BUSINESS LAW SECTION

CORPORATIONS COMMITTEE
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REVISIONS TO STREAMLINE AND UPDATE CORPORATION CODE PROVISIONS RELATING TO DISTRIBUTIONS AND REPURCHASES OF SHARES

LEGISLATIVE PROPOSAL (BLS-2011-01)

TO: Office of Governmental Affairs

FROM: David M. Hernand, Co-Chair, and Edward Deibert, Co-Chair, Corporations Committee (the "Committee"), Business Law Section (the "Section")

DATE: May 7, 2010

RE: Proposal to **amend** Sections 500, 503, 506 and 509 of the Corporations Code and **repeal** Sections 502 and 507 of the Corporations Code.

SECTION ACTION AND CONTACTS[1]

Date of Approval by Section Executive Committee (the "Executive Committee"): July 16, 2010

Approval Vote: For: 15 Against: 0

Executive Committee Contact:	**Committee Contact:**
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HISTORY, DIGEST AND PURPOSE

The mission statement of the Committee provides that it shall study, consider, and take a position on and advocate that position with respect to, among other things, "[n]eeded changes to the California Corporations Code" and "[o]ther statutory changes that would promote efficiency or effectiveness in practice if made." The Committee has concluded that it is consistent with that mission to propose amending and deleting portions of Chapter 5 of the General Corporation Law concerning dividends and reacquisitions of shares. Amended and restated Chapter 5, if enacted, would promote efficiency and

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[1] Contact information is as of the date submitted. After completion of the State Bar Annual Meeting following submission, the Committee will submit a Supplemental Contacts Information sheet to the Office of Governmental Affairs providing corresponding contact information for the following Bar year.

effectiveness in practice in that it would simplify, clarify, improve and modernize relevant provisions of the California Corporations Code (the "Code").

Background

In 1977, California significantly modified corporate law restrictions on corporations paying distributions to their shareholders including by redeeming shares. Prior to 1977, the law permitted corporations to pay dividends only from the corporation's "earned surplus," which was an antiquated legal accounting concept based on the idea that shares had a "par value" representing the stated amount of capital contributed to the corporation. The law treated such stated capital as a trust fund for creditors and provided that dividends to shareholders could only be paid out of a corporation's "earned surplus" capital (i.e., the amount of its actual capital in excess of its stated and paid-in capital). Before distributing corporate assets to shareholders (whether as a dividend or payment to redeem shares), a corporation had to calculate its earned surplus using concepts of par value, stated capital, earned surplus, paid-in surplus, reduction surplus, and treasury shares. Several exceptions allowed corporations to make distributions out of "net profits" for a six to twelve month period (so called "nimble dividends"), paid-in surplus (the amount paid by investors for shares in excess of stated capital) and surplus resulting from a corporation reducing its stated capital.

The new law adopted in 1977, embodied in Chapter 5 of the General Corporation Law (the "Existing Statute"), substantially abandoned all of these legal accounting concepts in favor of rules that focus on modern financial accounting concepts of retained earnings, balance sheet and liquidity tests, and solvency. The change in law was precipitated by perceptions that the prior approach and restrictions did not provide adequate protection to creditors.

Under the Existing Statute, a corporation can make a distribution of cash or property to shareholders only if (a) either (i) the corporation has retained earnings prior to such distribution equal or exceeding the amount of the distribution or (ii) the corporation can satisfy both a balance sheet test and a liquidity test (based on current assets and current liabilities) after giving effect to such distribution, and (b) the distribution will not render the corporation insolvent. The two-prong balance sheet and liquidity tests referenced in clause (a)(ii) of the preceding sentence permit a distribution to be made only if, after giving effect to the distribution, the corporation's total assets equal or exceed 125% of its total liabilities and the corporation's current assets equal or exceed its current liabilities (or 125% of current liabilities if the corporation's average earnings before interest and taxes for the two preceding fiscal years were less than its average interest expense during the same period). In making the balance sheet and liquidity calculations, certain assets and liabilities are excluded altogether, and, consistent with generally accepted accounting principles, assets are generally valued at their historical carrying value (not their current fair market value). Companies that cannot satisfy both the above-referenced balance sheet test and liquidity test and that do not have accumulated retained earnings cannot make distributions to their shareholders under the Existing Statute, even if the fair market value of their assets exceeds the amount of their liabilities.

The retained earnings test in the Existing Statute replaced the "nimble dividends" concept under the pre-1977 statute, and the Committee is not aware of any problems or concerns with respect to its implementation in practice. In addition, the solvency test contained in the Existing Statute (which must be satisfied in addition to the retained earnings or balance sheet/liquidity tests) is fairly well understood by corporations and their advisors and is consistent with restrictions on distributions imposed on limited liability companies and limited partnerships under California law and the approach used for corporations in most other states. The balance sheet and liquidity tests, however, are overly rigid and do not provide sufficient flexibility to corporations desiring to make distributions under varying circumstances, are inconsistent with the restrictions on distributions applicable to limited liability companies and limited

partnerships under California law, and are out of step with dividend restrictions imposed on corporations in most other states in the United States. These concerns are discussed in more detail below under "Reasons for the Proposal."

Summary of Existing Statute

The provisions of Sections 500 through 504 of the Existing Statute contain the restrictions applicable to distributions to shareholders. Distributions are defined in Section 166 of the Code and include dividends, share repurchases, and other transfers of cash or property to shareholders without consideration. Sections 500 and 501 of the Existing Statute are generally designed to protect the creditors of a corporation, and Sections 502 and 503 are designed to protect preferred shareholders with respect to a distribution to the common shareholders or any other junior class of shares of a corporation. Section 504 provides certain exceptions to the application of these provisions. Chapter 5 of the General Corporation Law applies to all domestic California corporations, and Sections 500 through 505 of the Corporations Code also purport to apply to certain foreign corporations that do business in California by virtue of Section 2115 of the Corporations Code.

