California's New General Corporation Law: Dividends and Reacquisitions of Shares

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Although dividend declaration reflects general business profitability and the expected return to shareholders of profit on their capital investment in an enterprise, it may serve several other important functions. Such declarations can stimulate market trading, create an enhanced credit structure, and simultaneously allow the corporation to escape the heavy tax imposed by the Internal Revenue Service on the accumulation of profits. However, the unbridled distribution of a corporation's assets in the form of dividends may endanger the investments of shareholders and the ability of creditors to obtain payment of corporate debts. Therefore, certain restrictions on the declaration of dividends have been found necessary for the protection of the shareholders and creditors of corporations.

Similarly, distributions in the form of redemptions or repurchases of a corporation's own shares must be subjected to certain limitations which protect the capital investment of shareholders and the rights of creditors. Investment for profit, on which our system of corporate capitalism is based, presupposes that corporate earnings, unless needed for investment in plant or as working capital, should normally be returned to all of the shareholders ratably in the form of dividends. However, the existence of a managerial power to purchase shares is less easily justified, and has led in practice to a wide variety of abuses. Such abuses include (1) purchases for market manipulation; (2) purchases in order

1. INT. REV. CODE OF 1954, §§531-537.
to affect voting control; (3) purchases in order to buy off a “troublemaker” whose troublemaking, however annoying to the management, may well be beneficial to the enterprise and to the shareholders; (4) purchases from insiders at prices which are unfair to the corporation; and (5) purchases from insiders in order to enable them to withdraw from an enterprise which has a theoretical surplus but which is actually in an unprosperous condition.³

With the enactment of the New General Corporation Law,⁴ California has adopted a new regulatory scheme designed to protect creditors and shareholders from improper distributions. This comment will attempt to delineate the major changes under the New Code by comparing the newly enacted provisions with those contained in the Old Corporations Code.⁵ The discussion will initially address certain general limitations on corporate distributions, and will then proceed to examine the specific limitations set forth in the New Code regarding distributions by way of dividends and reacquisitions.

GENERAL LIMITATIONS ON DISTRIBUTIONS

Generally, the restrictions on corporate distributions take three interrelated but distinguishable forms. First, the directors who declare dividends or otherwise make distributions which are not in the best interests of the corporations are liable to creditors and shareholders, under most statutory schemes, for such misuse of funds and neglect of fiduciary responsibilities.⁶ Secondly, there are certain implied restrictions on capital impairment which exist outside the statutes. One such restriction has evolved into the trust fund doctrine, which provides that the investments of shareholders should be kept in the business as a

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3. Dodd, supra note 2, at 706. See also 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS §146, at 298 (4th ed. 1975) [hereinafter cited as 1 BALLANTINE & STERLING].

4. CAL. Stats. 1975, c. 682 (effective January 1, 1977) [hereinafter all citations and references to the New General Corporation Law, enacted, CAL. Stats. 1975, c. 682, will be cited as or referred to as New CAL. CORP. CODE or New Code]. See generally REVIEW OF SELECTED 1975 CALIFORNIA LEGISLATION, this volume at 258 (General Corporation Law).

5. CAL. CORP. CODE §§100-35302, enacted, CAL. Stats. 1947, c. 1038 (effective until January 1, 1977) [hereinafter all citations and references to the General Corporation Law as enacted in 1947 will be cited as or referred to as CAL. CORP. CODE of Old Code].

6. See, e.g., DEL. CODE ANN., tit. 8, §174 (1974); N.Y. BUS. CORP. LAW, §719 (McKinney’s, 1974); CAL. CORP. CODE §825, replaced, CAL. Stats. 1975, c. 682, §316.

New CAL. CORP. CODE §316 states in part:
  . . . directors of a corporation who approve any of the following actions shall be jointly and severally liable to the corporation for the benefit of all of the creditors or shareholders entitled to institute an action . . .
  (1) The making of any distribution to its shareholders to the extent that it is contrary to the provisions of Sections 500 through 503, inclusive . . .
margin of safety for creditors, thereby furnishing some basis of financial responsibility. Further, there is an implied restriction founded on the principle that to do business without providing a sufficient financial basis is an abuse of the separate corporate entity privilege. Thirdly, the general corporation laws of nearly all jurisdictions state limitations on corporate distributions. Such statutory schemes, and California's New General Corporation Law in particular, shall be the major focus of this comment.

A. Director Liability as a Restriction on Corporate Distributions

The first of these three basic protections, that of director liability, involves a balancing of the necessity for a means by which shareholders and creditors may obtain redress for wrongful and negligent acts of corporate directors against the need to insulate these same directors from absolute responsibility for their actions. The latter consideration is necessary to encourage competent persons to engage in business management and to act without fear of the consequences of ordinary business decisions. The standard of care imposed upon directors has been the subject of much judicial discussion and seems to have evolved into a closely interrelated dual test of loyalty (good faith) and care (acts of a prudent person).

7. See Burke v. Marlboro Awning Co., 330 Mass. 294, 113 N.E.2d 222 (1953), which both condemned dividends and other distributions to shareholders which rendered the corporation incapable of satisfying the claims of creditors and held directors who distributed corporate assets to its stockholders personally liable for the amounts so distributed independently of statute. California cases rely heavily on H. Ballantine, Ballantine on Corporations 302-03 (1946 rev. ed.), where it is said:

If a corporation is organized . . . in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege. Quoted in Automotriz Del Golfo DeCalifornia S.A. De C.V. v. Resnick, 47 Cal. 2d 792, 797, 306 P.2d 1, 4 (1957).


13. See note 12 supra.
standard of care is beyond the scope of this comment, it is important to recognize that California's New General Corporation Law provides a statutory definition of the standard to which California corporate directors will be held in the future. Section 309(a) of the New Corporations Code explicitly states that:

A director shall perform the duties of a director . . . in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in like position would use under similar circumstances.

As will be seen, this protection against distributions which are not in the best interests of the corporation takes on added significance in light of the changes made by the New Code regarding restrictions on distributions.

B. Implied Restrictions on Corporate Distributions

The second basic protection noted above consists of the restrictions on capital impairment. Before a discussion of capital impairment may be commenced, however, a working understanding of the term "capital" is necessary. Prior to the enactment of modern statutes, the essential attribute of capital was defined in terms of a "trust fund" for the benefit of creditors. The capital of a corporation, under the early statutes, was the amount that the proprietors agreed to invest in the enterprise and was measured by the aggregate par value of the shares of stock issued and subscribed for. The trust fund doctrine was superimposed by the courts over this statutory definition, and thus assets equal to the amount of capital were impliedly held in trust for the protection of creditors. Whenever the assets were less than the amount of capital, the proprietors could not make distributions to themselves, but whenever the assets

14. For a complete analysis of the statutory and decisional law which sets forth this dual test, and for a discussion of the ramifications of California's New General Corporation Law provisions governing directors' liability, see Comment, California's New General Corporation Law: Directors' Liability to Corporations, this volume at 613.
18. See, e.g., note 7 supra. The fictional characterization of a balance sheet factor as a "trust fund" invites a confusion between assets, which are things of value, and capital, which connotes merely a dollar amount. The trust fund theory has been criticized as misleading because creditors' claims against a corporation are not limited to an equitable interest in the assets measured by the amount of capital but extend to all assets. Kreidmann, Dividends—Changing Patterns, 57 COLUM. L. REV. 372, 376 (1957). See also Warren, Safeguarding the Creditors of Corporations, 36 HARV. L. REV. 509, 544-47 (1923).
Exceeded that amount, the excess was regarded as surplus and was freely distributable. Since no particular assets were designated as being exclusively for the protection of creditors, and since the "fund" was itself a fiction, the theory was in essence simply a restriction on the amount of assets which could be distributed to shareholders. Modern statutes, including the New California Corporations Code, tend to limit distributions primarily to those made out of earned surplus or net profits. This approach limits permissible distributions to those derived from earnings from the business over and above liabilities including stated capital, and thus accomplishes the same function as the trust fund doctrine without the fictions inherent in it.

