Corporate & Securities Law Blog
Up-to-date Information on Corporate & Securities Law
Presented By SheppardMullin

California Corporations Code Amended to Simplify Restrictions on Distributions and Permit Waivers of Application of Section 500 to Preferences of Preferred Stock

September 6, 2011

On September 1, 2011, California governor Jerry Brown signed Assembly Bill No. 571, which simplifies restrictions on dividends, repurchases and redemptions of shares. The restrictions are set forth in Sections 500 to 509 of the California Corporations Code, and are commonly referred to collectively as "Section 500.[1]" These provisions are designed to protect the interests of creditors and senior equity holders against transactions that might undermine their seniority in the capital structure. Section 500 applies to companies incorporated in California and to companies incorporated elsewhere but deemed subject to the same restrictions by virtue of satisfying the requirements of Section 2115 of the California Corporations Code for "pseudo-California corporations." Section 500 uses the term "distributions" to encompass dividends of cash or property (other than shares of the corporation) and repurchases and redemptions of shares.

Section 500 has served as a trap for the unwary, a significant impediment to the ability to effect many transactions that do not intuitively threaten the interests of creditors or senior equity holders, a substantial risk for directors who face personal and potential criminal liability for distributions made in violation of Section 500, and a source of frustration to lawyers and clients who struggled to explain, apply and perform the financial gymnastics required under Section 500. In extreme cases, companies incorporated in California have had to reincorporate in other jurisdictions prior to effecting a transaction because the transaction would otherwise be prohibited under Section 500.

The changes to Section 500 create an opportunity for issuers of preferred stock (e.g., companies receiving venture capital in its most common form) to exempt the preferences of classes or series of preferred stock from the application of Section 500.   This would have the potential to improve companies' flexibility to undertake various actions that would otherwise require unanimous consent of holders of a class or series of preferred stock.

The following is a summary of the key changes resulting from AB 571.

When will the new law become effective?

The revised sections of the California Corporations Code will be effective on January 1, 2012.

What Sections of the California Corporations Code are affected?

The major changes are to Sections 500, 503.1, 503.2, 506 and 509. Sections 503.1 and 503.2 were repealed and the others were amended.

What are the current restrictions on distributions?

California Corporations Code Section 501, which is unchanged by AB 571, prohibits distributions if the corporation (or a subsidiary making the distribution) is, or as a result of the distribution would be, likely to be unable to meet liabilities as such liabilities mature. Liabilities otherwise provided for are excluded from the Section 501 test.

California Corporations Code Section 500 currently allows a corporation to make a distribution of cash or property to its shareholders only if:

1. the amount of the corporation's retained earnings prior to the distribution equals or exceeds the amount of the distribution, or

2. the corporation is able to satisfy balance sheet ratio tests set forth in Section 500(b) after giving effect to the distribution[2].

What will be the restrictions on distributions under AB 571?

As noted above, Section 501 is unchanged by AB 571, so a distribution will continue to be prohibited if a corporation is or will after the distribution be unable to pay its liabilities as they mature.

AB 571 amended California Corporations Code Section 500 to allow a corporation to make distributions if:

1. the amount of the corporation's retained earnings prior to the distribution equals or exceeds the sum of the distribution and the amount of cumulative dividends in arrears on series of preferred stock that are senior in dividend preference to the class or series to which the applicable distribution is being made, or

2. after giving effect to the distribution, the value of the corporation's assets equals or exceeds the sum of its liabilities and the amount of preferential rights upon dissolution, including accrued but unpaid dividends, of shareholders with rights upon dissolution superior to those of the shareholders receiving the distributions.

The articles of incorporation may provide that with respect to a class or series of preferred stock, distributions may be made without regard to preferential dividend amounts (for purposes of the test in paragraph 1 above) and/or preferential rights upon dissolution (for purposes of the test in paragraph 2 above).

Must the new tests be determined under GAAP?

No. A board of directors may base a determination that the value of its assets exceeds the amount of 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. AB 571 provides that the tests under California Corporations Code Section 500 are based on the board's good faith determination that the conditions are satisfied. Note that the good faith standard is not set forth in Section 501 relating to the ability to pay liabilities as they come due. The Section 501 standard remains objective and does not depend on the directors' state of mind.[3]

When is the effect of a distribution measured under AB 571?