Section 500: Section 500 prohibits distributions to shareholders unless (a) the amount of retained earnings immediately before the distribution is equal or greater than the amount of the proposed distribution or (b) immediately after the distribution, the sum of the assets (as adjusted) would be at least equal to 125% of its liabilities (as adjusted) (referred to above as the "balance sheet" test) and the current assets would be at least equal to (or in some instances 125% of) its current liabilities (referred to above as the "liquidity" test). The amount of any distribution payable in property is determined on the basis of the value at which the property is carried on the corporation's financial statements in accordance with generally accepted accounting principles. When applying these financial tests in the context of a share repurchase, a corporation may add to retained earnings all amounts previously deducted from retained earnings with respect to obligations incurred in connection with the repurchase (not in excess of the amount of obligations that will remain unpaid immediately before the distribution), and deduct from liabilities all amounts previously added to liabilities with respect to obligations incurred in connection with the repurchase (not in excess of the amount of obligations that will remain unpaid after the distribution).

Section 501: Section 501 limits distributions to a corporation's shareholders if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature. This is the "solvency test" referred to above.

Section 502: Section 502 concerns distributions to junior shares affecting liquidation preferences. A corporation may not make a distribution to shares junior in liquidation if, after a distribution, the excess of assets (as adjusted) over liabilities (as adjusted) would be less than the liquidation preference of shares having a senior liquidation preference. When applying Section 502 in the context of a share repurchase, all amounts that had been previously added to liabilities with respect to obligations incurred in connection with the corporation's repurchase of its shares shall be deducted from a corporation's liabilities (not in excess of the amount of obligations that will remain unpaid after the distribution).

Section 503: Section 503 concerns distributions to junior shares that affect cumulative dividends to senior shares that are in arrears. A corporation may not make a distribution on any shares junior in dividend payments unless the amount of retained earnings immediately before the distribution is equal or greater to the proposed distribution plus the aggregate amount of cumulative dividends in arrears for shares with dividend preference over the junior shares to which distribution is made. When applying Section 503 in the context of a share repurchase, all amounts that had been previously deducted from

retained earnings with respect to obligations incurred in connection with the corporation's repurchase of its shares shall be added back to retained earnings (not in excess of the amount of obligations that remain unpaid immediately prior to the distribution).

Section 503.1: Section 503.1 concerns the shares of a deceased shareholder. It provides that the provisions of Sections 500, 501, 502 and 503 of the Code shall not apply to a purchase or redemption of shares of a deceased shareholder from the proceeds of insurance on the life of such shareholder in excess of the total amount of all premiums paid by the corporation for such insurance, in order to carry out the provisions of an agreement between the corporation and such shareholder to purchase or redeem such shares upon the death of the shareholder. In other words, California law permits the purchase or redemption of shares of a deceased shareholder from life insurance proceeds (in excess of insurance premiums) to carry out the terms of an agreement by a corporation to purchase or redeem shares upon a shareholder's death.

Section 503.2: Section 503.2 concerns the shares of a disabled shareholder. It provides that the provisions of Sections 500, 501, 502, and 503 of the Code shall not apply to the purchase or redemption of shares of a disabled shareholder from the proceeds of disability insurance applicable to the disabled shareholder in excess of the total amount of all premiums paid by the corporation for the insurance, in order to carry out the provisions of an agreement between the corporation and the shareholder to purchase or redeem shares upon the disability of the shareholder as defined within that policy. For the purposes of Section 503.2, "disability insurance" means an agreement of indemnification against the insured's loss of the ability to work due to accident or illness. In other words, California law permits the purchase or redemption of shares of a disabled shareholder from life insurance proceeds (in excess of insurance premiums) to carry out the terms of an agreement by a corporation to purchase or redeem shares upon the disability of the shareholder as defined within that policy.

Section 504: Section 504 provides that Section 500 of the Code does not apply to dividends or stock repurchases or redemptions declared by certain regulated investment companies.

Section 505: Section 505 provides that Sections 500 through 511 of the Code do not prohibit additional restrictions on corporate distributions by provisions in the corporation's articles or bylaws or in any other agreement.

Section 506: Section 506 provides that any shareholder who receives a prohibited distribution knowing facts indicating its impropriety is liable (1) to the corporation for violating Section 500 or Section 501, for the benefit of all creditors whose debts or claims arose before distribution who have not consented to it and (2) to holders of preferred shares at the time of distribution who did not consent to it, for violating Sections 502 or 503, for the amount received with interest until paid (such an amount not to exceed liabilities owed to creditors at time of violation and injuries suffered by shareholders who did not consent to distribution). A suit to enforce liability may be brought in the name of the corporation. Shareholders sued may implead other shareholders and compel contribution.

Section 507: Section 507 provides that notice regarding the accounting treatment of a dividend (other than a dividend from retained earnings) must be provided to shareholders within three months after the end of the fiscal year in which a dividend is paid.

Section 508: Section 508 provides that Chapter 5 of the General Corporation Law does not apply in connection with any voluntary or involuntary dissolution under chapter 18 or 19 of the Code.

Section 509: Section 509 concerns redemptions. A corporation may redeem shares by (1) giving notice of redemption and (2) making payment or deposit of the redemption price of the shares, as provided in its

articles, or deposit of the redemption price pursuant to Section 509(d). Sections 509(b) and (c) set forth specific notice requirements. Section 509(d) sets forth detailed payment/deposit information.

Section 510: Section 510 concerns the reacquisition of shares. Upon reacquiring its own shares, such shares become authorized but unissued shares, unless a corporation's articles prohibit their reissuance. Section 510(b) sets forth rules regarding a corporation's reacquisition of a class or series of authorized shares when the corporation's articles prohibit the reissuance of such shares. Section 510(c) sets forth rules regarding a corporation's reacquisition of a series of authorized shares and provides the articles only prohibit the reissuance of those shares as shares of the same series. In Section 510, "reacquires" means that a corporation purchases, redeems, acquires by way of conversion to another class or series, or otherwise acquires its own shares, or that issued and outstanding shares cease to be outstanding.

