

## **Assembly Bill No. 571**

### CHAPTER 203

An act to amend Sections 163.1, 500, 506, and 509 of, to repeal Sections 502, 503.1, 503.2, and 507 of, and to repeal and add Section 503 of, the Corporations Code, relating to corporations.

[Approved by Governor September 1, 2011. Filed with  
Secretary of State September 1, 2011.]

#### LEGISLATIVE COUNSEL'S DIGEST

AB 571, Hagman. Corporations: distributions.

Existing law provides for the formation and governance of corporations. Existing law allows a corporation to make a distribution of cash or property to shareholders, including a dividend or a repurchase or redemption of shares, only if either the corporation has retained earnings prior to the distribution equal to or exceeding the amount of the distribution or the corporation can satisfy specified balance sheet test and liquidity requirements after giving effect to the distribution, and the distribution will not render the corporation insolvent.

This bill would allow a corporation to distribute cash or property to shareholders, including a dividend or repurchase or redemption of shares, if the amount of the corporation's retained earnings prior to the distribution equals or exceeds the sum of the distribution and the cumulative dividends in arrears on certain preferred stock and, 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, except as specified. The bill would provide that 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.

Existing law provides that a shareholder who knowingly receives an improper distribution is liable to the corporation's creditors and holders of preferred shares, as specified, and that those parties may bring suit in the name of the corporation to enforce those liabilities.

This bill would provide that holders of shares having preferential rights with respect to cumulative dividends in arrears shall not have the right to bring suit with respect to an improper distribution unless the amounts owed those holders, as specified, is greater than zero. The bill would also provide that a cause of action with respect to an obligation to return an improper distribution shall be extinguished unless brought within 4 years of the distribution date.

Existing law requires a corporation to provide notice, as specified, to shareholders, with respect to a dividend other than one chargeable to retained earnings, stating that the dividend is being made from a source other than retained earnings, and stating the accounting treatment of the dividend.

This bill would eliminate that requirement. The bill would make technical, conforming amendments.

*The people of the State of California do enact as follows:*

SECTION 1. Section 163.1 of the Corporations Code is amended to read:

163.1. For purposes of subdivision (b) of Section 500 and subdivision (b) of Section 506, “cumulative dividends in arrears” means only cumulative dividends that have not been paid as required on a scheduled payment date set forth in, or determined pursuant to, the articles of incorporation, regardless of whether those dividends had been declared prior to that scheduled payment date.

SEC. 2. Section 500 of the Corporations Code is amended to read:

500. (a) Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation’s shareholders (Section 166) unless the board of directors has determined in good faith either of the following:

(1) 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.

(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.

(b) For the purpose of applying paragraph (1) of subdivision (a) 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 of incorporation provide that a distribution can be made without regard to preferential dividends arrears amount, then the preferential dividends arrears amount shall be zero. For the purpose of applying paragraph (2) of subdivision (a) 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 of incorporation provide that a distribution can be made without regard to any preferential rights, then the preferential rights amount shall be zero. In the case of a distribution of cash or property in payment by the corporation in connection with the purchase of its shares, (1) 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 and (2) 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 paragraphs (1) or (2) of subdivision (a) 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 paragraph (2) of subdivision (a).

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

(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.

SEC. 3. Section 502 of the Corporations Code is repealed.

SEC. 4. Section 503 of the Corporations Code is repealed.

SEC. 5. Section 503 is added to the Corporations Code, to read:

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

(b) The provisions of Sections 500 and 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 subdivision, “disability insurance” means an agreement of indemnification against the insured’s loss of the ability to work due to accident or illness.

SEC. 6. Section 503.1 of the Corporations Code is repealed.

SEC. 7. Section 503.2 of the Corporations Code is repealed.

SEC. 8. Section 506 of the Corporations Code is amended to read:

506. (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 determining the value of any noncash 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 500 against any or all shareholders liable by one or more holders of shares having preferential rights with respect to cumulative dividends in arrears, in the case of a violation of paragraph (1) of subdivision (a) of Section 500, or upon dissolution, in the case of a violation of paragraph (2) of subdivision (a) of Section 500, in each case who have not consented to the applicable distribution, without regard to the provisions in Section 800, and in each case to the extent the applicable shares with preferential rights were outstanding at the time of the distribution; 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 unless the preferential dividends arrears amount, in the case of a violation of paragraph (1) of subdivision (a) of

Section 500, or the preferential rights amount, in the case of a violation of paragraph (2) of subdivision (a) of Section 500, was greater than zero. A cause of action with respect to an obligation to return a distribution pursuant to this section shall be extinguished unless the action is brought within four years after the date 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.

SEC. 9. Section 507 of the Corporations Code is repealed.

SEC. 10. Section 509 of the Corporations Code is amended to read:

509. (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 of incorporation, 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.