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CORPORATE LAWS

California Rides the Wave of Reform by Better Aligning Its Laws on Corporate Distributions With National Standards



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■ n what is certain to be a welcome development among executives and legal practitioners alike, California law's much-maligned treatment of corporate distributions will soon be significantly overhauled, with the reform to be ushered in on January 1, 2012.

Like the laws of other states, California corporate law regulates the circumstances under which a corporation can make distributions to its shareholders, prohibiting corporations that are financially unhealthy or insolvent from making them.¹ However, unlike the laws of many

¹ Existing California law, like that of Delaware, New York, and the vast majority of states, has as the centerpiece of its regulation of corporate distributions a statutory prohibition against a corporation making a distribution in the event of, or

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other states, California's corporate distribution law has earned a vocal chorus of jeers and derision. Critics contend that the law is not only needlessly arcane, but that, at its core, it represents poor policy, since its rigidity and excessive reliance on accounting principles can preclude financially sound corporations from distributing their profits. The California law's cause is not aided by the fact that it is a national outlier, finding itself significantly at variance with the standards adopted by a majority of the fifty states—including corporate law bellwethers Delaware and New York, as well as those states that have implemented statutes based on the ABA's Model Business Corporation Act ("Model Act"). What's more, the existing Sections 500-509 of the California Corporations Code ("Code"), which set forth the complex regime prescribing when a corporation may make a distribution to its shareholders, aren't even consistent with California's own law governing when distributions can be made by limited liability companies, which is simpler and more elegant.

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To address these shortcomings, the new provisions of the Code will streamline existing corporate distribution tests, bring California into closer alignment with its

which has the effect of producing, its insolvency. Once attention is directed beyond this bedrock first principle, however, the more vexing elements of the existing California law come into focus.

peer states, and resolve the inconsistency between the Code's treatment of distributions by corporations and its treatment of distributions by limited liability companies. In several respects, the California reform will actually result in the state's distribution laws being more streamlined than those of a number of other states (including Delaware and New York), setting an example for other jurisdictions that are considering modernizing their laws relating to corporate distributions.²

The Existing Legal Framework in California: Structure and Critiques

Under existing law, a California corporation may not make a distribution to its shareholders unless it satisfies either a retained earnings test or a two-pronged balance sheet and liquidity test. The retained earnings test, which will remain intact after the new law becomes effective at the beginning of 2012, permits a corporation to make a distribution if the amount of its retained earnings equals or exceeds the amount of the proposed distribution. Corporations that cannot satisfy the retained earnings test are currently corralled into a two-part financial test which requires that, immediately after giving effect to a proposed distribution, (1) the assets of the corporation (exclusive of goodwill, capitalized research and development expenses, and deferred charges) must equal or exceed 125 percent of the corporation's liabilities (excluding deferred taxes, deferred income, and other deferred credits), and (2) the current assets of the corporation must equal or exceed its current liabilities (or, in certain circumstances, that the corporation's current assets must equal or exceed 125 percent of its current liabilities).

If a corporation cannot satisfy the retained earnings test, but manages to qualify a proposed distribution pursuant to the two-part financial test described above, under existing California law, it must then also provide notice to each shareholder setting forth the accounting treatment of the distribution.

Moreover, Section 114 of the Code applies generally accepted accounting principles ("GAAP") to the above-described financial tests governing corporate distributions, leading to the possibility of a prohibition against distributions by corporations that, notwithstanding their potential fiscal health and positive liquidation value, happen to have assets booked at values less than their fair market value at the time of a proposed distribution and accordingly cannot satisfy the relevant tests.

Additionally, California takes the position that its so-called "long-arm statute" makes the Code provisions relating to corporate distributions applicable to foreign corporations with either (a) more than 50 percent of their operations located in California (as measured by a blended property, payroll, and sales test) or (b) over 50 percent of their record holders of voting securities located in California as of the record date of the last shareholder meeting. Accordingly, under California law, a corporation organized in New York that has significant operations or shareholder constituencies in

² Although beyond the scope of this article to treat in detail, it should be noted that, for corporations organized under the laws of a state other than California (which we refer to as "foreign corporations"), the new provisions of the Code—like the existing ones—will purport to apply to such corporations if they come within the scope of California's so-called "long-arm statute" embodied in Section 2115 of the Code.