Disregard of the separate corporate entity privilege is another deterrent to the misuse of corporate funds. A classic definition of a corporation was given by Chief Justice Marshall in Trustees of Dartmouth College v. Woodward, where he stated:

A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the character of its creation confers upon it . . . Among the most important are immortality, and . . . individuality.

This individuality and the accompanying insulation of shareholders from personal liability for the debts incurred by the corporation as an entity is one of the primary reasons for the existence of corporations. Yet courts uniformly disregard the corporate entity and "pierce the corporate veil" in situations where to do otherwise would result in the perpetration of a fraud or injustice upon unwitting creditors. Among the circumstances to be considered as bearing upon the equities of a case are the extent to which the financial affairs and accounts of a corporation

19. Garrett, supra note 17, at 239.
21. See New CAL. COP. CODE §500(a).
23. Id. at 636 (emphasis added).

Before the acts and obligations of a corporation can be legally recognized as those of a particular person, and vice versa, the following combination of circumstances must be made to appear: First, that the corporation is not only influenced and governed by that person, but that there is such a unity of interest and ownership that the individuality, or separateness, of the said person and corporation has ceased; second, that the facts are such that an adherence to the fiction of the separate existence of the corporation would, under the particular circumstances, sanction a fraud or promote injustice.
and those who control it are confused to the prejudice of creditors,\textsuperscript{25} and the extent to which the owners of a corporation provide inadequate capitalization and actively participate in the conduct of corporate affairs.\textsuperscript{26} Thus the directors of corporations are held in check by the threat of personal liability for misuse of corporate funds or improper distributions in a manner quite similar to the means by which courts and legislatures impose restrictions upon directors.\textsuperscript{27}

C. Statutory Restrictions on Corporate Distributions

Finally, the statutory schemes regulating dividends and redemption or repurchase of shares have evolved to meet the possible abuses of unbridled corporate distributions in a variety of ways. Unfortunately, much of the terminology used in the statutes is a confusing admixture of legal jargon and an ever-changing accounting lexicon. This has led to much litigation during the first century of practice under general business corporation statutes.\textsuperscript{28} Possibly in recognition of this confusion, California's New General Corporation Law has eliminated such terms as "par value", "no par value", "capital", "surplus", and "treasury shares", replacing the statutes which used them with generally simplified and easily understandable provisions governing this area.\textsuperscript{29} Those terms which remain in the New Code are, by implication, given meanings in accordance with "generally accepted accounting principles."\textsuperscript{30} However, no discussion of the changes set forth in the New Code could be undertaken without a working understanding of the accounting terminology inherent in most codes. Therefore, for the purpose of adequately comparing the distribution provisions of the New Code with those

\textsuperscript{25} W. CARY, CASES AND MATERIALS ON CORPORATIONS 90 (4th ed. abr. 1970).
\textsuperscript{27} See generally Ballantine, Corporations: Disregarding the Corporate Entity as a Regulatory Process, 31 CAL. L. REV. 426 (1943); Latty, The Corporate Entity as Solvent of Legal Problems, 34 MICH. L. REV. 597 (1936).
\textsuperscript{28} Garrett, supra note 17, at 239.
\textsuperscript{29} STATE BAR OF CALIFORNIA, COMMITTEE ON CORPORATIONS, EXPOSURE DRAFT No. 2, at iv (October 4, 1974) [hereinafter referred to as EXPOSURE DRAFT No. 2].
\textsuperscript{30} New CAL. CORP. CODE §500(b), which states, in part:
The amount of any distribution payable in property shall, for the purpose of this chapter, be determined on the basis of the value at which such property is carried on the corporation's financial statements in accordance with generally accepted accounting principles . . . . [Italics added].
In addition, New California Corporations Code §114 states:
All references in this division to financial statements, balance sheets, income statements, and statements of changes in financial position of a corporation, and all references to assets, liabilities, earnings, retained earnings and similar accounting items of a corporation mean such financial statements or such items prepared or determined in accordance with generally accepted accounting principles . . . subject to any specific accounting treatment required by a particular section of this division.
contained in the Old Code, various definitions must be made clear at the outset.

1. Statutory Terminology

The concepts of capital and surplus have been at the forefront of the confusion in terminology since the first corporation statutes. Except for the initial notion of capital as discussed in relation to the trust fund doctrine, the first serious effort to define capital in a legal sense began with the introduction of shares without par value in 1912. The aggregate par value of the outstanding issued shares could no longer be the measure of capital, and that part of a corporation's capital represented by outstanding no par value stock could be expressed only in the dollar value of the consideration received for them. Garrett, in his article on capital and surplus under the modern corporation statutes, continued to trace the evolution of the concept of capital:

The later recognition of the right of a corporation to allocate only a portion of the consideration for no par value shares to capital created a need for a third category to represent the interests of stockholders. Surplus was no longer derived solely from profits of the business; it became a mixture of profits and a portion of the consideration contributed by stockholders. To separate the mixture into its component parts, surplus was divided into capital (or paid-in) surplus, representing a portion of the consideration received for no par value shares not allocated to capital, and earned surplus, representing profits. This occasioned the adoption of new terminology and refinements in the definition and use of the new terms. New rules were required for regulating the rights of stockholders in the three categories.

As capital stock developed diverse characteristics, the statutes became more complex. Capital stock became divisible into classes and into series within a class. Varying rights and preferences adhered to different types of stock and this stock could in turn be divided into par value and no par value shares. Various classes could be redeemed, converted, exchanged or reclassified, and dividends could be paid in cash, property, or shares of stock of the corporation. The past 50 years has thus been an era of modernization. Terms such as capital, capital

31. Garrett, supra note 17, at 239.
32. Id. at 239.
33. Id. at 239-40.
34. Id. at 240.
35. Id.
36. Id.
37. One of the outstanding breakthroughs in this area was the conception of the American Bar Association's Model Business Corporation Act. The first complete edi-
stock, surplus, earnings, and profits, which were found in the earlier statutes, have given way to "stated capital" and various kinds of surplus under the modern statutes. The concept of impairment of capital as an implied limitation on corporate distributions has now come to mean impairment of stated capital.

