Date of Hearing: May 2, 2011

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Mike Eng, Chair
AB 571 (Hagman) – As Amended: April 25, 2011

SUBJECT: Corporations: distributions.

SUMMARY: Seeks to amend and delete portions of the General Corporation Law concerning dividends and reacquisitions of shares. Specifically, this bill:

1) Provides that a corporation cannot distribute to its shareholders unless the board of directors has determined in good faith the following:

    a) The amount retained earnings of the corporation immediately prior to the distribution equals or exceeds the sum of the amount of the proposed distribution plus the preferential dividends arrears amount.

    b) 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.

2) Defines "preferential dividends arrears amount" as an amount 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 a distribution can be made without regard to preferential dividends arrears amount, then the amount shall be zero.

3) Defines "preferential rights amount" as the amount that would be needed if the corporation were to be dissolved at the time of the distribution to satisfy the preferential rights.

4) Allows the board of directors to determine that distributions are not prohibited on the following:

    a) Financial statements prepared on the basis of accounting practices and principles

    b) A fair valuation

    c) Any other method that is reasonable under the circumstances

5) Deletes the requirement that corporations provide notice to shareholders with respect to a dividend other than one chargeable to retained earnings, stating that dividend is being made from a source other than retained earnings.

EXISTING LAW establishes the Corporations Code to provide the fundamental terms and provisions for the governance of corporations. Section 500-511 relates to dividends and requisition of shares.

FISCAL EFFECT: None.

COMMENTS:

According to the sponsor, the Business Law Section, Corporations Committee, of the State Bar of California, this measure is necessary to replace 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. AB 571 would allow 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.

According to the Author, this measure will simplify and clarify the formula pursuant to which corporations may make distributions to shareholders; 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; 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; 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, make the approach used by California to restrict distributions more consistent with the approach used in other states so that California will not be competitively disadvantaged in attracting new businesses.

BACKGROUND: In 1977, California significantly modified corporate law restrictions on corporations paying distributions to their shareholders 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 either the corporation has retained earnings prior to such distribution equal or exceeding the amount of the distribution or 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 the distribution will not render the corporation insolvent. The two-prong balance sheet and liquidity tests referenced 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 State Bar 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 and 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 three partnerships under California law, and are out of step with dividend restrictions imposed on corporations in most other states in the United States.

REGISTERED SUPPORT / OPPOSITION:

Support

The State Bar of California - **Sponsor**

Opposition

None on file.

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