California would be required to comply not only with New York state law relating to distributions, but also the more burdensome and complicated California laws.³

Unsurprisingly, critiques of the California regime have been animated and numerous. The complicated and formulaic structure of the existing law has frustrated corporations unable to rely on the simpler and more familiar retained earnings test. Even in those cases in which the more complex and multi-faceted financial tests could be satisfied by corporations unable to rely on the retained earnings test, the onerous and expensive chore of notifying each and every shareholder of the accounting treatment applicable to the distribution had to be undertaken. Furthermore, the application of GAAP to the statutory provisions relating to corporate distributions, although anticipated at the time of the law's adoption to result in the use of more modern and familiar valuation processes, has actually resulted in the accounting fiction of "book value" imposing real-world prohibitions against corporate distributions that would otherwise be perfectly legitimate and economically sensible if a different valuation mechanism were applied.

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Finally, inasmuch as the existing California law pertaining to distributions by limited liability companies does not reflect the complicated corporate distribution model, instead, relying on the simpler tests that the new law implements for corporations and which are discussed in further detail below, California law suffers from an internal inconsistency that is difficult to justify conceptually.

For all of the foregoing reasons, many corporations, especially growth companies—which frequently hold assets with a market value exceeding their book value—and "S" corporations—which are taxed as pass-through entities and therefore often need to make tax distributions to shareholders at regular intervals—have found California's corporate distribution regime cumbersome, exasperating, and ripe for reform.

The New California Law

To the relief of executives and legal practitioners, the new provisions of the Code concerning corporate distributions will both simplify the law and bring California into closer alignment with national standards, including the standards adopted by Delaware and New York. As mentioned above, the retained earnings test will remain intact, although slightly adjusted so as to take account of dividends owing in respect of preferential dividend

³ Due to the application of the internal affairs doctrine, pursuant to which the "internal affairs" of a corporation are governed by the law of the state in which the corporation is organized, it is worth noting that not all states recognize the validity of California's long-arm statute. The internal affairs doctrine is alive and well in a number of states, including Delaware. It is, however, beyond the scope of this article to consider in detail the effect of the internal affairs doctrine on California's long-arm statute.

rights, which, for purposes of the test, will be treated as deemed reductions to the amount of retained earnings, unless the articles of incorporation provide otherwise.

For corporations that cannot rely on the retained earnings test, the new law puts into effect a second test that is significantly simpler than the two-part regime currently in place. Under the new test, a corporation will be permitted to make a distribution if, immediately after the distribution, its assets equal or exceed the sum of: (a) total liabilities plus (b) the liquidation preference of any shares which have a preference upon dissolution over the rights of shareholders receiving the distribution. As with the retained earnings test, corporations may specify in their articles of incorporation that distributions made in accordance with the newly enunciated balance sheet test can be made without regard to the amount of any liquidation preferences.

Crucially, the new law provides further that the board of directors may base its determination that a distribution satisfies the requirements of the Code on any of the following: (a) financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances, (b) a fair valuation, or (c) any other method that is reasonable under the circumstances. This “balance sheet” test will give boards appropriate measures of latitude and discretion to employ the standard most fitting for the corporation’s operating and financial circumstances.

In another important move, the new law does away with the requirement to notify shareholders of the accounting treatment of the distribution payment made if the retained earnings test was not used in qualifying the payment.⁴ The reformed distribution regime also provides temporal guidance concerning the application of its tests. Under the new law, the effect of a distribution under the above-described tests is measured as of the date the distribution is authorized so long as the payment is made within 120 days after the date of its authorization.

Executives and boards of corporations that pay dividends with regularity will find California’s new distribution tests both simpler to apply and more closely aligned with the realities of the financial health of their enterprises. They will also applaud the elimination of the burden associated with giving shareholders complicated notices. In addition, with California’s move in the direction of the national mainstream, foreign corporations seeking to comply with California’s “long-arm statute” will likely experience a reduction in the effort they are required to devote to tracking and applying disparate state distribution laws.