This essential term has been typically defined in New York's Corporation statute and this definition shall serve as a starting point for the remainder of the discussion of terms. New York defines stated capital as the sum of (A) the par value of all shares with par value that have been issued, (B) the amount of the consideration received for all shares without par value that have been issued, except such part of the consideration therefore as may have been allocated to surplus in a manner permitted by law, and (C) such amounts not included in clauses (A) and (B) as have been transferred to stated capital, whether upon the distribution of shares or otherwise, minus all reductions from such sums as have been effected in a manner permitted by law.

For purposes of this discussion, the surpluses are basically divisible into what was formerly called "earned surplus" and "capital surplus." The definition of "earned surplus," or "retained earnings," has been the source of as much argument as that of the term "capital." Ballantine & Sterling has given a concise and wholly adequate definition of the term when they state:

The earned surplus rule limits the authority to declare dividends according to the existence of a balance or excess of assets over liabilities including stated capital, such excess being derived from profits or earnings. Earned surplus then represents the accumulated net earnings or balance of profits since incorporation or time

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38. Garrett, supra note 17, at 241.
40. The accounting profession has gradually discarded the term "earned surplus" in favor of "retained earnings." The terms are essentially synonymous and shall be treated as such in this comment. California's New Corporation Code has recognized this change and appropriately uses the latter term. This change in terminology had not taken place, however, at the conception of the Old Corporation Code and the term "earned surplus" will therefore necessarily be used in the comparison of the two codes.
of recapitalization, after deductions for the amount of dividends paid therefrom, losses, and other charges.  

Earned surplus is to be distinguished from “net profits” in that a distribution out of earned surplus presupposes that there is no impairment of capital while this is not necessarily true of a distribution from the net profits.  

Net profits have been defined as the balance of the earnings or the realized or accrued profits for a given fiscal period after deducting from income all costs and expenses, including depreciation, interest, depletion, taxes for the period, and losses or any other charges.  

Under some statutes, including the Old California Corporations Code, distributions may, subject to certain limitations, be made from net profits in spite of an impairment of capital.  

Since the New Code no longer allows such “nimble dividends,” an exploration of the ramifications of the change shall be undertaken later in the comment.  

“Capital surplus” is simply the contributed capital of a corporation in excess of that carried in the capital stock or stated capital accounts.  

Generally, it is subdivided into “paid-in surplus” and “reduction surplus.”  “Paid-in surplus” is the amount in excess of the par value of a corporation’s outstanding stock, or in excess of the stated value of no par stock.  

It may arise at the time of incorporation or at any time thereafter when the holders of newly issued stock pay an excess amount to equalize their investment with that of stockholders already participating in the corporate enterprise.  

“Capital reduction surplus” results when capital is reduced pursuant to statutory proceedings, and is the amount by which capital is reduced.  

This might result when the par...

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41. 1 BALLANTINE & STERLING, supra note 3, § 127, at 256; THE MODEL BUSINESS CORPORATIONS ACT, supra note 37, at § 2(1), defines the term “earned surplus” as follows: “Earned surplus” means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus.  

42. 1 BALLANTINE & STERLING, supra note 3, § 127, at 257-58 state that “[the net profit rule authorizes the declaration of dividends out of net profits for the preceding accounting period, in spite of impairment of the value of the net assets below stated capital.”  

43. 1 BALLANTINE & STERLING, supra note 3, § 127, at 258.  

44. Statutes which allow such distributions from net profits despite capital impairment have been termed “nimble dividend” statutes. See Kriedmann, Dividends—Changing Patterns, 57 COLUM. L. REV. 372, 373 (1957) [hereinafter cited as Kriedmann].  

45. See text accompanying notes 69 and 70 infra.  


47. Kriedmann, supra note 44, at 377.  

48. Id.  

49. The Old California Corporations Code sets forth the procedure for a formal reduction of stated capital as a three-step operation: (1) A resolution of the directors
value of shares with a par value is reduced or when the stated value of a no-par common stock is reduced, for example, from ten dollars per share to one dollar per share, thus creating a nine dollar reduction surplus.\textsuperscript{59} It may also result from the purchase by a corporation of its own shares out of stated capital, or from the retirement of redeemable shares purchased out of earned surplus for less than the original value at issuance.\textsuperscript{61}

Accountants have also created two further classifications to indicate the origin of particular surpluses, and these deserve at least brief mention. "Donated surplus" is created by contributions to the corporation with a resulting increase in assets without any corresponding increase in capital or liability accounts, and "revaluation or reappraisal surplus" results from the unrealized appreciation of assets which is created when assets are revalued in excess of book value and are then carried on the books at the revalued or reappraised amount.\textsuperscript{52}

The final basic term which must be defined is "insolvency." The term may be used in two senses. In the bankruptcy sense, a corporation is insolvent if the net assets are less than stated capital.\textsuperscript{63} Those statutes which allow the "nimble dividends" allow such distributions in spite of this type of insolvency.\textsuperscript{54} Although the Old California Corporations Code allows these dividends, it does so only if there will be no impairment of the capital attributable to shares with liquidation preferences.\textsuperscript{65} California also proscribes the declaration of dividends out of net profits which would render the corporation insolvent in the equity sense of the term, that is, unable to meet its debts and liabilities as they mature.\textsuperscript{66}

approved by a majority of the outstanding shares regardless of limitations on voting power, determining what the stated capital as reduced shall be (§1904); (2) The readjustment of outstanding par value shares to correspond to the stated capital as reduced (§1905); and (3) The distribution of any reduction surplus resulting from the reduction of stated capital, if this is desired (§1906). See 1 Ballantine & Sterling, supra note 3, §163 et seq.

51. Stated capital is reduced by the retirement of shares, and the assets which were necessary to redeem the shares prior to retirement amount to less than the consideration received by the corporation for their issuance initially, thus creating a surplus. Cal. Corp. Code §§1905(b), 1906.
52. The 1942 case of Randall v. Bailey, 288 N.Y. 280, 43 N.E.2d 43 (1942), initiated the use of revaluation surplus as a source of dividend payment. In holding that the directors had acted properly in allowing such distributions, the court indirectly challenged the conventional accounting treatment of assets by which fixed assets are figured at cost less depreciation, and current assets, such as inventories, are carried at the lower of cost or market value. As a result, many states have enacted statutes to restrict the use of unrealized appreciation of fixed assets, including California in Old Corporation Code Sections 1502 and 1505. See generally Kriedmann, supra note 44, at 380; Southern Cal. Home Builders v. Young, 45 Cal. App. 679, 188 P. 586 (1920).
54. See, e.g., Cal. Corp. Code §1500(b).
55. Cal. Corp. Code §1500(b); see text accompanying notes 60 and 67 infra.
With this basic glossary, a comparison of the distribution provisions contained in the Old California Corporations Code with those contained in the New Code will be facilitated. It should be noted at the outset that Section 166 of the New Code defines "distributions" as comprehending both dividends and redemptions or repurchases of shares. Although Chapter 5 (commencing with Section 500) of the New Code provides general limitations on all distributions, the discussion of such limitations will be divided for the purposes of this comment into two sections, the first dealing with dividends, the second with reacquisition of shares.