Section 511: Section 511 concerns negotiable instruments and notice. A negotiable instrument for the purchase or redemption of shares shall be enforceable even without notice that it was issued for that purpose.

Other existing Code sections that mention distributions to shareholders are the following: *Section 166* (which defines "Distributions to Its Shareholders" by a corporation), and *Section 2115* ("Applicability of General Corporation Law to Foreign Corporations," which references Sections 500 to 505 and Section 506).

Proposal

The Committee proposes that Sections 500, 503, 506 and 509 of the Code be amended and Sections 502 and 507 of the Code be repealed, specifically as set forth below under the "Text of Proposal" (the "Proposed Statute"). The Proposed Statute replaces the unnecessarily complicated and rigid balance sheet and liquidity tests in the Existing Statute with tests that permit a corporation to distribute cash or property to shareholders (whether as a dividend or repurchase or redemption of shares) if, after giving effect to the distribution, the value of the corporation's assets equals or exceeds the sum of its liabilities and the liquidation preference of any preferred stock, and provides the corporation with greater flexibility in how to value assets and liabilities. Under the Proposed Statute, a corporation's board of directors may base a determination that the value of its assets exceeds the amount of its liabilities on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, a fair valuation, or any other method that is reasonable under the circumstances. The Proposed Statute would not change the ability of a corporation's board of directors to declare a dividend out of retained earnings as provided under the Existing Statute. All distributions will continue to be subject to the same solvency test that is applied under the Existing Statute.

The following are specific changes made by the Proposed Statute:

Section 500 would be amended to effect the following principal changes to the Existing Statute:

(i) Section 500(a)(1) of the Proposed Statute would maintain the "retained earnings" test under the Existing Statute. Under the Proposed Statute, a corporation may make a distribution from retained earnings to the extent that the corporation's retained earnings exceed (a) the amount of the distribution plus (b) unless the articles provide otherwise, the amount (if any) of dividends in arrears on shares with preferential dividend rights (referred to in the Proposed Statute as the "preferential dividends arrears amount"). The substantive provisions of Section 503 of the Existing Statute (relating to distributions to junior shares that affect cumulative dividends on senior shares) have been moved to Section 500(a)(1) and Section 500(b) of the Proposed Statute in order to consolidate and simplify the provisions relating to the retained earnings test. In addition, the Proposed Statute changes the Existing Statute in that it would

permit corporations to specify in their articles that distributions under the retained earnings test can be made without regard to the preferential dividends arrears amount.

(ii) Section 500(a)(2) of the Proposed Statue eliminates the overly formulaic and rigid balance sheet and liquidity tests set forth in Section 500(b) of the Existing Statute and replaces them with a new alternative balance sheet test which provides that immediately after the distribution, the value of the corporation's assets must equal or exceed the sum of (a) its total liabilities plus (b) the liquidation preference of any shares having a preference upon dissolution over the rights of shareholders receiving the distribution (referred to in the Proposed Statute as the "preferential rights amount"). This new test makes the Corporations Code more consistent with the applicable parallel provisions of the Beverly-Killea Limited Liability Company Act (the "LLC Act") and the Uniform Limited Partnership Act of 2008 (the "LP Act") which regulate distributions for California limited liability companies and limited partnerships, respectively. (See Section 17254 of the LLC Act and Section 15905.08 of the LP Act). The substantive provisions of Section 502 of the Existing Statute (relating to distributions to junior shares that affect liquidation preferences of senior shares) have been moved to Section 500(a)(2) and Section 500(b) of the Proposed Statute in order to consolidate and simplify the provisions relating to the new balance sheet test. In addition, the Proposed Statute changes the Existing Statute in that it would permit corporations to specify in their articles that distributions under the new balance sheet test can be made without regard to the preferential rights amount.

(iii) Subdivision (c) of the Existing Statute has been amended to add definitions for the terms "preferential dividends arrears amount" and "preferential rights amount."

(iv) A new subdivision (c) has been added which, consistent with Section 17254(b) of the LLC Act and Section 1905.08(c) of the LP Act, provides that the board of directors of a corporation may make a determination that a distribution is not prohibited under subdivisions (a) of Section 500 or under Section 501 based on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, a fair valuation or any other method that is reasonable under the circumstances.

(v) A new subdivision (d) has been added to reflect that the determination of whether a distribution satisfies either the retained earnings test or the new balance sheet test is to be made as of the date of the authorization if the authorization occurs within 120 days prior to the distribution date.

(vi) A new subdivision (e) has been added which, consistent with Section 17254(b) of the LLC Act and Section 1905.08(c) of the LP Act, provides that (i) indebtedness is not taken into account for purposes of subdivision (a)(2) of the Proposed Statute if the terms of such indebtedness provide that principal and interest payments thereon are to be made only if, and to the extent that, a distribution to shareholders could be made under subdivision (a)(2) and (ii) if indebtedness is issued as a distribution, then principal and interest payments on such indebtedness are treated as distributions measured on the dates that payments are made.

(vii) Subdivision (e) of the Existing Statute was renumbered as subdivision (f).

Section 501, which prohibits distributions that would render a corporation insolvent, would remain unchanged.

Section 502 would be repealed. As noted above, the substantive provisions of Section 502 have been moved to and consolidated with the provisions of Section 500(a)(1) and Section 500(b) of the Proposed Statute.

Section 503 would be amended by repealing existing Section 503 and replacing it with the applicable substantive provisions of Sections 503.1 and 503.2 of the Existing Statute (with no substantive modifications to such Sections, other than cross-reference updates). As noted above, the substantive provisions of Section 503 have been moved to and consolidated with the provisions of Section 500(a)(2) and Section 500(b) of the Proposed Statute.

Section 504 would remain unchanged.

Section 505 would remain unchanged.

