Keepin' It Legal

An S Corporation Inequity in §2000 Proceedings

— by Paul Steiner and Donald Glenn

In 1977, the California Legislature made major revisions to the Corporations Code. Section 2000 added "expanded and improved" procedures authorizing the purchase of a moving party's shares in both voluntary and involuntary dissolution proceedings.

The §2000 value standard is "fair value" and takes into account the possibility, if any, of a sale of the entire business as a going concern. Prior law left to the discretion of the trial court the important question of the valuation date, sometimes causing great additional expense to the litigants. In 1983, subsection (f) was added to §2000 making the date of filing the action for dissolution the prescribed valuation date. This date was chosen because it was thought to be the "most equitable" under most circumstances, and having a prescribed date would be more cost effective for litigants. But allowance is made for the court to establish a different valuation date "for good cause." Though discussed, precisely why the filing date was considered the most equitable is not entirely clear from the legislative history. It is likely, however, that most actions would be brought to halt the "persistent and pervasive" waste or misapplication of corporate property referred to in Corporations Code §1800[b][4] which would compromise the moving party's investment. In those cases, the sooner the shares are valued the fairer, as an early valuation date would preclude continued erosion.

Section 2000 applies to all corporations including an S corporation. No special provisions were made for S corporations despite its very different pass-through tax treatment. This creates special problems. Consider a dissolution action brought under one of the provisions of §1800 by a minority shareholder of a closely held corporation with three equal shareholders, because of wrongdoing by the other two shareholders. The action is vigorously defended, paid for by the corporation on behalf of its officers and directors (while your client pays his or her attorney's fees and other costs of litigation), and discovery is intense and expensive. The majority decides it needs to build up reserves because of the litigation and other business needs, so though it is profitable, no dividends are declared after the litigation commences. Come April 15, the minority shareholder faces the unpleasant task of paying taxes on one-third of the corporation's profits without receiving any dividends to pay for them. Then, the majority makes a §2000 election.

Valuing S corporation shares as of the action filing date results in an injustice. The minority is forced to pay taxes on income not received and pay legal costs. Whereas an earlier valuation date is generally fairer to blunt the "persistent waste and mismanagement," here the opposite is true. If you represent the minority shareholder, how do you remedy this situation?

Here are three choices to consider: one, allow the matter to proceed and push for a speedy resolution; two, request the Court to deem the sale as occurring on the date of the filing of the action and require the corporation to reimburse the moving party for the tax payments made plus interest; three, seek a change in valuation date so that the appraisers can take these inequities into account. The choice will depend on the circumstances of your case. Choice one would seem correct if the amount involved is too small to justify mounting the challenge. Choice two is a possible solution, but does not correct the situation if the case is protracted and the value of the corporation continues to increase during the litigation while the client continues to pay taxes but receives no dividends. Further, there is no assurance that the IRS would agree that the client was relieved of the S corporation tax obligation even if the court were to adopt the "deemed" rather than the actual sale date for the shares. Perhaps the most effective is choice three, seek a change in the valuation date for "good cause".

There is no statutory or case law guidance on what constitutes the "good cause" necessary for a change in valuation date. A review of the legislative history of Subsection (f) and of §2000 generally reveals no consideration of the valuation date question as applied to an S corporation. It is left to the sound discretion of the trial court. As suggested above, however, it appears that the equity or fairness of the situation is the most relevant consideration. The change of valuation date in these circumstances is consistent with the concept of "fair value" as applied to an S corporation. Fair value does not seek or require an unfair result. But a later valuation date allows the arbitrators or the court to take into account the unfair consequences of the actions of the majority. Appraisers of S Corporations in §2000 cases may be faced with valuation issues that occur or persist after the initial valuation date. It may be a choice between a legal remedy of alternate valuation date or a remedy crafted by the appraisers assuming they have the latitude to provide such a remedy.

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