**Distributions by Way of Dividends**

**A. Restrictions Under the Old Code**

Before the New Code takes effect in 1977, dividend distribution will be governed by Sections 1500 et seq. of the Old California Corporations Code. Briefly, these provisions give directors authority to declare dividends either in cash or in property (1) out of earned surplus, to use the somewhat antiquated terminology; or, (2) even though the net assets amount to less than stated capital, out of net profits earned during the preceding accounting period (which must be between six months and one year in duration); or, (3) out of paid-in surplus or reduction surplus. Under the Old California Corporations Code, there are two general limitations on the payment of dividends regardless of the source. First, no dividend may be paid which would endanger the solvency of the corporation in any sense. Second, no dividend may be declared out of an unrealized appreciation in the value of the corporate assets, or from profits derived from an exchange of assets if such profits are not yet realized or currently realizable in cash.

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57. *New Cal. Corp. Code* §166 states:

"Distribution to its shareholders" means the transfer of cash or property by a corporation to its shareholders without consideration, whether by way of dividend or otherwise, except a dividend in shares of the corporation, or the purchase or redemption of its shares for cash or property, including such transfer, purchase, or redemption by a subsidiary of the corporation. The time of any distribution by way of dividend shall be the date of declaration thereof and the time of any distribution by purchase or redemption of shares shall be the date cash or property is transferred by the corporation, whether or not pursuant to a contract of an earlier date.

58. *New Cal. Corp. Code* §500 begins with the language: "Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders unless:... (emphasis added), and proceeds to set forth the general limitations. As will be demonstrated in the text accompanying note 77 infra, this is a radical change from the Old Corporations Code which had different sets of rules governing distributions in the form of dividends and those in the form of reacquisitions.


"cash" has been interpreted to mean readily marketable,\textsuperscript{64} and therefore an exchange of real estate for readily marketable securities could conceivably place a corporation in the position of being able to declare dividends, even without the sale of the securities. On the other hand, an exchange of real estate for real estate will not facilitate an allowable distribution from this same corporation until the real property has been sold and a profit realized.\textsuperscript{65} The point at which profit may be considered to be "realized" has been much debated.\textsuperscript{66}

In order to protect creditors and preferred shareholders, payment of dividends out of net profits is subject to the additional limitation that, if the value of the net assets of the corporation amounts to less than the aggregate amount of stated capital attributable to shares having liquidation preferences (because of depreciation, depletion, losses, or some other cause), the corporation cannot declare dividends out of net profits except upon such shares.\textsuperscript{67} Once the value of the net assets has been restored to equal or exceed the aggregate amount of capital received in consideration for these preferred shares, the assets are freely distributable to any class of stock.\textsuperscript{68} It is not necessary that there be earnings or profits in the particular year in which the dividend is declared, as long as there is an earned surplus over the stated capital from earnings of the previous accounting period.\textsuperscript{69}

The justification for the privilege of paying dividends in spite of a capital deficit, that is, for the privilege of declaring "nimble dividends", is stated by Ballantine & Sterling as follows:

It makes it possible for corporations, when they are making money and in solvent condition, to pay dividends out of net profits without the necessity of reducing stated capital, even in cases where the corporation has a deficit or its assets may have diminished in value. It was felt that investors, especially holders of preferred shares, should not forego dividends and income from their investment in order to enable their corporation to make up at once its capital losses, if it is on the upgrade and has been making profits from current operations over a reasonable period.\textsuperscript{70}

\textsuperscript{64} Id.
\textsuperscript{65} 1 BALLANTINE \& STERLING, supra note 3, §128, at 260.
\textsuperscript{66} 1 BALLANTINE \& STERLING, supra note 3, §130, at 264.
\textsuperscript{67} Id.
\textsuperscript{68} Id.
\textsuperscript{69} See R. BAKER \& W. CARY, CASES AND MATERIALS ON CORPORATIONS, 1206-08 (3d ed. 1959); Hills, Dividends from Unrealized Capital Appreciation, 6 N.Y.L. REV. 155, 195 (1928).
\textsuperscript{70} Id.
It seems as if this rationale, while adhered to in the past, has not convinced the California Legislature of the necessity or propriety of continuing the "nimble dividend" provision, since the New Code discards this avenue for distribution entirely.

As originally promulgated, the California Corporations Code did not allow distributions out of paid-in surplus, but a 1929 amendment of Section 1500 (formerly Civil Code §309) made dividends payable from this surplus on preferred shares. The result was that a corporation with common stock as its sole class of stock could not use paid-in surplus to pay dividends. Such a corporation was forced to reduce stated capital pursuant to statutory proceedings in order to create a reduction surplus which was, in turn, an allowable source for distribution. In 1957, the Old Code was amended to permit a corporation with a one-class stock structure to declare dividends out of paid-in surplus as well as reduction surplus. The statute continued to protect the preferred shareholder in multi-class corporations by providing that if any outstanding shares were entitled to preferential dividends, dividends could be paid out of paid-in surplus, or out of reduction surplus, only upon such shares.

Section 1503 of the Old Code makes special provision for the "wasting asset corporation". These corporations have been defined as those engaged solely or "substantially" in the exploitation of wasting assets such as mines or oil wells, or in the liquidation of specific assets. One common example would be a corporation organized to subdivide a particular tract of land or to liquidate the assets of a decedent or bankrupt estate. Under this special provision, no deduction or allowance for depletion need be made from the income derived from the exploitation of such wasting assets in determining amounts available for dividends. Under Section 1500(b), dividends are limited to net profits, but under the "wasting assets" provision of Section 1503, dividends may be paid out of a source that may involve a return of capital to the shareholders. For this reason the Old Code requires that the shareholders be notified that no deduction or allowance has been made for depletion.

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71. CAL. STATS. 1929, c. 711, §12, at 1266 (amending CAL. CIV. CODE §309).
72. See, e.g., CAL. CORP. CODE §1906(a); former CAL. CIV. CODE §§309, 359, repealed, CAL. STATS. 1947, c. 1038, §10001, at 2439.
73. CAL. CORP. CODE §1500(c), amended, CAL. STATS. 1957, c. 2261, §9, at 3951.
74. CAL. CORP. CODE §1500(c).
75. 1 BALLANTINE & STERLING, supra note 3, §134, at 269.
76. CAL. CORP. CODE §1503.
B. Restrictions Under the New Code

California's New General Corporation Law is a somewhat revolutionary change in the evolution of regulatory provisions governing financial aspects of corporations. The New Code in essence abolishes the artificial structure composed of "capital," "par values," "treasury shares" and "surpluses." Having apparently determined that these terms were not essential to a regulatory scheme designed to prohibit distributions which would impair the ability of the corporation to meet its obligations, the drafters of the New Code proceeded to establish a simplified structure of basic requirements to be met in order for corporate distributions to issue.

Section 501 of the New Code sets forth the equitable solvency limitation derived from Sections 1501 and 1708 of the Old Code, and provides that:

Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.

This solvency limitation, though not expressly indicative of a permissible dividend source, acts as a constant admonition to the corporation and, inasmuch as the definition is at least to some extent a subjective test, it also acts as an overlap with the directors' fiduciary obligations of good faith.

