

## VALUATION

# The Impact of Pending Litigation on Fair Value

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Of the many types of engagements that business valuation analysts perform, one is determining the value of a business in involuntary dissolution proceedings. In February 2009, in *Cotton v. Expo Power Systems*,<sup>1</sup> California's Second District Court of Appeal clarified the scope of an appraisal under California Corporations Code Section 2000. This decision makes it clear that appraisers must consider the impact of pending litigation when determining fair value under Section 2000.

Section 2000 provides a means for a corporation or a majority of its shareholders to avoid involuntary dissolution by purchasing, at their fair value, the shares of the shareholder bringing an involuntary dissolution action. Fair value is "the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation."<sup>2</sup> The "valuation date" is either the inception of the involuntary dissolution proceeding, or an alternate date set by the court upon a showing of good cause.<sup>3</sup>

If the parties do not agree on the fair value of the shares, then the court must appoint three disinterested appraisers through an order stating the time (e.g., deadline) and manner of producing evidence if required.<sup>4</sup> If the court confirms the appraisers' award, it becomes final; but if the court disagrees with their award, the court must examine it *de novo*,<sup>5</sup> and fix the correct value.<sup>6</sup>

In *Cotton v. Expo*, Ken Cotton, a minority shareholder in Expo Power Systems, Inc., brought actions for involuntary dissolution on October 31, 2003, and a derivative claim on

behalf of Expo on November 12, 2003. A derivative claim is a lawsuit instituted by a stockholder to enforce the rights of the corporation when the corporate board refuses to do so. If successful, the corporation and not the stockholder benefits. Under corporate law, a court may order the dissolution of a corporation against its will, i.e., involuntarily, if certain statutory criteria are met. In California the grounds are abandonment of business, deadlocked directors, deadlocked shareholders, fraud, mismanagement, protection of shareholders of a closely held corporation, expiration of the corporate term, and similar grounds that the attorney general may assert. Cotton grounded both his involuntary dissolution and his derivative claims on the allegation that the defendants breached their fiduciary duties to him by diverting Expo's assets for their own purposes. To avoid involuntary dissolution of Expo, the defendants elected to purchase Cotton's Expo shares under Section 2000 on December 31, 2003. On April 4, 2005, the court appointed three appraisers to determine the fair value of Expo.

In November 2006, the appraisers issued a report to the court. The opinion does not provide a reason for the 18-month delay between the court's order and the completion of the appraisers' report, but implies that this delay runs counter to the summary nature of a Section 2000 special proceeding. The appraisers' report expressly declined to consider the derivative action when determining the fair value of Expo, making it clear that they made no valuation of any disputed claim in litigation. The trial court entered an order confirming the appraisers' determination of the fair value of Expo exclusive

<sup>1</sup> *Cotton v. Expo Power Systems, Inc.* (2009), --- Cal.Rptr.3d ----, 2009 WL 294935, 09 Cal. Daily Op. Serv. 1598, Cal.App. 2 Dist., February 9, 2009 (NO. B205731).

<sup>2</sup> Corp. Code § 2000 subd. (a).

<sup>3</sup> Corp. Code § 2000 subd. (f).

<sup>4</sup> Corp. Code § 2000 subd. (c).

<sup>5</sup> *De novo* is a standard of judicial review that is also referred to as independent review. Under this standard, an appellate court gives no deference to the trial court's ruling or the reasons for its ruling, but instead decides the matter anew.

<sup>6</sup> *Venables v. Credential Ins. Agency Inc.* (1956), 140 Cal.App.2d 724, 727.

of the derivative action, because the appraisers could not determine its value without a trial. To compensate for this omission, the court's order deferred the purchase of Cotton's Expo shares until 10 days after the entry of final judgment in the derivative action. The order did not provide for the modification of the fair value if the derivative claims succeeded.

The Court of Appeal disagreed with the lower court's order, because the lower court improperly deferred the buyout date and approved the appraisers' report. With respect to the report, the Court of Appeal confirmed that a derivative action is a corporate asset, and that the appraisers must consider it when arriving at fair value. Because the appraisers' report did not consider the value of the derivative claim, it was incomplete, leaving the trial court with two alternatives: (a) obtain a complete report or (b) conduct a hearing to resolve the deficiency. In its opinion, the Court of Appeal makes it clear that pending litigation must be considered in assessing the fair value of a corporation, and that the court can receive expert testimony during a hearing to guide its determination of fair value.

### Three Practical Considerations

In light of *Cotton v. Expo*, appraisers should revisit their current practices in three respects:

First, appraisers should take steps to ensure that they timely complete the report. The Court of Appeal expressed dissatisfaction with the passage of time in this instance, stating that the appraisers' report should have been completed in 2003, not 2008, and reiterating that Cotton was entitled to a valuation date in November 2003.

Second, the Court of Appeal made it clear that appraisers must consider pending litigation when determining fair value. The opinion focused upon the derivative action as a corporate asset but by extension an appraiser cannot ignore other litigation when arriving at fair value.

Third, the decision makes it clear that the trial court may use experts to determine the effect of pending litigation at hearing if the parties do not agree with the appraisers' report.

To comply, appraisers must consider the effect of all pending litigation, not just derivative claims, when determining fair value. Appraisers should assess the possible impact of the pending litigation on fair value, looking at the potential gains or losses to the corporation from a settlement, judgment, or verdict, and related litigation costs.

To aid their assessment, the appraisers can obtain and review copies the pleadings, discovery responses (including depositions), procedural history, and past settlements or verdicts of comparable matters in the relevant jurisdiction. This information will disclose the nature and amount of the damages sought. The appraiser can query the corporation's defense counsel about the likely costs of defending the action, including attorney fees, expert witness fees, court filing fees,

investigator expenses, exhibits, court reporter charges, and the potential for an adverse award of attorneys fees. Publications such as *Trials Digest*, *Verdict Search*, and *Verdicts & Settlements*, and databases available on LexisNexis and Westlaw, regularly report trial and settlement outcomes, giving the appraiser an idea of the value of a particular claim and its likelihood of success. The judicial branch in question may also provide statistics regarding the outcome of litigation by claim type. Government agencies charged with enforcing particular laws, such as the EEOC, may also publish data on their enforcement outcomes. In addition, academic literature may contain relevant surveys of particular types of litigation. The appraisers' report should clearly state the scope of the materials reviewed and the basis for the assessment, to put the court in a position to determine if the appraiser's report adequately assesses the impact of litigation upon fair value.

The *Cotton v. Expo* decision is unclear as to whether or how the appraisers can or should use appropriate experts to aid their review of pending litigation. Appraisers may seek court guidance on this point at the outset of the engagement. The appraisers' report does not bind the court whose duty it is to set fair value. If the court deems an appraisers' report insufficient, the court can hold a hearing to correct the shortcomings it perceives. Alternatively, a trial court can include a litigation expert on its panel of appraisers to facilitate the evaluation of pending litigation in the determination of fair value, and reduce the need for a hearing.

In any event, *Cotton v. Expo* Power Systems makes it clear that Section 2000 requires the consideration of litigation when determining fair value. **VE**



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