Section 506 would be amended to add a four year statute of limitations with respect to any action brought by a creditor or shareholder under Section 506, to clarify an existing ambiguity in subdivision (a) of Section 506 of the Existing Statute relating to the amount of liability imposed on a shareholder that receives a prohibited distribution of non-cash property and to insert appropriate cross-references to the applicable provisions of Section 500 with respect to suits initiated by holders of shares with preferential rights.

Section 507 would be repealed to eliminate an unnecessary notice requirement that currently applies with respect to accounting treatment dividends.

Section 508 would remain unchanged.

Section 509 would be amended to clarify that a corporation that has shares redeemable at its option may provide a notice of redemption as provided in its articles (in addition to a notice of redemption that conforms to the procedures of subdivisions (b) and (c) of Section 509).

Section 510 would remain unchanged.

Section 511 would remain unchanged.

Reasons for the Proposal

The Committee believes that the Proposed Statute is necessary and advisable in order to (i) simplify and clarify the formula pursuant to which corporations may make distributions to shareholders, (ii) remove unnecessarily rigid restrictions contained in the existing balance sheet and liquidity tests on the ability of financially healthy corporations to make distributions to shareholders, (iii) eliminate material substantive differences in the standards relating to dividends and distributions applicable to California corporations, on the one hand, and California limited liability companies and limited partnerships, on the other hand, (iv) enable shareholders of S-corporations to receive dividends or distributions to satisfy their tax obligations related to their ownership interests to the same extent that partners or members of a limited partnership or limited liability company can receive such distributions, and (v) make the approach used by California to restrict dividends and distributions more consistent with the approach used in other states so that California will not be competitively disadvantaged in attracting businesses.

The Existing Statute imposes unnecessary restrictions on financially healthy corporations, particularly those which have both historical book losses and appreciated property. Such corporations may have no retained earnings and thus are unable to rely on Section 500(a) of the Existing Statute to make distributions to their shareholders. In addition, such corporations might have assets with values far in excess of liabilities but not be able to rely on Section 500(b) of the Existing Statute to make distributions to their shareholders because the carrying value of those assets in accordance with generally

accepted accounting principles (which is the accounting standard applicable under Section 500(b)) is not reflective of the fair market value of such assets. The discrepancy between the carrying value of assets on a corporation's books and records and the fair market value of those assets can occur for a number of reasons.

Under generally accepted accounting principles, long term and intangible assets generally are carried on a corporation's financial statements at its historical acquisition cost (subject to impairment charges which may be taken from time to time) and are generally not trued up to reflect unrealized appreciation. In addition, certain assets (for example, valuable long term contracts) may not be reflected as assets on a balance sheet at all.

Generally accepted accounting principles also require depreciation of certain long term assets (including definite-lived intangibles), even though the amounts depreciated may not be reflective of the actual reduction in value of the underlying asset. Hence, the Existing Statute can produce the unbalanced result that the corporation receives no benefit from unrealized appreciation, but suffers the detriment of artificial depreciation in the value of some types of assets. Section 500(b) also can operate to prohibit distributions to shareholders situations where the value of a corporation's assets under generally accepted accounting principles exceeds the amount of its liabilities because the Existing Statute requires a corporation to satisfy both a general assets/liabilities balance sheet test (in Section 500(b)(1)) *and* the liquidity test (based on current assets/current liabilities in Section 500(b)(2)). As a result, for example, a corporation with assets valued at 500% of the value of its liabilities would be prohibited from declaring a dividend if, at the time of the proposed dividend, its current assets did not exceed (or, if applicable, were not at least 125% of) its current liabilities.

The restrictions on distributions contained in the Existing Statute differ significantly from parallel provisions contained in the more recently enacted Beverly-Killea Limited Liability Company Act (the "LLC Act") and the Uniform Limited Partnership Act of 2008 (the "LP Act"), both of which focus on the actual fair market value of the distributing entity's assets. Under Sections 17254 of the LLC Act and 15905.08 of the LP Act (both of which are virtually identical), a distribution is permissible if, after giving effect to the distribution, the value of the assets of the limited liability company or limited partnership would exceed the amount of its liabilities (and, if applicable, the amount of preferential rights of other equity holders). Both the LLC Act and the LP Act invoke a rule of reasonableness for purposes of determining whether this condition has been satisfied: the distributing entity may base a determination that the value of its assets exceeds the amount of its liabilities on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, a fair valuation, or any other method that is reasonableness under the circumstances. The Committee is not aware of any complaints by creditors rights groups that the interests of creditors and preferred equityholders are not adequately protected by the applicable provisions of the LP Act and the LLC Act, and there does not appear to be any reason why corporations should be subject to restrictions that are different from, or more stringent than, the restrictions applicable to limited partnerships and limited liability companies.

The potential impact of the overly formulaic approach of the Existing Statute can be particularly severe on shareholders of S corporations. As with most limited liability companies and limited partnerships, S corporations are "flow through" entities, meaning that taxes on corporate income are paid at the shareholder, as opposed to corporate, level. As a result, these shareholders may have a particular need for distributions from the corporations they own in order to satisfy their individual income tax obligations. The Existing Statute, however, may operate to prohibit such distributions, even in situations where an identically situated limited liability company or limited partnership would be permitted to make distributions to its equityholders. Due to qualifying limitations on the ability to elect S corporation status, the vast majority of S corporations are small businesses or family owned proprietorships, and there is no

reason for them to be disadvantaged solely as a result of their decision to operate their business in corporate form.

The Proposed Statute would also make the approach used by California to restrict dividends and distributions more consistent with the approach used in other states. For example, the ABA's Model Business Corporation Act (the "Model Act") regulates dividends and distributions in a manner that is very similar to the approach set forth Sections 500(a)(2) and 501 of the Proposed Statute. In particular, the Model Act provides that (subject to any restrictions in the articles of incorporation) a board of directors may authorize a dividend or distribution unless, after giving effect to the distribution "(1) the corporation would not be able to pay its debts as they become due in the usual course of business or (2) the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution." Similar to the language of the Proposed Statute, Section 6.40(d) of the Model Act authorizes corporations to make such asset and liability determinations on the basis of financial statements prepared in accordance with accounting practices and principles that are reasonable in the circumstances, a fair valuation, or any other method that is reasonable in the circumstances.