Section 500 provides the specific financial requirements which must be met in the form of an alternative test whereby the corporation may make a distribution only if: (1) the amount of retained earnings immediately prior to the distribution equals or exceeds the amount of the proposed distribution; or (2) immediately after giving effect to the distribution, the sum of the assets of the corporation would be at least equal to one and one-quarter times its liabilities and the current assets of the corporation would be at least equal to its current liabilities. The

78. The language "likely to meet its liabilities as they mature" apparently leaves directors with a certain degree of discretion to be exercised within the parameters of business judgment.
79. New CAL. CORP. CODE §500 states in full:
Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) unless:
(a) The amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution; or
(b) Immediately after giving effect thereto:
two tests contained in Section 500 of the New Code adequately guarantee the protection of shareholders and creditors. If the corporation has sufficient retained earnings (earned surplus) to declare a dividend under subdivision (a), there need be no reduction in any capital account other than retained earnings. Thus the capital investment of shareholders of all classes are secure and the liabilities owed to creditors are by definition covered by sufficient corporate assets. If a dividend is paid pursuant to subdivision (b), creditor’s rights are totally protected since, regardless of the distribution source, current assets of the corporation are at least equal to current liabilities and assets are at least one and one-quarter times the liabilities after the dividend.

The remainder of Section 500(b) reiterates the provisions of the Old Code with regard to the use of appreciation as a source for the payment of dividends.\(^8^0\) Like the Old Code, the New Code expressly excludes appreciation of assets not yet realized from any determination of the amount of assets which are available for distribution under the provisions of Section 500.\(^8^1\) The exception to the rule, once again, is that appreciation of readily marketable securities and profits derived from an exchange of assets (if the asset received is currently realizable in cash) are allowable entries in the computation of distributable assets.\(^8^2\)

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(1) The sum of the assets of the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 1¼ times its liabilities; (not including deferred taxes, deferred income and other deferred credits); and

(2) The current assets of the corporation would be at least equal to its current liabilities or, if the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for such fiscal years, at least equal to 1¼ times its current liabilities; provided, however, that in determining the amount of the assets of the corporation no appreciation in value not yet realized shall in any event be included, except with respect to readily marketable securities, and profits derived from an exchange of assets shall not be included unless the assets received are currently realizable in cash; and provided, further, that for the purpose of this subdivision “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 such 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 such contracts or providing service to utility customers. The amount of any distribution payable in property shall, for the purpose of this chapter, be determined on the basis of the value at which such property is carried on the corporation’s financial statements in accordance with generally accepted accounting principles. Clause (2) of subdivision (b) is not applicable to a corporation which does not classify its assets into current and fixed under generally accepted accounting principles.

80. See text accompanying note 63 supra.
81. For the complete language of New Cal. Corp. Code §500(b), see note 79 supra.
82. See note 79 supra.
The New Code adds two sections which deal specifically with the protection of preferred shareholders, and in particular those owners of classes of stock which have cumulative dividend preferences or liquidation preferences. Section 502 provides that no distribution shall be made on any class or series of stock which is junior to any other class or series with respect to distribution of assets on liquidation unless, after such distribution, the excess of the corporation's assets over its liabilities covers the liquidation preferences of those senior shares. Section 503 provides that no distribution shall be made on any class or series of stock which is junior with respect to the payment of dividends unless the amount of retained earnings immediately prior to such distribution equals the amount of the distribution plus the aggregate amount of cumulative dividends in arrears on those shares having such dividend preferences. These two sections embody the limitations inherent in Section 1500(b) of the Old Corporations Code.

The ultimate result of these changes in California's Corporation Code seems multifaceted. The New Code, in its wholesale simplification of the existing fiscal provisions, has discarded the controversial "nimble dividend" which is now allowable under Section 1500(b) of the Old Code. The California Legislature has also omitted from the New Code the exemption from the rules regarding determination of distributable assets for "wasting asset" companies such as that contained in Section 1503 of the Old Code.

Furthermore, the legislature seems to have eliminated the need for manipulations by corporations to fit their assets into categories which, under the Old Code, would have allowed distribution. Under the New Code's alternative test, management may now have a certain degree of enhanced freedom with respect to the internal workings of the corporation and the allocation of financial resources. Distributions may now be made from any of the previously existing surpluses or out of the capital account, subject to certain limitations and to the mandate of Section 507 of the New Code which requires notice to be given to shareholders of the

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83. New Cal. Corp. Code §172 defines "liquidation preference" as "amounts payable on shares of any class upon voluntary or involuntary dissolution, winding up or distribution of the entire assets of the corporation, including any cumulative dividends accrued and unpaid, in priority to shares of another class or classes." See also New Cal. Corp. Code §§502, 503.

84. See text accompanying notes 60, 67, 68, and 69 supra.

85. 1 Ballantine & Sterling, supra note 3, §134, at 271 state: "This doctrine as to wasting asset corporations and liquidating corporations was formerly recognized in this state as a kind of judicial exception to §309, Civ. C., prior to 1931. It is of very questionable policy or utility, and might well be repealed." (emphasis added).

See generally Comment, Liquidating Dividends by Wasting Asset Corporations, 34 Cal. L. Rev. 204 (1946).
source of the distribution if made from some source other than retained earnings. Whether these results are as beneficial as they seem at first glance will be investigated later in this comment.

**Distributions By Way of Reacquisition of Shares**

Although Section 166 of the New Code defines “distributions” as meaning dividends, redemptions, and repurchases of shares, it is important to make the distinction between “redemption” of shares and “purchase” or “acquisition” of shares. The term “redemption” refers to the paying off, retirement, or repurchase of shares or securities pursuant to a provision giving the corporation an option to purchase such shares at the book value or other specified redemption price. Redeemed shares are cancelled and withdrawn from issue, and stated capital is reduced accordingly. Shares which are not paid for pursuant to such a redemption provision in the articles of incorporation are said to be “purchased” and, as shall be seen, certain more restrictive limitations exist under the Old Code as to these latter “purchases”. A repurchase of shares is to be distinguished from a redemption in that, at least under the Old Code, repurchased shares are not cancelled. Because they remain issued, they have no effect on stated capital, and are carried by the corporation as “treasury stock”.

A corporation has the power to redeem its shares only if expressly provided in the articles, and such a redemption is exercisable only at

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86. New Cal. Corp. Code §507 reads:

Each distribution to shareholders other than one chargeable to retained earnings shall be identified in a notice to shareholders as being made from a source other than retained earnings, stating the accounting treatment thereof. The notice shall accompany the distribution or shall be given within three months after the end of the fiscal year in which the distribution is made.

87. 1 Ballantine & Sterling, supra note 3, §144, at 289.2. See generally Jones, Redeemable Corporate Securities, 5 S. Cal. L. Rev. 83, 91 (1931).

88. 1 Ballantine & Sterling, supra note 3, §144, at 289.2.


91. Compare Old California Corporations Code §1101 with Section 402 of the New Code:

§1101: Redemption right; corporate option; sinking fund

If the articles makes any class or series of shares subject to redemption, the right of redemption shall be exercisable at the option of the corporation only, but the articles may provide for the setting aside of a sinking fund or funds which may be required to be applied to the purchase or redemption of such shares. Any such sinking fund may be measured by the net earnings of the corporation for any year or years or by an amount sufficient to redeem a specified percentage or number of shares, or by any combination of such measures. The application of sinking fund moneys to the purchase or redemption of such shares shall be subject to the provisions of Chapter 4 of this part.

