

CORPORATE DIVIDEND CHANGES

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California corporations are limited as to how much they may pay out in any one year to its shareholders. In particular, California Corporations Code Sections 500 - 506 limit the amount of dividends/distributions that may be paid out. They further provide creditor protection and recovery for excess distributions in certain situations.

AB 571, effective January 1, 2012, has changed the limits. It has also modified some of the other provisions. The most significant change is that AB 571 now unifies two former alternate tests into a two-prong, single test. The second prong of that test is substantially simplified.

Prior Law

Prior law is still important to know as it remains applicable to distributions prior to 2012. Most distributions were limited to one of two tests, the Retained Earnings Test or the Assets Test.

Retained Earnings Test. To be very honest, most corporations simply followed the Retained Earnings Test as it was a lot easier to understand. Under the Retained Earnings Test, a proposed distribution could not exceed the amount of the corporation's retained earnings. For example, if Company A's total current and cumulative retained earnings totaled \$750,000 in 2011, then the maximum amount of dividends that could be distributed during the 2011 year would be \$750,000.

Assets Test. Corporations could also follow the Assets Test, but had to be very careful as there were two parts and the second part had two different standards. The first part, the Net Assets Rule, allowed a distribution if, based on its financial statements after the distribution, the corporation's "total assets" equaled or exceeded at least one hundred twenty five percent (125%) of "total liabilities." Both total assets and total liabilities were subject, however to statutory adjustments to exclude certain assets.

The second part could be a bit confusing. A corporation with a strong earnings record could simply determine if after the distribution, the corporation's current assets had to exceed its current liabilities. While this Net Current Assets seemed basic. Current assets includes cash and assets realizable into cash within twelve months, i.e., inventory and receivables. Current liabilities are obligations payable within 12 months.

However, the Net Current Assets Rule had to be modified under some very complex rules. In particular, after a distribution, current assets had to equal or exceed one hundred twenty five percent (125%) of current liabilities if the "average amount of the prior two year *earnings* (before taxes and interest), was less than the interest expense."

Unfortunately, the term *earnings* was not completely financial based. Earnings could not be counted if “*not realizable in cash*”. Furthermore, the Board of Directors had to acknowledge in good faith, and reasonably, that the timing of receipt of cash from earnings would within the “*same 12 months used for current liabilities*”. In addition, statutory language seemingly limited the earnings to either just contracts for fixed or periodic payments during the term of the contract or for public utilities it was only for contracts for service connections, but, only if future costs were "given effect" if not included in liabilities. Obviously, these nuances created a lot of confusion, and required legal interpretation.

Other Provisions. Prior law also covered a number of other concerns and options. The law provided that no distributions could be made on common stock ahead of preferred dividends in arrears. The two tests were inapplicable to REITS and regulated investment companies since they had federal statutory distribution provisions under the tax code.

New Law

Two-Prong Test. AB 571, is effective for distributions on or after January 1, 2012. It changes the general rules for determining permitted dividends and distributions. Essentially, there are now two prongs:

Retained Earnings Rule. The previous Retained Earnings Test is now the first prong, the Retained Assets Rule. It remains essentially unchanged. The Rule, however, acknowledges that the payment of preferred dividends in arrears (the “preferential dividends arrears amount”) and common dividends can be paid concurrently, i.e. on the same date, as long as there are adequate retained earnings. Furthermore, if the corporation’s articles of incorporation allow, common dividends can be paid ahead of preferred dividends, i.e. the preferential dividends arrears amount can be “zero”, even if there are unpaid preferred dividends in arrears.

Net Assets Rule. The second prong is now a very simplified Net Assets Rule. The sole standard is whether after the distribution the total assets exceed total liabilities (plus the preferred rights amount).

As a simplified rule, there is no longer any special adjustments to exclude any assets or liabilities. The separate Current Net Assets rule is eliminated.

On the other hand, there is now a new concept of a “preferred rights amounts.” This is the amount that would have to be paid to the preferred shareholders (ahead of common shareholders) if the corporation liquidated. That amount must now be added to liabilities computing the distribution allowed under the Net Assets Rule.

Example. Assume Company A’s net worth on June 1, 2012 is \$700,000. It’s retained earnings of \$750,00 is unchanged. Company A has outstanding preferred stock was entitled to \$100,000 as a liquidation preference (\$100/share) and has \$30,000 in arrears dividends payable on liquidation. Articles allow common stock dividends to be paid ahead of arrears preferred, except in liquidation. Based on these facts, the June 1, 2012 dividend limit (assuming creditors debts can be paid) is \$570,000, i.e., the lesser of (i) retained earnings (\$750,000) or (ii) \$570,000 (\$700,000 less \$130,000).

Measuring Assets/Liabilities. In addition, the computation of total assets and liabilities is far more flexible. The Board may rely on using values based on any of the following options (i) financial statements prepared based on reasonable accounting practices and principals (i.e., book value), (ii) a fair (market) valuation or (iii) any other reasonable valuation method.

Again, under the new provisions both rules must be satisfied.

Other Provisions

While the foregoing is intended to only highlight some of the significant changes, three other areas are worth mentioning.

Unchanged Provisions. First, the new law retains unchanged most of the remaining provisions. Section 501 remains in tact and provides that a distribution is not allowed if it would cause the corporation (or subsidiary) to be unable to pay its debts. Unchanged, but reorganized is the new Section 503 wherein distributions to redeem a shareholder are still permitted free of any “test” so long as the redemption distributions are made out of insurance proceeds, whether due to life insurance or disability benefits. As before, redemptions are tricky; exceeding insurance can cause the limitations under Section 500 of the California Corporations Code to apply.

Atypical Shareholder Loans. Second, as additional provisions, AB 571 now covers the treatment of two atypical loans. It now covers the treatment of shareholder loans where repayment is tied into shareholder distributions. It also covers a dividend/distribution consisting of a promissory note or other indebtedness promise to pay by corporation.

Creditor Provisions. Third, there are changes to notice and creditor provisions. Corporations are no longer required by California law to send a notice explaining the character of distributions made from other than retained earnings. Because most distributions are now limited by both retained earnings and assets, this provision became unnecessary. In addition, AB 571 clarifies the creditor recovery period. The statute now expressly states that a creditor has four years from the date of the distribution to bring a legal action. If a shareholder sufficiently knew the facts and circumstances that would indicate the impropriety of the distribution, the creditor may bring action in the name of the corporation for recovery.

Comparison to LLCs

It is noteworthy that these new provisions are similar, but are still not the same as the limits that apply to distributions to owners of other legal entities. For example, for limited liability companies (LLCs), California Corporations Code (Beverly-Killea Limited Liability Company Act) Section 17255 does not require that there be retained earnings as a condition of making distributions. However, the remaining provisions are similar, as to the Total Assets Rule and whether a distribution would cause the LLC to be unable to pay its debts.