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Amendment to the California Corporations Code Governing Corporate Distributions and Dividends to Shareholders

Nikole Varvitsiotis, Esq.

In September 2011, the Governor of California signed California Assembly Bill No. 571 into law, which modernizes and simplifies the distribution requirements for California corporations and quasi-California corporations.

AB 571 took effect on January 1, 2012 and significantly amends Sections 500-509 of the California Corporations Code (the "Code"), which govern corporate distributions, including dividends of cash or property and share repurchases and redemptions. Notably, the amendment replaces the rigid balance sheet and liquidity tests with a simpler test that permits a solvent corporation to make distributions to its shareholders as long as the value of the corporation's assets would exceed its liabilities after giving effect to the distribution. The new law aligns the standards relating to distributions by California corporations with the standards relating to distributions by California limited partnerships and limited liability companies and with the approach used by other states. It also has ramifications for corporate financing transactions.

Background and Prior Law

Section 166 of the Code defines a "distribution to shareholders" as the transfer of cash or property by a corporation to its shareholders or the purchase or redemption of its shares for cash or property. Section 500 of the Code restricts distributions to shareholders to protect senior equity holders and creditors of the corporation. The prior law required a corporation to satisfy a solvency test and either a retained earnings test or a two-pronged balance sheet test in order to make distributions to its shareholders.

Solvency Test

A corporation must meet a general solvency test, which prohibits distributions that would make a corporation insolvent. Pursuant to Section 501 of the Code, a corporation may not make a distribution to its shareholders if the corporation is, or as a result of the distribution would likely be, unable to meet its liabilities as they mature. The restriction is designed to protect a corporation's creditors against the dissipation of its assets. This test must be met, regardless of whether the corporation could meet either the retained earnings tests or the two-pronged balance sheet test described below.

Retained Earnings Test

Under the retained earnings test, a corporation could pay a distribution, provided that the amount of its retained earnings immediately prior to the distribution equaled or exceeded the amount of the proposed distribution.

Assets/Liabilities Test

If a solvent corporation failed to satisfy the retained earnings test, it could have still paid a dividend if it was able to satisfy the assets/liability test. This test took into account both a corporation's net worth and its liquidity, as measured by ratios of total assets/liabilities and current assets/liabilities. Under the two-pronged balance sheet and liquidity test, a corporation was permitted to make a distribution only if, after giving effect to the distribution, the corporation's total assets equaled or exceeded 125% of its total liabilities and the corporation's current assets equaled or exceeded its current liabilities (or 125% of current liabilities if the corporation's average earnings before interest and taxes for the two preceding fiscal years was less than its average interest expense during the same period). In making the balance sheet and liquidity calculations under the old statute, certain assets and liabilities were excluded altogether, and, consistent with generally accepted accounting principles, assets were generally required to be valued at their historical carrying value (which was not necessarily reflective of the current fair market value of those assets). Corporations unable to satisfy both prongs of this balance sheet and liquidity test and that did not have accumulated retained earnings were prohibited from making distributions to their shareholders under the old statute, even if the fair market value of their assets exceeds the amount of their liabilities.

Critics of the prior law argued that it imposed unnecessary restrictions on the issuance of distributions by financially health corporations, particularly those that had both historical book losses and appreciated property. Such a corporation would not be able to satisfy the retained earnings test and, while it may have assets valued in excess of its liabilities, would not be able to satisfy the assets/liabilities test if the carrying value of its assets was not reflective of the fair market value.

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Amendments to Sections 500-509 of the Code

The newly enacted law allows a California corporation or quasi-California corporation to make distributions if it meets the general solvency test and either the retained earnings test or the new, simplified balance sheet test.

The general solvency test, which prohibits distributions that would render a corporation insolvent, remains unchanged by AB 571 and continues to operate as a protection for creditors against improper distributions.

Under the amended Section 500, a California corporation or quasi-California corporation may make a distribution if its board of directors determines in good faith either of the following:

- The amount of retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of (A) the amount of the proposed distribution plus (B) the preferential dividends arrears amount.
- Immediately after the distribution, the value of the corporation's assets would equal or exceed the sum of its total liabilities plus preferential rights amount.

The term "preferential dividends arrears amount" means the amount, if any, of cumulative dividends in arrears on all shares having a preference with respect to the payment of dividends over the class or series to which the applicable distribution is being made.

The term "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.

AB 571 also makes a number of other changes and clarifications, including the following:

- Provides that a board of directors may make a determination that a distribution is permitted under the new balance sheet test 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;
- Clarifies that the effect of a distribution for purposes of determining whether a distribution satisfies either the retained earnings test or the new balance sheet test is measured as of the date of the authorization of the distribution if the authorization occurs within 120 days prior to the distribution date;
- Establishes a four-year statute of limitations with respect to any action brought by a creditor or shareholder (which is consistent with the four-year statute of limitations for California limited liability companies and limited partnerships); and
- Eliminates an unnecessary requirement that a corporation provide notice of distributions to shareholders that are not made in reliance on the retained earnings test.

Summary

California law now provides greater flexibility to a board of directors of California and quasi-California corporations to issue distributions to shareholders and redeem and repurchase shares. The amendment replaces the rigid balance sheet and liquidity tests with a simpler test, which permits a solvent corporation to make distributions to its shareholders as long as the value of the corporation's assets would exceed its liabilities after giving effect to the distribution. Further, it eliminates the discrepancy between the laws governing distributions by California limited partnership and limited liability companies.

The revised statute also has ramifications for corporate financing transactions. Officers and directors have greater freedom to structure and declare shareholder distributions consequently improving their ability to consider and undertake various equity and debt financing transactions. Alternatively, creditors and senior equity holders no longer have some of the protections afforded by the prior law.

Nikole Varvitsiotis is an Associate in the firm's Corporate Practice Group. She can be reached at (213) 891-5123 or nvarvitsiotis@buchalter.com.

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