As amended, Cal. Stats. 1957, c. 2261, §4, at 3949; 1 Ballantine & Sterling, supra note 3, § 144, at 292, summarize the policy of Section 1101 as follows:

[T]he articles may not give holders of redeemable shares the right to require the corporation to redeem them whenever the holders would like to have their money back, nor may the articles fix a date certain on or before which the
the option of the corporation. It is to be noted that impliedly under the Old Code and expressly under Section 402(c) of the New Code, redemption rights cannot be created in the articles of a corporation which has but one class (and one series) of common stock. To allow

corporation must redeem the shares, but the articles may require the corporation to apply a certain amount to such redemption, measured by net earnings or a specified number or percentage of shares, and there is no reason why the corporation cannot apply such amount to redemption of shares either out of stated capital or any kind of surplus.

New CAL. CORP. CODE § 402 provides:

(a) A corporation may provide in its articles for one or more classes or series of shares which are redeemable, in whole or in part, at the option of the corporation only (except as provided in subdivision (b)), at such price or prices within such time or upon the happening of one or more specified events and upon such terms and conditions as are stated in the articles.

(b) A corporation shall not issue redeemable or other shares which purport by their terms to grant to any holder thereof the right to compel the corporation to redeem such shares, except that an open-end investment company registered under the United States Investment Company Act of 1940 may, if its articles so provide, issue shares which are redeemable at the option of the holder at a price approximately equal to the shares' proportionate interest in the net assets of the corporation and a shareholder may compel redemption of such shares in accordance with their terms.

(c) No redeemable common shares, other than (1) those authorized under subdivision (b), (2) shares of a corporation which has a license or franchise from a governmental agency to conduct its business or is a member corporation of a national securities exchange registered under the United States Securities Exchange Act of 1934, which license, franchise or membership is conditioned upon some or all of the holders of its stock possessing prescribed qualifications, to the extent necessary to prevent the loss of such a license, franchise or membership or to reinstate it, or (3) shares of a professional corporation as defined in Part 4 of Division 3 of this title, shall be issued or redeemed unless the corporation at the time has outstanding a class of common shares that is not subject to redemption.

(d) Nothing in this section shall prevent a corporation from creating a sinking fund or other provision for, or entering into an agreement for, the redemption or purchase of its shares to the extent permitted by Chapter 5.

92. See note 91 supra.

93. The Old California Corporations Code makes an exception to this rule, under Section 1716, for "open end investment companies." Section 1716(a) defines an "investment company" as:

a corporation, trust, association, or fund which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and whose assets are invested principally in cash or in securities or other issuers.

Section 1716(b) then defines an "open end investment company" as:

an investment company which issues one or more series or classes of securities under the terms of which the holder of the security, upon presentation thereof to the issuer, is entitled to receive approximately his proportionate share of the current net assets of the issuer applicable to such series or class, or the cash equivalent thereof.

Then the exception is stated by §1716(c):

An open end investment company may, from time to time, redeem its shares, in accordance with their terms, at approximately the proportionate share of the current net assets of the issuer applicable to such shares, or in the cash equivalent thereof.

1 BALLANTINE & STERLING, supra note 3, §162, at 324-25, state:

The rapid growth in popularity in recent years of the "mutual funds" [held to be an open end investment company in Investment Co. Institute v. Camp, 401 U.S. 617, 675 & n.11 (1971)] necessitated these sections to permit redemption at the option of the shareholders of these companies, and to give the companies redemption privileges not subject to the restrictions imposed by the law on the other corporations.
such a redemption would, obviously, perpetuate one of the abuses statutory limitations seek to curtail, namely, the ability of management to eliminate "troublemakers" with whom they are in disagreement. 94

A. Restrictions Under the Old Code

The Old Code regulates distributions by way of redemption and repurchase in Sections 1700 through 1715. Generally, the Old Code authorizes the purchase or redemption of redeemable shares out of either stated capital or any kind of surplus, 95 subject to two general limitations. These two limitations are set forth in Section 1708, the counterpart of Section 1501 regarding dividends. Briefly, a redemption may not be made when (1) there is a reasonable ground to believe that the corporation is unable, or will thereby be rendered unable, to satisfy its debts and liabilities as they fall due (excepting such as have otherwise been adequately provided for); or (2) there is reasonable ground to believe that the net assets of the corporation will be reduced thereby to an amount less than the lowest aggregate liquidation preferences of shares to remain outstanding having prior or equal claims to the assets.

In many situations, and in a refinancing transaction in particular, it is extremely important to know definitely that the outstanding shares proposed to be redeemed have in fact been redeemed and to know exactly at what point in time the redemption is effective. If the articles provide for the redemption of certain classes of stock, but do not provide an exact procedure by which these shares are redeemed, the result may be to place practical and legal obstacles in the way of a beneficial refinancing which has as its objective the redemption of the outstanding

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94. See text accompanying notes 2 and 3 supra.
95. CAL. CORP. CODE §1706.
preferred stock. Because the articles of incorporation of many corporations with outstanding redeemable preferred shares were inadequate in setting forth such a precise procedure by which the corporation exercised its redemption rights, the Old Code provides such a procedure.

This procedure is contained in Section 1700, and comprehends two basic steps: notice of redemption and payment or deposit of the redemption price. Pursuant to Section 1701 of the Old Code, notice may be given by publication in newspapers of general circulation in the county of the principal office of the corporation, for specified time periods. The notice must set forth a description of the class or series (or part thereof) of the shares to be redeemed, the date of the redemption, the redemption price, and the place where payment for redeemed shares may be obtained. Further, section 1702 provides that the corporation must mail personal notice of the redemption to holders of the shares which are to be redeemed. It is to be noted, however, that failure to comply with this mailed notice provision does not invalidate the redemption. Under Section 1703, on or before the date fixed for the redemption, the corporation may deposit with any bank or trust company in the state, as a trust fund, a sum sufficient to redeem the called shares, together with instructions and authority necessary for the depository to carry out the redemption proceeding.

Commentators have argued that purchases of non-redeemable shares by a corporation out of accounts other than retained earnings may open the door to the various abuses noted earlier, and hence such distributions should be limited to payment out of retained earnings. Provisions which permit the management of a corporation to make purchases out of corporate surpluses appear to assume that creditors and shareholders have the right to insist that the capital fund be preserved, but that the use of surplus for the purpose of buying shares is not a wrong to creditors and is a wrong to shareholders only if the transaction is entered into by management for some improper motive. Where there is an improper motive, the shareholders are assumed to be adequately

96. 1 BALLANTINE & STERLING, supra note 3, §145, at 294.
97. See CAL. CORP. CODE §§1700-1703.
98. Dodd, supra note 2, at 706; see generally, Levy, Purchase by a Corporation of Its Own Stock, 15 MINN. L. REV. 1 (1931); Nussbaum, Acquisition by a Corporation of Its Own Stock, 35 COLUM. L. REV. 971 (1935); England v. Christenson, 243 Cal. App. 2d 413, 423, 52 Cal. Rptr. 402, 408 (1966) where it is stated:

Although the present sections [CAL. CORP. CODE §1705 et seq.] have relaxed the stricter prohibition of a predecessor statute [former CAL. CIV. CODE §309], it is nevertheless manifest that they have retained a general and complete prohibition against a corporation's purchase of its own shares, except in those particular instances specified in the code (§1705). The present law therefore continues a vigilant and protective influence over corporate capital since . . . a corporation's power to purchase its own shares is subject to much abuse.
99. Dodd, supra note 2, at 706.
protected by their right to obtain redress for any violation by the man-
gers of their fiduciary obligations.  