A majority of the states have adopted the general substantive approach to dividends and distributions contained in the Model Act.[2] Many of the remaining states outside of California that have not adopted the approach set forth in the Model Act, including Delaware and New York, continue to employ the concepts of stated capital and surplus for purposes of determining the permissibility of dividends or distributions. While somewhat antiquated, those doctrines are ultimately more consistent with the approach to distributions contained in the Proposed Statute than the Existing Statute in that they ultimately look to measure the excess of the actual value of a corporation's assets over the corporation's stated capital and liabilities to determine the permissibility of a distribution.[3] Both Delaware and New York also permit corporations to issue dividends from net profits from the preceding fiscal year (which is similar, conceptually, to the ability of California corporations to make distributions from retained earnings under the Existing Statute and, if enacted, the Proposed Statute). California's existing rigid and overly formulaic restrictions on corporate dividends and distributions make California less attractive as a state in which to incorporate and conduct business in comparison to the vast majority of other states. The Proposed Statute will eliminate this competitive disadvantage.

It is important to note, however, that the Committee does not propose to eliminate or modify Section 501 of the Existing Statute, which also protects creditors by prohibiting any distributions which would render a corporation insolvent. As a result, creditors (and preferred shareholders) will continue to enjoy the protection of this important solvency test if the Proposed Statute is enacted.

For the foregoing reasons, the Committee believes that certain provisions of the Existing Statute, particularly the provisions containing the overly formulaic balance sheet and liquidity tests, should be

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2 These states include Arkansas, Alabama, Arizona, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New Mexico, North Carolina, North Dakota, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

3 For example, Delaware permits corporations to make distributions from "surplus" which is defined as the excess of a corporation's net assets (i.e. the amount by which total assets exceed total liabilities) over a corporations' stated capital. See 8 Del Code Ann §§154 and 170. For many Delaware corporations, "stated capital" is limited to the nominal par value of a corporation's shares and, as a result, this formula is very similar to the new balance sheet test contained in the Proposed Statute and test contained in the California LLC Act and LP Act. California abandoned the concept of "par value" and "stated capital" in 1977. New York's Business Corporation Code contains provisions similar to Delaware's statute. See N.Y. Bus. Corp. Code § 510(a).

modified and/or discarded in favor of the simpler, more rational and more efficient approach to distributions contained in the LLC Act and the LP Act. The Committee believes that this approach can be equally protective of creditor and shareholder rights, without unduly restricting a corporation's ability to make distributions to its shareholders.

APPLICATION

If enacted in 2011, the proposed amendments to the Affected Sections described above would become effective January 1, 2012.

PENDING LITIGATION

There is none to our knowledge.

LIKELY SUPPORT AND OPPOSITION

We anticipate that the proposed new provisions and amendments described above would receive unanimous support from California corporations, foreign corporations operating in California, investors and corporate law practitioners, with particularly strong support from closely-held, family-owned, professional and certain special-purpose corporations, their owners and attorneys. It is possible that some creditors' rights groups will object to reconciling the standards applicable to distributions by corporations with the standards applicable to limited liability companies and limited partnerships, but we are not aware that any such groups opposed California's adoption of such standards when the LLC Act and the LP Act were enacted in recent years.

FISCAL IMPACT

No negative fiscal impact is expected. The Proposed Statute may make California a more attractive location for companies to conduct business, which would increase tax revenues and create jobs.

GERMANENESS

The subject matter of the proposed new provisions and amendments described above is one in which the members of the Section (and, in particular, the members of the Committee) have special expertise because they are called upon to interpret provisions of the Code and provide guidance on California corporate and securities law matters. The subject matter requires the special knowledge, training, experience and technical expertise of the Section.

TEXT OF PROPOSAL

SECTION 1. THE FOLLOWING SECTIONS OF THE CORPORATIONS CODE ARE AMENDED OR REPEALED AS FOLLOWS:

§ 500. Distributions; retained earnings assets remaining after-completion; exemption of broker-dealer licensee meeting certain net capital requirements

(a) Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation~~'~~**'**s shareholders (Section 166) ~~except as follows~~**unless the board of directors has determined in good faith that either**:

~~(a) The distribution may be made if~~ **(1)** the amount of ~~the~~ retained earnings of the corporation immediately prior ~~thereto~~**to the distribution** equals or exceeds the **sum of (i) the** amount of the proposed distribution~~.~~ **plus (ii) the preferential dividends arrears amount; or**

~~(b) The distribution may be made if immediately after giving effect thereto:~~

~~(1) The sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 11/4 times its liabilities (not including deferred taxes, deferred income and other deferred credits); and~~

~~(2) The current assets of the corporation would be at least equal to its current liabilities or, if the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for those fiscal years, at least equal to 11/4 times its current liabilities; provided, however, that in determining the amount of the assets of the corporation profits derived from an exchange of assets shall not be included unless the assets received are currently realizable in cash; and provided, further, that for the purpose of this subdivision "current assets" may include net amounts which the board has determined in good faith may reasonably be expected to be received from customers during the 12-month period used in calculating current liabilities pursuant to existing contractual relationships obligating those customers to make fixed or periodic payments during the term of the contract or, in the case of public utilities, pursuant to service connections with customers, after in each case giving effect to future costs not then included in current liabilities but reasonably expected to be incurred by the corporation in performing those contracts or providing service to utility customers. Paragraph (2) of subdivision (b) is not applicable to a corporation which does not classify its assets into current and fixed under generally accepted accounting principles.~~

~~(c) The amount of any distribution payable in property shall, for the purposes of this chapter, be determined on the basis of the value at which the property is carried on the corporation's financial statements in accordance with generally accepted accounting principles.~~

(2) immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus the preferential rights amount.