The effect of a *distribution* is measured as of the date the distribution is authorized if the payment occurs within 120 days after the date of authorization.

Can a corporation incur indebtedness that will not affect the ability to make distributions?

Under AB 571, yes. 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 Section 500, such indebtedness is not a liability for purposes of the calculation of assets over liabilities plus preferential rights.

What happens if debt is issued to pay for the repurchase of shares?

Under AB 571, if debt is issued to pay the purchase price for repurchase of outstanding shares (or for any other type of distribution), each payment of principal or interest on the indebtedness will be treated as a distribution, the effect of which is measured on the date the payment of the indebtedness is actually made.

Did anything else change?

Yes. AB 571 implemented the following additional changes:

- the statute of limitations for recovery of illegal distributions is set at four years after the date the distribution is made;
- preferred shareholders cannot bring suit in the name of the corporation against shareholders who receive illegal distributions unless the amount of their preferred dividend amount in arrears or preferential rights upon dissolution is greater than zero; and
- the requirement for a special notice to be sent with dividends not chargeable to retained earnings was repealed.

What should you do now?

Corporations that are incorporated in California or which are or may become subject to California's pseudo-California corporation law (California Corporations Code Section 2115), and which will be issuing new classes or series of preferred stock, should consider including provisions that allow distributions to be made without regard to Section 500. In many cases, protective provisions included in the preferred stock rights will provide equal or better protection, and protective provisions usually permit waiver by less than all the holders of the class or series of preferred stock. By contrast, making a distribution that would otherwise be prohibited by Section 500 would require the consent of all holders of a class or series of preferred stock in order to eliminate the risk of challenge.

What if you have questions?

For any questions or more information on these or any related matters, please contact any attorney in the firm's corporate and securities practice group.

John Tishler (858.720.8943, jtishler@sheppardmullin.com), Kirt Shuldberg (858.720.7442, kshuldberg@sheppardmullin.com), Edwin Astudillo (858.720.7468, eastudillo@sheppardmullin.com) and Julie Komosinski

(858.720.7464, jkomosinski@sheppardmullin.com) participated in drafting this article.

Disclaimer

[1] In this article, we use "Section 500" to refer generally to Section 500 to 509 of the California Corporations Code, and to "California Corporations Code Section 500" to refer to that section as distinguished from the later sections.

[2] There are two types of balance sheet ratio tests in Section 500(b). The first type is the ratio of the corporation's total assets to its total liabilities, after giving effect to the distribution. In order to satisfy this first test, the corporation's total assets, after giving effect to the distribution, must be equal to at least 125% of its total liabilities. However, when making this determination, certain assets are excluded from the asset side of the balance sheet and must be deducted before computing this ratio. These consist of "goodwill, capitalized research and development expenses and deferred charges." Certain items are also excluded from liabilities. These items are "deferred taxes, deferred income and other deferred credits."

The second type requires that the corporation's current assets, after giving effect to the distribution, be at least equal to its current liabilities. This second test is applicable to a corporation only if it classifies its assets as either current or fixed under GAAP. In cases where the average of a corporation's earnings before taxes on income and before interest expense for the two preceding fiscal years is less than the average of the interest expense of the corporation for those same fiscal years, the corporation's current assets, after giving effect to the distribution, must be equal to at least 125% of its current liabilities. For purposes of this test, 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.

When determining the amount of the assets of the corporation, profits derived from an exchange of assets must not be included unless the assets received are currently realizable in cash.

In general, the computations under the foregoing tests must rely on financial statements prepared or determined in conformity with GAAP.

[3] Under Sections 309 and 316(a) of the California Corporations Code, the direct personal liability of a director for an illegal distribution is limited to situations where a director acts willfully or negligently. The good faith standard added to California Corporations Code Section 500 will therefore have an effect primarily on actions by or on behalf of the corporation to recover illegal distributions from shareholders who received them. Under AB 571, the corporation will not be able to recover from shareholders if the board conducted the balance sheet tests in good faith even if a court were to later disagree with the board's conclusion that the tests were satisfied.