These assumptions may well be challenged. Although the purchase of shares out of surplus, or at least out of earned surplus, may not be objectionable under certain circumstances and may even be advantageous to the corporate enterprise, such purchases are generally of dubious desirability. It is the theory of the Old Corporation Code that as a general rule a corporation should not be allowed to purchase its own shares except out of earned surplus which would be available for distribution in the form of dividends. The withdrawal of assets by a shareholder surrendering his or her shares to the corporation for value has the same effect upon creditors as a distribution of assets by way of dividends. The Old Code does, however, allow the purchase of a corporation's own shares out of reduction surplus, if the statutory provisions regarding the reduction of stated capital are followed. It is important to note that Section 1907 of the Old Code forbids distributions from reduction surplus when such distributions would reduce the amount of assets below one and one-quarter times the corporation's debt and liabilities. It is also important to reiterate that a formal reduction of capital pursuant to Sections 1906-1909 requires both a resolution of the board of directors and the approval by vote or written consent of a majority of the outstanding shares, regardless of restrictions or limitations on their voting power.

There are, however, various situations in which a corporation is authorized to retire the shares of one or more of its own shareholders out of capital for legitimate corporate purposes. Such occasions include: (1) the collection or compromise of a claim; (2) forfeiture of shares for delinquent assessments or nonpayment of the subscription price thereon; (3) compensation of dissenting shareholders; (4) agreements with employees (other than directors); (5) elimination of fractional shares; and (6) purchase of redeemable preferred shares.

The Old Code also provides for the existence of “treasury shares,” which are shares issued and thereafter acquired by the corporation, but not retired or restored to the status of unissued shares. Section 1714

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100. Id.
101. Id.
102. CAL. CORP. CODE §1707(c); see Tiedje v. Aluminum Taper Milling Co., 46 Cal. 2d 450, 296 P.2d 554 (1956).
104. CAL. CORP. CODE §1707(b).
105. CAL. CORP. CODE §§1705, 1706.
106. CAL. CORP. CODE §116.
limits the rights attaching to treasury shares so that for most purposes they are treated as still being issued. The only difference between reacquired shares held as “treasury” shares and those reacquired shares which have been “retired” is that the first may be resold by the corporation for any consideration which the directors in good faith deem sufficient. Before resale, however, the corporation must obtain a permit for such reissue from the Commissioner of Corporations pursuant to the California Corporate Securities Law of 1968. Shares reacquired out of earned surplus, paid-in surplus, by way of gift or bequest, or upon the distribution of the assets of another corporation may be carried as treasury shares or may be retired, but no change in stated capital may be made upon such retirement without compliance with statutory proceedings pursuant to Section 1904. Just as the retirement of such shares has no effect upon the stated capital of the corporation without a vote of shareholders to reduce capital, the reacquisition of such shares, without cancellation, does not increase the assets of the corporation.

Their existence as issued shares is a pure fiction, a figure of speech to explain the special rules and privileges as to their reissue. They no more represent a present asset than authorized but unissued shares, being merely the opportunity to acquire new assets if anyone wishes to buy the shares.

It is this fiction, perhaps, and the resulting confusion, that the California Legislature sought to eradicate when it abolished the concept of treasury shares in the New Code.

If the articles of the corporation prohibit the reissue of any of its shares upon reacquisition thereof, Section 1713 of the Old Code requires the corporation, upon the acquisition of such shares, to reduce the authorized number of shares in that particular class by the number of shares so acquired. The New Code reenacts this provision and requires that the articles be amended to eliminate any statements of rights, preferences, privileges, and restrictions relating solely to the reacquired class or series.
B. Restrictions Under the New Code

The New Code, as it does in protecting creditors and shareholders from improper distributions in the form of dividends, regulates distributions by way of redemptions and repurchases pursuant to the simplified provisions of Sections 500 and 501. After giving corporations the authority to issue redeemable shares, it proceeds to protect creditors through the wholly adequate dual test of Section 500. Since the Old Code provides that redeemable shares may be purchased out of any surplus, or, for that matter, out of stated capital itself, the fact that Section 500 does not specify particular sources from which corporate assets may be distributed is of no consequence. The rights and preferences of preferred shareholders are, once again, protected by Sections 502 and 503. The New Code, however, allows purchases of non-redeemable shares out of either retained earnings or any account, be it surplus or capital, so long as the provisions of Section 500(b) are observed. Although Section 500(b) provides that after the distribution the assets must equal one and one-quarter times the corporation's liabilities, the fact that no consent of shareholders must necessarily be obtained by the directors in order to purchase shares out of the capital account may leave the directors free to "buy off" a dissenting shareholder. In short, although the dual test of Section 500 insures complete protection of creditors, and although the rights and preferences of preferred shareholders are adequately protected by Sections 502 and 503, the common stock shareholder may not be protected from managerial abuses to the extent that he is under the Old Code. As shall be seen, this casts a considerable burden upon the statutory liability of directors as a protection of the shareholder.

The procedural requirements for the redemption of shares now present in Sections 1700 through 1703 of the Old Code are reinstated practically verbatim in the New Code. As noted earlier, the New Code eliminates the fictions inherent in the concept of treasury shares, by providing that any reissuable acquired shares of a corporation must revert to the status of "authorized but unissued.

CONCLUSION

The New Code goes a long way toward the goal of increasing the protection of creditors and preferred shareholders while giving manage-
ment freedom to allocate resources as it deems proper. In addition to the basic good faith solvency limitation of Section 501, the provisions of Section 500 in essence increase financial requirements for distribution of corporate assets. As long as the distribution, be it dividend or reacquisition, is paid from the retained earnings account only and the retained earnings of the corporation equal the amount of the distribution, the distribution would be allowable under the sanction of Section 500(a). Section 500(b) of the New Code utilizes the limitation contained in Section 1907 of the Old Code (dealing with the use of reduction surplus for distributions) and applies it across the board as an alternative test for any distribution which probably would not qualify under the test of Section 500(a). That is, the new restriction that assets must be one and one-quarter times the liabilities after the proposed distribution (regardless of the account used) increases the financial requirements hitherto existent with respect to paid-in surplus, donated surplus, and other accounts. It seems that this increase in the asset to liability ratio was necessary to adequately compensate for the elimination of the various surpluses; if all are to be regulated by a single test, the test must of necessity be the most stringent of all those presently existing. That most restrictive test is found in Section 1907 of the Old Code.\textsuperscript{119} This seems to quite adequately protect creditors in all situations, preferred shareholders being constantly protected, regardless of the form of the distribution, by Sections 502 and 503. Thus, the need for a particular surplus in order for dividends or reacquisitions to be authorized has been eliminated.