(~~d~~**b**) For the purpose of applying ~~this section~~**subdivision (a)(1)** to a distribution by a corporation**, "preferential dividends arrears amount" means the amount, if any, of cumulative dividends in arrears on all shares having a preference with respect to payment of dividends over the class or series to which the applicable distribution is being made; provided that if the articles provide that a distribution can be made without regard to any such preferential dividends arrears amount, then the preferential dividends arrears amount shall be zero. For the purpose of applying subdivision (a)(2) to a distribution by a corporation, "preferential rights amount" means the amount that would be needed if the corporation were to be dissolved at the time of the distribution to satisfy the preferential rights (including accrued but unpaid dividends) of other shareholders upon dissolution that are superior to the rights of the shareholders receiving the distribution; provided that if the articles provide that a distribution can be made without regard to any such preferential rights, then the preferential rights amount shall be zero. In addition, in the case of a distribution** of cash or property in payment by the corporation in connection with the purchase of its shares, **(i)** there shall be added to retained earnings all amounts that had been previously deducted

therefrom with respect to obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that remain unpaid immediately prior to the distribution~~. In addition,~~ **and (ii)** there shall be deducted from liabilities all amounts that had been previously added thereto with respect to the obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that will remain unpaid after the distribution, provided that no addition to retained earnings or deduction from liabilities under this subdivision shall occur on account of any obligation that is a distribution to the corporation's shareholders (Section 166) at the time the obligation is incurred.

(c) The board of directors may base a determination that a distribution is not prohibited under subdivision (a) or under Section 501 on any of the following:

(1) Financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances.

(2) A fair valuation.

(3) Any other method that is reasonable under the circumstances.

(d) The effect of a distribution under subdivision (a)(1) or (a)(2) is measured as of the date the distribution is authorized if the payment occurs within 120 days after the date of authorization.

(e) (1) If terms of indebtedness provide that payment of principal and interest is to be made only if, and to the extent that, payment of a distribution to shareholders could then be made under this section, indebtedness of a corporation, including indebtedness issued as a distribution, is not a liability for purposes of determinations made under subdivision (a)(2).

(2) If indebtedness is issued as a distribution, each payment of principal or interest on the indebtedness is treated as a distribution, the effect of which is measured on the date the payment of the indebtedness is actually made.

(~~e~~**f**) This section does not apply to a corporation licensed as a broker-dealer under Chapter 2 (commencing with Section 25210) of Part 3 of Division 1 of Title 4, if immediately after giving effect to any distribution the corporation is in compliance with the net capital rules of the Commissioner of Corporations and the Securities and Exchange Commission~~.~~.

§ 501. Inability to meet liabilities as they mature; prohibition of distribution

Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for as they mature).

~~§ 502. Distributions to junior shares if excess of assets over liabilities less than liquidation preference of senior shares; prohibition~~

~~Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) on any shares of its stock of any class or series that are junior to outstanding shares of any other class or series with respect to distribution of assets on liquidation if, after giving effect thereto, the excess of its assets (exclusive of goodwill, capitalized research and development expenses and deferred charges) over its liabilities (not including deferred taxes, deferred income and other deferred credits) would be less than the liquidation preference of all shares having a preference on liquidation over the class or series to which the distribution is made; provided, however; that for the purpose of applying this section to a distribution by a corporation of cash or property in payment by the corporation in connection with the purchase of its shares, there shall be deducted from liabilities all amounts that had been previously added thereto with respect to the obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that will remain unpaid after the distribution; provided, further, that no deduction from liabilities shall occur on account of any obligation that is a distribution to the corporation's shareholders (Section 166) at the time the obligation is incurred.~~

~~§ 503. Retained earnings necessary to allow distribution to junior shares~~

~~Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) on any shares of its stock of any class or series that are junior to outstanding shares of any other class or series with respect to payment of dividends, and as to which senior class or series the corporation has cumulative dividends in arrears, unless the amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution plus the aggregate amount of the cumulative dividends in arrears on all shares having a preference with respect to payment of dividends over the class or series to which the distribution is made; provided, however, that for the purpose of applying this section to a distribution by a corporation of cash or property in payment by the corporation in connection with the purchase of its shares, there shall be added to retained earnings all amounts that had been previously deducted therefrom with respect to obligations incurred in connection with the corporation's repurchase of its shares and reflected on the corporation's balance sheet, but not in excess of the principal of the obligations that remain unpaid immediately prior to the distribution; provided, further, that no addition to retained earnings shall occur on account of any obligation that is a distribution to the corporation's shareholders (Section 166) at the time the obligation is incurred.~~

~~§ 503.1. Shares of deceased shareholder; purchase or redemption from insurance proceeds on life of deceased~~

§ 502. Intentionally Deleted

§ 503. Nonapplicability to Redemption of Deceased and Disabled Shareholder's Shares

(a) The provisions of Sections ~~500, 501, 502~~**500** and ~~503~~**501** shall not apply to a purchase or redemption of shares of a deceased shareholder from the proceeds of insurance on the life of such shareholder in excess of the total amount of all premiums paid by the corporation for such insurance, in order to carry out the provisions of an agreement between the corporation and such shareholder to purchase or redeem such shares upon the death of the shareholder.

~~§ 503.2. Shares of disabled shareholder; purchase or redemption of shares from proceeds of disability insurance; disability insurance defined~~

(b) The provisions of Sections ~~500, 501, 502,~~**500** and ~~503~~**501** shall not apply to the purchase or redemption of shares of a disabled shareholder from the proceeds of disability insurance applicable to the disabled shareholder in excess of the total amount of all premiums paid by the corporation for the insurance, in order to carry out the provisions of an agreement between the corporation and the shareholder to purchase or redeem shares upon the disability of the shareholder as defined within that policy. For the purposes of this ~~section~~**subdivision**, "disability insurance" means an agreement of indemnification against the insured's loss of the ability to work due to accident or illness.

