur. The transactional lawyer drafting written agreements governing entities should also consider including an arbitration clause. If breaking up does lead to litigation, arbitration may provide a more cost-effective forum and expedited relief.