This particular detachment from a "capital-impairment" test for the distribution of corporate funds may seem a step in the direction of increased protections, but it remains to be seen how well the scheme will actually function. The introduction of no-par stock statutes created complications which brought to the fore the possibility of dividends clearly not from earnings, yet still not from legal capital.\textsuperscript{120} The policy question of whether huge amounts of paid-in surplus should be available for dividends led to the more basic question of whether mere impairment of legal capital was a satisfactory test on which to base the legality of...
of dividends. A capital-impairment test may have seemed satisfactory when the principle of dividend regulation was to maintain a cushion against insolvency for the benefit of creditors. However, the objectives of dividend regulation have been broadened to include the protection of the shareholders against a diminution of their actual investment, the protection of different classes of shareholders against each other, the prevention of inferences misleading to existing shareholders or to potential investors or creditors which might result from unjustifiable dividends, and even the maintenance of the financial soundness of large business corporations in the interest of their employees and customers. Therefore, California seems to have rightly abandoned an antiquated test of the legality of distributions. It remains to be analyzed, however, whether the broadened objectives of distribution regulation have been met and whether the New Code adequately protects against the potential abuses discussed at the beginning of this comment.

A hypothetical situation may serve to clarify some of the ramifications of the New Code's provisions. Under the New Code a situation might well arise in which a corporation would have current assets of $150,000 and other assets (property, equipment, etc.) of $50,000. Hypothetical liabilities exist of $100,000, retained earnings are present in the sum of $50,000, and the capital account could reflect investments of $25,000 in common stock and $25,000 in preferred stock. The balance sheet, in summary form, would appear as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$150,000</td>
<td>Preferred</td>
</tr>
<tr>
<td>Other</td>
<td>50,000</td>
<td>$25,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Common</td>
</tr>
<tr>
<td></td>
<td></td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Retained</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Earn.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50,000</td>
</tr>
</tbody>
</table>

Total: $200,000        Total: $200,000

Under the New Code, management could technically declare a "dividend" out of capital and/or retained earnings under Section 500(b) of $75,000 ($50,000 from retained earnings, $25,000 from capital, for instance). This would leave assets of $125,000, which would still be one and one-quarter times the $100,000 in liabilities. Retained earnings and the Common account would read zero, and the Preferred accounts would read $25,000. Assuming the distribution was made in accordance with the articles and statute regarding protection of the preferred stock's rights, the "dividend," to the Common stock at least, is not a return of profits on the shareholders' investments. What is termed a "dividend" is, at least to some extent, in essence a partial liquidation of

121. Id. at 1364-65.
122. Id. at 1364.
the stock of the common shareholder. Although the voting and other
effects attaching to this class of stock may not be affected, the ultimate
cash value of the stock has been lowered. This would seem like a
somewhat undesirable method of alleviating shareholder pressure for
dividends and could be a somewhat fraudulent distribution\textsuperscript{123} if it
weren't for the notice requirement of Section 507.\textsuperscript{124} It may be argued
that no harm has actually occurred since the shareholder has been
informed that this distribution has been made partly out of capital, so that
the dividend should not be recognized for what it actually is. It may
also be argued in rebuttal that, as a practical matter, a dividend is
normally in the form of a check, which in this case would be accompa-
nied by the letter of notification. The average uninitiated or overly busy
investor will likely cash the check and deposit the letter, unread, deep in
his files. Furthermore, it may not be a legitimate assumption that all
shareholders, although chargeable with a certain quantity of business
knowledge, know the difference between a distribution from capital and
a distribution from retained earnings, or the ramifications thereof.

For purposes of comparison, it might be noted that the Model Busi-
ness Corporation Act of the American Bar Association allows distribu-
tions in partial liquidation out of the capital account subject to the
limitations that (1) the corporation is not insolvent and would not be
rendered insolvent by the distribution; (2) the remaining assets are not
less than the voluntary liquidation preference of the remaining shares;
(3) all accrued cumulative dividends on preferred shares have been
paid; (4) disclosure of the source of the distribution accompany the
distribution; and (5) authority for such a distribution is contained in the
charter documents and approved by the vote of at least two-thirds of
each class.\textsuperscript{125} California's New Code contains limitations which quite
adequately incorporate the protections inherent in the first four limita-
tions of the Model Act,\textsuperscript{126} but has no provision for shareholder consent
to such a distribution. It can be argued that the directors must have in
good faith determined that the capital is not needed for the operation of
the enterprise and that the investor is given the opportunity to reinvest
his own assets in another productive organization. However, if one of
the objectives of distribution limitations is to protect shareholders from a
diminution of their actual investment and to prevent inferences which
are misleading to them, it seems quite within the bounds of reason to
require such a limitation in a statutory scheme.

\textsuperscript{123} Fraudulent in the sense that the shareholder believes he or she is getting an
adequate return on the investment, and to some extent non-taxable at that.
\textsuperscript{124} See note 86 supra, and text accompanying.
\textsuperscript{125} See Model Business Corporation Act, supra note 37, at §§66-70.
Furthermore, in relation to the authority to purchase a corporation's own non-redeemable shares, it has been seen that under the Old Code only two sources are available, except in certain specified instances, for such distributions. The justification for the use of retained earnings, the first of these sources, is self-evident. The use of reduction surplus is justifiable only because of the harsh restrictions contained in Section 1907 of the Old Code (now embodied in the New Code) and because of the fact that a reduction of stated capital through formal proceedings, in order to obtain the requisite surplus, requires the approval of the majority of the outstanding shares. Once again, a provision requiring shareholder consent to certain distributions does not seem to be an outrageous consideration. This new freedom to redeem or repurchase shares seems to do little in the prevention of the abuses as stated initially in this comment.

The statutory "good faith" limitation on the management's distribution of assets \(^{127}\) now takes on an added significance. Since the common law restriction on the impairment of capital is now seemingly totally abrogated, the limitations on corporate distributions boil down to the protections of Chapter 5 (commencing with Section 500) of the New Code, and the directors' liability for those distributions which are not in the best interests of the corporate community of shareholders as a whole. The language of Section 501 leaves a judgmental factor in the directors' determination as to whether the corporation will be "likely" to be able to meet its obligations and liabilities as they mature. Good faith here again takes on added significance.

It seems as though the California Legislature has done much to strengthen the statutory provisions which protect creditors of corporations from abusive distributions by corporate management. Likewise, the New Code, by reinstating certain provisions of the Old Corporations Code, more than adequately protects the rights of holders of preferred stock. However, as has been demonstrated, it is possible under the statutory restrictions of the New Code to declare a dividend which impairs the capital investments of the owners of common shares, and which, without the consent of the corporation's shareholders, acts as a partial liquidation of those shares. Whether the ability to declare these "dividends" actually results in an increase in those abuses which general corporation laws seek to proscribe must of necessity be left to the courts and legislature in the future.

If future abuses do in fact become apparent, an amendment could be considered by the legislature which would simply add a provision,\(^ {127}\) See note 6 and text accompanying note 15 \textit{supra}.

\(^{127}\)
similar to that contained in the Model Business Corporation Act, putting such distributions out of capital to the vote of shareholders prior to declaration. Such an amendment would render an already investor-oriented scheme of distribution provisions even more protective, and would allow shareholders a personal voice in the affairs of the corporation when impairment of capital is under consideration.

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