§ 504. Application of distribution provisions

(a) The provisions of Section 500 do not apply to a dividend declared by either of the following:

(1) A regulated investment company, as defined in the federal Internal Revenue Code, as amended, to the extent that the dividend is necessary to maintain the status of the corporation as a regulated investment company under the provisions of that code.

(2) A real estate investment trust, as defined in Part II of Subchapter M of Chapter 1 of Subtitle A of the federal Internal Revenue Code, as amended, to the extent that the dividend is necessary to maintain the status of the corporation as a real estate investment trust under the provisions of that code.

(b) The provisions of this chapter do not apply to any purchase or redemption of shares redeemable at the option of the holder by a registered open-end investment company under the United States Investment Company Act of 1940, so long as the right of redemption remains unsuspended under the provisions of that statute and the articles and bylaws of the corporation.

§ 505. Additional restrictions in articles, bylaws or agreements

Nothing in this chapter prohibits additional restrictions upon the declaration of dividends or the purchase or redemption of a corporation's own shares by provision in the articles or bylaws or in any indenture or other agreement entered into by the corporation.

§ 506. Receipt of prohibited dividend; liability of shareholder; suit by creditors or other shareholder; fraudulent transfers~~.~~

(a) Any shareholder who receives any distribution prohibited by this chapter with knowledge of facts indicating the impropriety thereof is liable to the corporation for the benefit of all of the creditors or shareholders entitled to institute an action under subdivision (b) for the amount so received by the shareholder with interest thereon at the legal rate on judgments until paid, but not exceeding the liabilities of the corporation owed to nonconsenting creditors at the time of the violation and the injury suffered by nonconsenting shareholders, as the case may be. For purposes of ~~this chapter, in the event that any shareholder receives any distribution of the corporation's property that is prohibited by this chapter,~~**determining the value of any non-cash property received in a distribution described in the preceding sentence,** the shareholder receiving that illegal distribution shall be liable to the corporation for an amount equal to the fair market value of the property at the time of the illegal distribution plus interest thereon from the date of the distribution at the legal rate on judgments until paid, together with all reasonably incurred costs of appraisal or other valuation, if any, of that property, but not exceeding the

liabilities of the corporation owed to nonconsenting creditors at the time of the violation and the injury suffered by nonconsenting shareholders, as the case may be.

(b) Suit may be brought in the name of the corporation to enforce the liability (1) to creditors arising under subdivision (a) for a violation of Section 500 or 501 against any or all shareholders liable by any one or more creditors of the corporation whose debts or claims arose prior to the time of the distribution to shareholders and who have not consented thereto, whether or not they have reduced their claims to judgment, or (2) to shareholders arising under subdivision (a) for a violation of Section ~~502 or 503~~**500** against any or all shareholders liable by ~~any~~ one or more holders of ~~preferred~~ shares **having preferential rights with respect to cumulative dividends in arrears (in the case of a violation of subdivision (a)(1) of Section 500) or upon dissolution (in the case of a violation of subdivision (a)(2) of Section 500) who have not consented to the applicable distribution (without regard to the provisions in Section 800), in each case to the extent the applicable shares with preferential rights were** outstanding at the time of the distribution ~~who have not consented thereto~~**; provided that holders of shares of preferential rights shall not have the right to bring suit in the name of the corporation under this subdivision (b) unless the preferential dividends arrears amount (in the case of a violation of subdivision (a)(1) of Section 500) or the preferential rights amount (in the case of a violation of subdivision (a)(2) of Section 500) was greater than zero, in each case who have not consented to the applicable distribution**, without regard to the provisions of Section 800. **A cause of action with respect to an obligation to return a distribution pursuant to this Section 506 is extinguished unless the action is brought within four years after the distribution is made.**

(c) Any shareholder sued under this section may implead all other shareholders liable under this section and may compel contribution, either in that action or in an independent action against shareholders not joined in that action.

(d) Nothing contained in this section affects any liability which any shareholder may have under Chapter 1 (commencing with Section 3439) of Title 2 of Part 2 of Division 4 of the Civil Code.

~~**§ 507. Dividend not chargeable to retained earnings; notice to shareholders**~~

~~Each dividend other than one chargeable to retained earnings shall be identified in a notice to shareholders as being made from a source other than retained earnings, stating the accounting treatment thereof. The notice shall accompany the dividend or shall be given within three months after the end of the fiscal year in which the dividend is paid.~~

§ 507. Intentionally Deleted

§ 508. Involuntary of voluntary dissolution; inapplicability of chapter

This chapter does not apply in connection with any proceeding for winding up and dissolution under Chapter 18 or 19.

§ 509. Redemption of shares; notice; payment or deposit of price~~.~~

(a) A corporation may redeem any or all shares which are redeemable at its option by (1) giving notice of redemption **as provided in subdivisions (b) and (c) or as otherwise provided in its articles**, and (2) payment or deposit of the redemption price of the shares as provided in its articles or deposit of the redemption price pursuant to subdivision (d).

(b) Subject to any provisions in the articles with respect to the notice required for redemption of shares, the corporation may give notice of the redemption of any or all shares subject to redemption by causing a notice of redemption to be published in a newspaper of general circulation in the county in which the principal executive office of the corporation is located at least once a week for two successive weeks, in each instance on any day of the week, commencing not earlier than 60 nor later than 20 days before the date fixed for redemption. The notice of redemption shall set forth all of the following:

(1) The class or series of shares or part of any class or series of shares to be redeemed.

(2) The date fixed for redemption.

(3) The redemption price.

(4) If the shares are certificated securities, the place at which the shareholders may obtain payment of the redemption price upon surrender of their share certificates.