National Perspective: Comparison of the New California Law To the Model Act and Existing Delaware and New York Law

In addition to the benefits of a simpler and more modern law, the reform of California’s distribution laws will bring them into closer alignment with those of Delaware and New York, as well as the distribution laws in states that have implemented statutes patterned after the Model Act. However, several important differ-

⁴ Despite the liberalization of the notice regime, a board of directors should nevertheless carefully document its decision to make a distribution, the basis upon which it determines that the corporation is entitled to make the distribution and the relevant application of the retained earnings or balance sheet test that was employed.

ences between the California model and the Delaware, New York, and Model Act approaches will remain after the California corporate distribution reforms become effective. A brief summary of key similarities and differences among the distribution laws of these three states and the Model Act follows.

The most significant difference between the new California law and the existing laws of Delaware and New York, as well as the provisions of the Model Act, is the presence of a retained earnings test under California law.

As discussed, California’s new law implements a simple and flexible balance sheet-based test for those companies that do not satisfy its retained earnings test. This central reform will bring California into conformity with the prevailing standard, which is to maintain a balance sheet-based test calling for a flexible look at balance sheet values based on a corporation’s good faith assessment of the valuation principles most applicable to its circumstances.⁵ Although the tests applied by New York and Delaware continue to rely on somewhat antiquated concepts of “stated capital” and “surplus”, which are not used in the Model Act nor applied under the new California law, the balance sheet tests applied in New York and Delaware are nevertheless conceptually consistent with California’s new approach, since they are ultimately concerned with measuring the excess of actual value of assets over liabilities. The new California law will also leave intact the existing “solvency test”, which, like New York and Delaware law and the laws of those states that have implemented the Model Act, prohibit distributions that would result in the corporation being unable to meet its liabilities as they mature.

The most significant difference between the new California law and the existing laws of Delaware and New York, as well as the provisions of the Model Act, is the presence of a retained earnings test under California law. California’s new law also does not adopt two of the more controversial aspects of both Delaware and New York law: (1) a so-called “nimble dividends” provision, under which a corporation is permitted to pay dividends out of net profits for the current or prior fiscal year, irrespective of its ability to satisfy any balance sheet test, and (2) tailored treatment for companies in natural resources industries whose assets are principally comprised of depreciated (“wasting”) assets. California’s rejection of these concepts further illustrates its determined attempt to move its law of distributions in the direction of simplicity.⁶

⁵ This standard is adopted by New York, Delaware and those states that have implemented the relevant portions of the Model Act. As previously mentioned, taken as a whole, these states represent a significant majority of the fifty states.

⁶ Some commentators have likened California’s retained earnings test to the “nimble dividends” concepts in the New York and Delaware statutes inasmuch as both refer conceptually

A number of the principal similarities and differences among the existing California law, the new California law, the Model Act, existing Delaware law, and existing New York law concerning corporate distributions appear in the chart below:

Applicable Law	Retained Earnings Test	Solvency Test	“Balance Sheet” Test	“Nimble Dividends” Permitted	“Wasting” Assets Provision	Mandated GAAP-Based Balance Sheet Valuation
Existing (pre-January 1, 2012) California Law	Yes	Yes	Yes ⁷	No	No	Yes
New (post-January 1, 2012) California Law	Yes	Yes	Yes	No	No	No
Model Act	No	Yes	Yes	No	No	No
Delaware	No	Yes	Yes	Yes	Yes	No
New York	No	Yes	Yes	Yes	Yes	No

ally to net income not distributed by the corporation. We believe that the retained earnings test is, in purpose and effect, somewhat dissimilar to the “nimble dividends” concept, since the nimble dividends test has the potential effect of permitting distributions even under circumstances in which no profits have been retained over time and assets are less than liabilities.

⁷ As described above, the existing California law includes a balance sheet surplus test as the second prong of the second test.

Conclusion

California’s forward-looking effort to reform a corporate distribution regime that suffers from several meaningful infirmities is certain to win plaudits in many a board room. Replacing the highly formalistic, rigid, and complex model that preceded it, the new California corporate distribution law will offer a simple and flexible approach shorn of significant administrative burdens and less likely than its predecessor to artificially prevent financially healthy companies from paying divi-

dends. Not only has California taken a decisive step away from a disfavored model and towards a more practical and sensible corporate distribution regime, the state has—by avoiding several controversial or outdated features in effect under Delaware and New York corporate distribution law—set an example for other states seeking to reform outmoded statutes and implement in their place provisions that are more modern, streamlined, and administratively manageable.