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From:	The State Bar of California - Business Law Section <Businesslaw@calbar.ca.gov>
Sent:	Thursday, June 15, 2017 5:45 AM
To:	Corey R. Weber
Subject:	ILC E-Bulletin: California Court of Appeals clarifies the procedure trial courts should follow when determining the fair value of minority shareholder interests in an involuntary dissolution

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THE STATE BAR OF CALIFORNIA
Business Law Section

Insolvency Law e-Bulletin

June 15, 2017

Dear constituency list members of the Insolvency Law Committee,the following is a case update analyzing a recent case of interest:

SUMMARY

In *Goles v. Sawhney*, 5 Cal. App. 5th 1014, 210 Cal. Rptr.3d 261 (2016), the California Court of Appeals for the Second District of California reversed a judgment by a trial court determining a fair value appraisal of a minority interest in Katana Software, Inc. ("Katana") by taking the mathematical average of three disparate appraisals, two of which inappropriately accounted for a "lack-of-control" discount (because the majority owners were the "purchasers"), and none of which took into account the value of the minority shareholders' derivative claims against the majority shareholders. The matter was remanded to the trial court for a further determination regarding the fair market value of appellants' minority interest. To read the full published decision, click here: http://bit.ly/2q71FbI.

FACTS

Katana was a closely held corporation. The Goles, who owned 36.7% of the shares in Katana, sued two shareholders who together owned the remaining 63.3% of Katana for the involuntary dissolution of Katana pursuant to Section 1800 of the California Corporations Code ("Cal. Corp. Code"). The Goles also sought an accounting, injunctive relief, damages for breach of fiduciary duty, and the sums due and owing on a promissory note.

To avoid dissolution of Katana, the majority shareholders brought a motion to appraise the fair value of Katana and to buy out the Goles' minority interests pursuant to Section 2000 of the Cal. Corp. Code. The trial court stayed the proceedings and, in accordance with Section 2000, appointed three disinterested appraisers. The appraisal reports valued the Goles' shares at $69,000, $150,000, and $200,000. *Id.* None of the appraisers considered the Goles' derivative claims against the majority shareholders when determining the fair market value of the Goles' shares. Two of the appraisals applied a lack-of-control discount to their valuation of the minority's shares. The trial court ruled that the fair value of the Goles' interest in Katana was $139,666.67 (the "Valuation"), which was calculated by averaging the three appraisal report valuations.

The Goles appealed the Valuation, arguing that it was erroneous as a matter of law because the Valuation improperly: (1) failed to account for the Goles' derivative claims; (2) included a lack-of-control discount; and (3) did not otherwise comply with Cal. Corp. Code section 2000. The Court of Appeals reversed the trial court's Valuation, finding all three of the Goles' arguments on appeal persuasive.

Reasoning

As to the first issue, the Goles argued that if they prevailed on their derivative claims (which included allegations of corporate looting), it would result in an increased market value for their shares. Therefore, they argued, all of the appraisers undervalued the Goles' shares by not considering the Goles' derivative claims. Relying on the Cal. Corp. Code and established precedent, the Court of Appeals noted that: "'[a] derivative claim (or other claim that may yield a potential recovery for the corporation) is a corporate asset that must be considered when determining 'fair value.' . . . 'If successful, a derivative claim will accrue to the direct benefit of the corporation and not to the stockholder who litigated it." *Id.* at 1019, 210 Cal. Rptr. 3d at 265 (internal citations omitted). Therefore, the Court of Appeals found that the trial court committed reversible error when it considered the appraisals that did not "include an assessment of the value, if any, of pending derivative actions and their effect on the fair value of the shares," *Id*. at 1019, 210 Cal. Rptr. 3d at 265.

The Court of Appeals also concluded that the trial court committed a reversible error when it relied on the two appraisals which discounted the fair value of the Goles' shares (by 15-20 percent) due to the lack of control associated with minority shares in closely-held corporations. The Court of Appeals observed that Section 2000 does not permit a lack-of-control discount when determining the fair value of a minority shareholder interest because the shares are being purchased by someone who is already in control of the corporation; thus, the shares cannot be worth less to the purchaser because they come from a non-controlling shareholder. *Id.* at 1019-20, 210 Cal. Rptr. 3d at 265.

Lastly, the Court of Appeals found that the trial court committed reversible error by confirming all three disparate appraisals by averaging them. The Court of Appeals relied on Section 2000, which provides "[t]he award of the appraisers or of a majority of them, *when confirmed by the court*, shall be final and conclusive upon all parties." Cal. Corp. Code § 2000(c) (emphasis added). The Court of Appeals further reasoned that "such an *award* requires that at least two of the appraisals reach a consensus on fair value…. Here, the trial court *confirmed* all three appraisal reports even though there was no consensus." Goles, 5 Cal. App. 5that 1020, 210 Cal. Rptr. 3d at 266 (emphasis in original). The Court of Appeals explained that even if the trial court intended to determine, *de novo*, the fair market value of the shares, it could not base that valuation on the mathematical average of the defective appraisals that used a lack-of-control discount and did not consider the value of the Goles' derivative claims.

The Valuation was therefore reversed and remanded for further determination, and the trial court was ordered "to obtain a majority fair value appraisal that takes into account the derivative claims and does not use a lack-of-control discount." *Id.* at 1021, 210 Cal. Rptr. 3d at 267. In the alternative, the Court of Appeals noted that "the trial court may take evidence on the derivative claims and make a de novo determination of the fair value of [the minority] shareholder interest, consistent with [S]ection 2000." *Id.* at 1021, 210 Cal. Rptr. 3d at 267.

AUTHOR'S COMMENTARY

This is the right result. The trial court clearly erred when it made a determination of value that was inconsistent with the provisions of Cal. Corp. Code section 2000. Two of the appraisals inappropriately applied a lack-of-control discount notwithstanding that the “purchasers” were already in control of Katana, and all of the appraisals failed to account for the value of the Goles’ claims against the majority shareholders. Based on those deficiencies, the Court of Appeals rightly concluded the appraisals could not be relied upon as a basis for determining the fair value of the Goles’ minority interest in Katana.

These materials were prepared by ILC member Michael W. Davis of Brutzkus Gubner Rozansky Seror Weber LLP in Woodland Hills, California (mdavis@bg.law). Editorial contributions were provided by Adam Lewis of Morrison Foerster in San Francisco, California.

Thank you for your continued support of the Committee.

Best regards,

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