(c) If the corporation gives notice of redemption pursuant to subdivision (b), it shall also mail a copy of the notice of redemption to each holder of record of shares to be redeemed as of the date of mailing or record date fixed in accordance with Section 701, addressed to the holder at the address of such holder appearing on the books of the corporation or given by the holder to the corporation for the purpose of notice, or if no such address appears or is given at the place where the principal executive office of the corporation is located, not earlier than 60 nor later than 20 days before the date fixed for redemption. Failure to comply with this subdivision does not invalidate the redemption of the shares.

(d) If, on or prior to any date fixed for redemption of redeemable shares, the corporation deposits with any bank or trust company in this state as a trust fund, (1) a sum sufficient to redeem, on the date fixed for redemption thereof, the shares called for redemption, (2) in the case of the redemption of any uncertificated securities, an officer's certificate setting forth the holders thereof registered on the books of the corporation and the number of shares held by each, and (3) irrevocable instructions and authority to the bank or trust company to publish the notice of redemption thereof (or to complete publication if theretofore commenced) and to pay, on and after the date fixed for redemption or prior thereto, the redemption price of the shares to their respective holders upon the surrender of their share certificates, in the case of certificated securities, or the delivery of the officer's certificate in the case of uncertificated securities, then from and after the date of the deposit (although prior to the date fixed for redemption) the shares called shall be redeemed and the dividends on those shares shall cease to accrue after the date fixed for redemption. The deposit shall constitute full payment of the shares to their holders and from and after the date of the deposit the shares shall no longer be outstanding and the holders thereof shall cease to be shareholders with respect to the shares and shall have no rights with respect thereto except the right to receive from the bank or trust company payment of the redemption price of the shares without interest, upon surrender of their certificates therefor, in the case of certificated securities, and any right to convert the shares which may exist and then continue for any period fixed by its terms.

In determining the holders of uncertificated securities, the bank or trust company shall be entitled to rely on any officer's certificate deposited with it in accordance with this subdivision.

§ 510. Acquisition of own shares; status; prohibition of reissue by articles; reduction in authorized shares; amendment of articles; filing

(a) When a corporation reacquires its own shares, those shares are restored to the status of authorized but unissued shares, unless the articles prohibit the reissuance thereof.

(b) When a corporation reacquires authorized shares of a class or series and the articles prohibit the reissuance of those shares:

(1) If all of the authorized shares of that class or series, as the case may be, are reacquired, then (A) that class or series is automatically eliminated, (B) in the case of reacquisition of all of the authorized shares of a series, the authorized number of shares of the class to which the shares belonged is reduced by the number of shares so reacquired, and (C) the articles shall be amended to eliminate any statement of rights, preferences, privileges, and restrictions relating solely to that class or series.

(2) If less than all of the authorized shares but all of the issued and outstanding shares of that class or series, as the case may be, are reacquired, the authorized number of shares of the class or series is automatically reduced by the number of shares so reacquired, and the board shall determine either (A) to eliminate that class or series, whereupon the articles shall be amended to eliminate any statement of rights, preferences, privileges, and restrictions relating solely to that class or series, or (B) not to eliminate that class or series, whereupon the articles shall be amended to reflect that reduction of the number of authorized shares of that class or series by the shares so reacquired.

(3) If less than all of the authorized shares and less than all of the issued and outstanding shares of a class or series, as the case maybe, are reacquired, the authorized number of shares of that class or series shall be automatically reduced by the number of shares reacquired, and the articles shall be amended to reflect that reduction.

(c) When a corporation reacquires authorized shares of a series of shares and the articles only prohibit the reissuance of those shares as shares of the same series:

(1) If all of the authorized shares of that series are reacquired, then that series is automatically eliminated, the articles shall be amended to eliminate any statement of rights, preferences, privileges, and restrictions relating solely to that series, and the board shall determine either (A) to return those shares to the status of authorized but undesignated shares of the class to which they belong or (B) to eliminate those shares entirely, whereupon the articles in either case shall be amended to reflect the reduction in the authorized shares of that series and the effect, if any, on the class to which that series belongs.

(2) If all of the issued and outstanding shares of that series (but less than all of the authorized shares of that series) are reacquired, the board shall determine either (A) to eliminate that series, whereupon the articles shall be amended to eliminate any statement of rights, preferences, privileges, and restrictions relating solely to that series, or (B) not to eliminate that series, whereupon the articles shall be amended to reflect the return of the reacquired shares to the status of authorized but undesignated shares of the class to which they belong.

(3) If less than all of the issued and outstanding shares of that series are reacquired, the authorized number of shares of that series shall be automatically reduced by the number of shares reacquired, and the board shall determine either (A) to return those shares to the status of authorized but undesignated shares of the class to which they belong, or (B) to eliminate those shares entirely, whereupon the articles in either case shall be amended to reflect the reduction in the authorized shares of that series and the effect, if any, on the class to which that series, belongs.

(d) "Reacquires" as used in this section means that a corporation purchases, redeems, acquires by way of conversion to another class or series, or otherwise acquires its own shares or that issued and outstanding shares cease to be outstanding.

(e) The provisions of this section are subject to any contrary or inconsistent provision in the articles.

(f) A certificate of amendment shall be filed in accordance with the requirements of Chapter 9 (commencing with Section 900) reflecting any elimination or reduction of authorized shares set forth in subdivisions (b) and (c), and any related elimination from the articles of the designation and the rights, preferences, privileges, and restrictions of any series or class of stock that is eliminated, except that approval by the outstanding shares (Section 152) shall not be required to adopt any such amendment. Nothing contained in this section is intended to alter or otherwise affect the powers of the board to amend the articles as contemplated in Sections 202 and 401.

§511. Holder in due course without notice; enforcement of negotiable instruments

Notwithstanding the provisions of this chapter, a negotiable instrument issued by a corporation for the purchase or redemption of shares shall be enforceable by a holder in due course (Section 3302 of the Commercial Code) without notice that it was issued for that purpose or by a person who acquired the instrument through such a holder.